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YOUR INVESTMENT PLAYBOOK FOR 2015

As we begin this new year, one thing is already quite apparent: markets everywhere are becoming far more volatile than they have been in quite a while. A number of things seem to be coalescing all at once that will make things a *lot* more treacherous for investors, even as opportunities for greater profits manifest themselves. During the course of this inaugural issue for 2015, I will be describing my "take" on all the major markets...the events that are roiling them even more...and some of the things I think we have to look forward to with equal parts trepidation and profit expectation.

The big story as we begin the year remains the (ongoing?) plunge in the crude oil price since last summer. This multifaceted event will have far-reaching consequences only the beginnings of which are starting to be understood by commentators and experts alike who have been very slow to digest all this. The upheaval in the energy market (which will be spreading) will go down as the "Black Swan" event of 2014 once its effects are more fully understood, *and felt*.

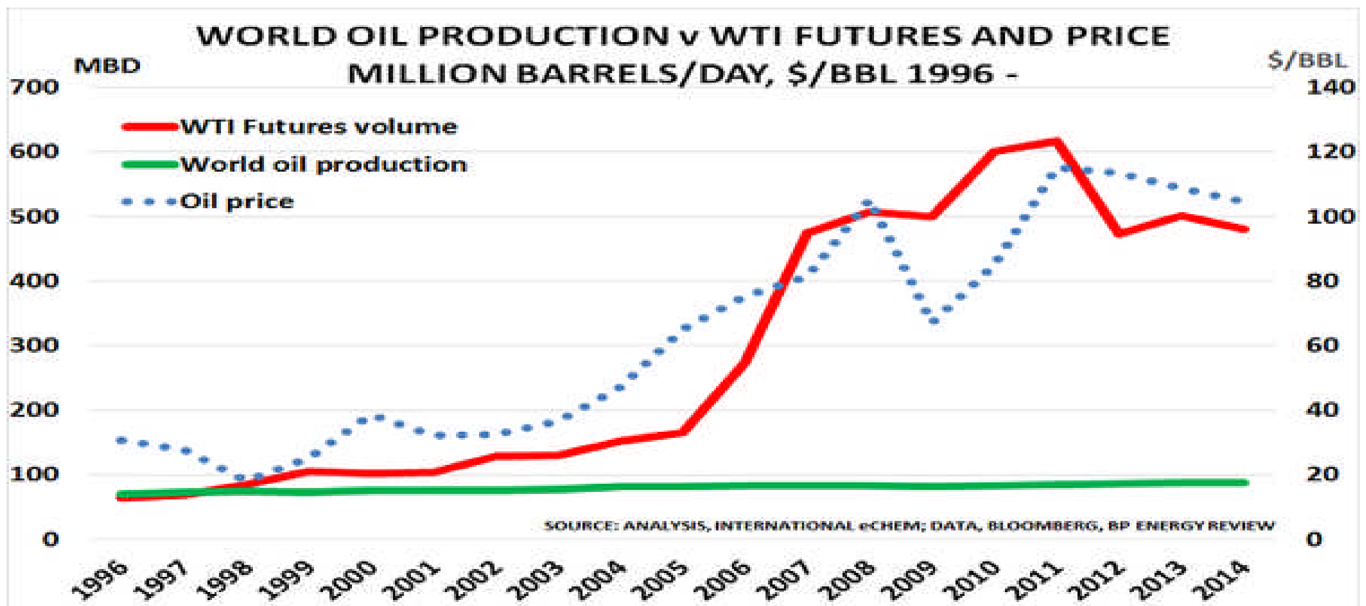
And it is even more than that. Old alliances are being trashed by what indeed truly is in part a "war" over market share. Once upon a time, a nation like Saudi Arabia would not dare to have "crossed" the United States. In one instance when it did--during the embargo of the 1970s--then-President Gerald Ford reminded the Saudis that they would have neither oil riches nor even a nation were not for the protection of America and its financial/military strength. In perhaps his greatest (yet largely forgotten) act as president, Ford simply informed the Saudis that they will continue to sell America oil *or else*.

