BERKSHIRE MONEY MANAGEMENT

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The Art of the Oil Deal

For a long time now I've been predicting a recession sometime around 2020-2022. On October 3rd of this year I posted an article I wrote on BerkshireMM.com titled "Checking My Homework" to challenge my own theory. In it, I wrote:

> "The biggest flaw by economists, in my opinion, is that they try to track the entirety of a $19 trillion economy… the stock market turns down before the economy, but no one tries to improve on the methods to track expectations of the economy and to thus be more in line with where it's going, as opposed to where it's been. My way is a better mousetrap."

That better mousetrap is looking at sub-cycles instead of the whole economy, because not everything turns down at once. You know these sub-cycles; things like labor, monetary policy, profits, housing, commercial real estate, credit, energy, capital spending, autos, and fiscal policy. (Of those, only labor, profits, and capital spending are late in the cycle; only autos are very late. None are yet turning down, though we expect monetary policy to do so in 2019.)

The 26% drop in US benchmark West Texas Intermediate (WTI) oil prices since October 3rd, falling from $76.41 to $56.46, has caught our attention. I wonder if there is something wrong in the energy sub-cycle, rather than the something glorious, as I referred to in last week's column— the savings for consumers act as a de facto stimulus just as we enter the holiday shopping season.

However, remember the title of the article, "Checking My Homework." So much of what we do as investment advisors is playing Devil's Advocate to our own decisions. What is glorious today may be hot garbage tomorrow. Investments aren't meant to be held forever. They are meant to make you money. That's it. They're tools for you to use. We can't afford (with your money or ours) to stick to an investment decision out of homage to the archaic broker's mantra of "invest for the long term" when the information considered when making the investment has changed. When I'm wrong, I change my mind. So, let's try to figure out if I'm wrong on seeing that 26% drop of oil prices as a good thing.

A drop of that magnitude, and in such a short duration, is a red flag that the economy is slowing quickly. Oil volatility in 2017 was not the cause of the financial crisis, but it certainly was a signal that things were off. That being said, volatility can be a false positive. There have been 14 instances since 2000 in which oil prices dropped more than 20% in 20 days. On average, the prices rose 1.9% in the following 20 days. Notable exceptions were the aforementioned financial crisis, and in 2014 when prices dropped 70%, which stalled the economy and corporate profits.

The good news is that it's been a rise in supply, not demand that has dropped prices. The Trump administration had threatened to completely shut down all Iranian oil exports. President Trump said there would be no exceptions on waivers for sanctions on countries dealing with Iran. But that didn't happen. Instead, coincidentally before midterm elections, Trump quasi-secretly allowed Iran to keep exporting more than a million barrels per day while Saudi Arabia sharply increased its output to make up for the missing supply.

I say "quasi-secretly" because the US was rather upfront about saying we wouldn't disclose agreements with Iran's oil buyers because they wanted to avoid complaints from some who were asked to cut more than others. I am not making this stuff up. It was clever, but manipulative, pre-mid-term politics to bring down the cost of oil to voters. Saudi officials have not been silent on it, saying very clearly that they feel used.

This is all rather fortuitous for the US consumer going into the holiday shopping season. But here's the problem – mean reversion. Saudi officials want to get oil back up to $80 per barrel, not an outrageous number but sill about 12% higher than it was. But prices of anything in the capital markets don't tend to move with precision. As the Saudis attempt to normalize oil prices, the market is all but guaranteed to overshoot to the upside as it typically does when prices mean revert. That suggests $90-$100 barrels over the next year, just as the Fed is deep in a tightening cycle. That combination is the textbook description of what causes a recession.

Contrarians as we are, we like to buy when everyone else has sold, and we're getting close. Entering October, only 7% of hedge funds were short oil, but positions have spiked to 20%, which is right below the long-term average of 22%. I expect oil to stabilize short-term and to rise mid-term.

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