But--and this is one of the themes that will become even more pronounced in 2015 on top of what we have already seen--the U.S.-centric New World Order of the post-war period is unraveling. The Saudis now feel like they need to look out for Number One. As the above well-traveled

cartoon from *The Economist* helps illustrate, there is now controversy between the U.S. and Saudi Arabia; former(?) energy allies now locked in a deadly competitive duel as -- among other things -- the Saudis are apparently intent on driving the nascent shale boom in the U.S. into an early extinction. Elsewhere--thanks to the fashion in which America, N.A.T.O. and the European Union are waging a similar war against Russia at the moment--we are seeing some old (and potentially new) Western allies link arms with an emerging Russia/China axis when it comes to energy. And closer to home, the developing fallout may even end up pulling key countries in our own hemisphere away from a closer relationship with America.

A few days back, I listened to a very successful hedge fund manager discuss this whole situation. Speaking of both the market implications (which, again, we have really not begun to feel the effects of) and geopolitical ones alike, he simply stated that there is NO WAY that THE biggest, most important *and most traded* commodity on the planet can plunge 60% or so now in several months' time, and there *not be major fallout.*

THE ROOT CAUSE OF THE PROBLEM



The operative phrase above is "most traded." As the above graphic shows, speculators fueled with *abundant* cheap credit and leverage have from time to time given the oil price quite a ride. Usually, they have used periods of a stable or weakening U.S. dollar (in which, of course, oil is generally priced and traded in internationally) to borrow/short dollars and buy crude oil futures contracts. *The trouble is, when one or more events causes the dollar to rise, this process is reversed; often violently, as we saw in 2008 and have seen again since mid-2014.*

I have commented frequently in recent months that there might end up being quite a price to pay for both the unchecked rise in the U.S. dollar and the commensurate plunge in the oil price. As was the case in 2008's even sharper drop (from a high above $140/barrel to a low in the $30's in a matter of mere months) this latest debacle in energy prices is *much* less about basic supply and demand issues and all that than it is *a skewed financial market event*. Even in light of the latest downward

revisions to expected demand put out by the I.E.A., we are likely to see current levels of global production of still around 93 million barrels a day of crude oil *only modestly* run ahead of demand.

Without a doubt, intensifying recession and deflation pressures in much of the world are indeed a growing part of this entire equation. However, such a drastic plunge as we have seen--to the point where individual companies *and entire countries* are in trouble from the drastically reduced income--was first and foremost caused by financial market speculators, enabled by the Federal Reserve, having trashed the price.

SHALE PRODUCTION: FROM "RENAISSANCE" TO A BUST?

As you know, I have long wondered aloud about the long-term viability of America's so-called "Energy Renaissance" to the extent that it and the accompanying return of domestic U.S. oil production to levels not seen in a few decades has been based almost exclusively on *higher-cost* oil (and natural gas) recoveries from underground shale formations. **And I have not been alone in expressing the view that neither the economics nor the geology of many of the "fracking" plays at the core of this alleged renaissance are sustainable long-term.**

In an article last February 27 entitled, "Dream of U.S. Oil Independence Slams Against Shale Costs" *before* everything started coming unglued, *Bloomberg Business Week* had the courage to buck the Pollyanna-ish and conventional "wisdom." In pointing out the very nature of the average fracked well (as opposed to traditional wells that tapped into static oil and gas pools/formations) they reminded us that, "Shale output drops faster than production from conventional methods. It will take 2500 new wells a year just to sustain output of 1 million barrels a day in North Dakota's Bakken Shale, according to the Paris-based International Energy Agency. *Iraq could do the same with 60.*" (*Emphasis added.)*

One result of the "economics" of shale production

Memorably, at a Houston energy market symposium just after that article appeared, Chevron's C.E.O. John Watson famously remarked that, "$100 is the new $20" for crude oil's price. Among other things, he also appropriately explained that fracking to recover both oil and natural gas in underground shale formations was both more capital-intensive and, in the end, more expensive than a traditional well. And as *Business Week* pointed out, this is partly because it takes a whole lot more drilling to maintain production levels. Above you can see an aerial view from an area in Wyoming; drill pads everywhere, but most of them now not even being used. In a recent trip to the Northeast to visit friends and family, an old friend of mine was marveling aloud at how a lot of the bucolic, rolling farm landscape we both knew in northern Pennsylvania now "looks like the back of a porcupine" from drill rigs seemingly *everywhere*.

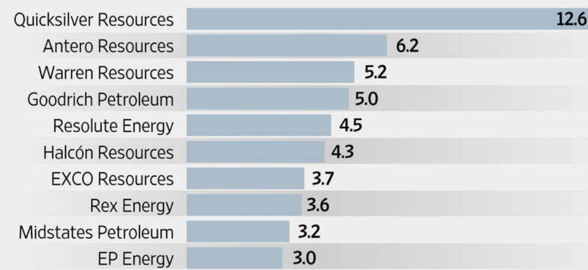
It would be worrisome enough for the fracking industry particularly--now having been blindsided by the destruction that carry traders have done to the market price of oil--to figure out how to survive now with prices in many cases well below *cash* production costs (forget about many of these being profitable on a GAAP accounting basis!) **What makes the situation dangerous for *everybody*--and for the broader economy and markets--is that the energy industry has got into its present predicament in the first place, in part, thanks to Wall Street force-feeding it *mountains* of cheap credit.**

You would think that, with oil having been in the $90's and $100's per barrel most of the time until recently following the recovery from the 2008-2009 lows, the energy industry would be in Fat City. *Especially, wouldn't you think, for such a powerful industry being said to be in an epic "boom," and disproportionately responsible for the big gains in good jobs in recent years?* But to a great extent this is not the case. All this "success" in the energy industry has come about as the overall indebtedness of the industry has soared; mostly, in the cases of the hottest "fracking" plays that Wall Street just couldn't pump money into fast enough. Indeed, it's been reported that, cumulatively, some $600 billion of debt has been taken on by this industry (less a handful of the "majors") since 2010.

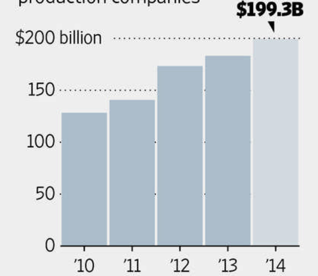
Oil Check

U.S. oil companies boomed on borrowed money. Corporate debt loads ballooned in recent years.

Ratio of net debt to EBITDA from last 12 months



Debt for U.S. oil exploration and production companies



Note: Publicly traded U.S. corporations with at least $100 million in revenue over the last 12 months that are primarily focused on oil and gas production.
Source: S&P Capital IQ

Note: Figures exclude Chevron and Exxon Mobil; 2014 is up to the third quarter
The Wall Street Journal

Previously, a notorious example of a bubble that looked like a boom until the music stopped was the mortgage and real estate markets. The Federal Reserve and the so-called shadow banking systems alike force-fed massive amounts of new, cheap credit into all manner of mortgages and such. Employment boomed as a housing market on steroids went nuts.

I recently had my son record me in a "mini seminar" of sorts entitled "What Led to the 2008 Financial Crisis?" In it, I explain for you the *specific steps* that Wall Street primarily took in blowing the mortgage bubble; effectively creating unnatural demand for mortgages—especially sub-prime mortgages—that never legitimately existed in the first place. You can watch the presentation at my You Tube channel, at https://www.youtube.com/channel/UCdGx9NPLTogMj4_4Ye_HLLA/videos

At the conclusion of this seminar, I explained that we would soon be considering the possibility that the same type of activity that has force-fed gobs of credit *into the energy industry* would potentially lead us to the NEXT blow up. At the time, precious few others were talking about this. Now everybody is.

Without a recovery in the oil price almost as spectacular as has been its decline, it seems quite apparent that--*at best*--America's shale boom will be rudely interrupted. There is little disagreement about that. *But what remains to be seen is the fallout elsewhere*. A sobering explanation of some of the risks we still face in areas like the bond market (a subject I have also been beating my gums about a LOT

in the recent past; among other things, refer back to my explanation of how the junk bond market works these days in the issue dated July 21, 2014) came recently from Wilbur Ross. The well-known and long-tenured investor and money manager has forgotten more than most people know about things like distressed debt and energy. And the picture he painted in a recent *CNBC* interview was part-instructive...and part made even *my* flesh crawl a bit.

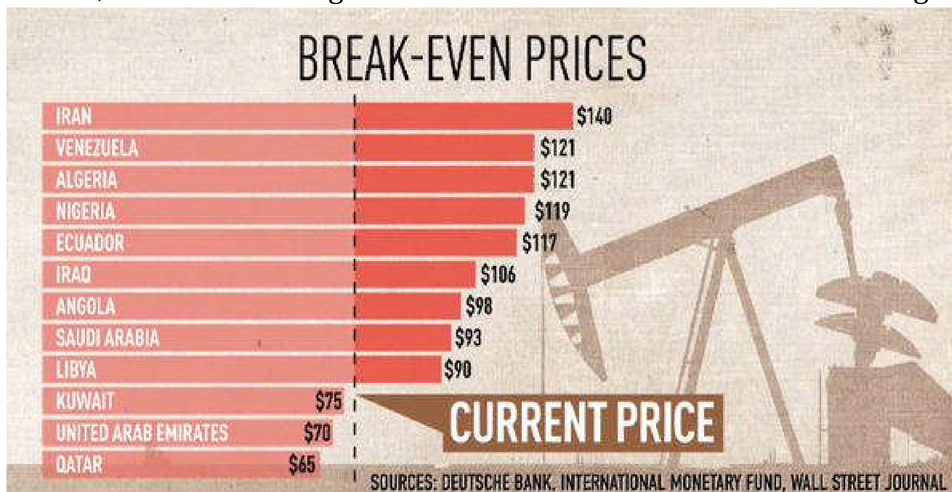
It must be remembered that most of the investment firms that once served as market makers for high-yield corporate debt no longer exist. Accordingly--as I wrote back last July (and have on other occasions) and as Ross pointed out--if a pension fund, hedge fund or someone else gets a case of the jitters and wants to sell its debt in a troubled, leveraged shale producer, *there may not be anyone to sell it to!* Firms (often the original underwriter) which, in past days, would be a buyer of last resort aren't there. The result could be--and according to some reports *already has been* in a few cases-- that if you want *or need* to sell such a bond, there may be NO BID PRICE WHATSOEVER for it. From anyone.

This, as Ross simply explained, is where the "contagion" effect really comes in. If you need to raise money and now *can't* get what you need (if anything at all) from your tanking energy bond, you of course *have to sell something else*. And this could spread. And if some recent signs of growing *illiquidity* in some markets grow, it will. Top that all off with growing fears of bank failures (many publicly-traded banks in Texas have seen a quarter or so of their share prices evaporate recently) and the contagion effect *that* could also have as the oil patch moves deeper into an acute "bust" phase once more.

All of this remains--despite the other subjects I'll be talking about--the one existential threat to the markets with the highest probability of causing major upheavals in 2015.

WHAT MIGHT BRING ABOUT A BOTTOM?

What will mark at least the beginning of the end of this present oil price shock and its corollary effects is a reversal of the two main causes of it. First and foremost, something, or some combination of factors, will have to bring an end to both the U.S. dollar's months-long surge and expectations that it will continue. *And it may not be just the Federal Reserve that finally has to cry "Uncle."* To our south, countries like Venezuela and Mexico are unraveling anew. Other emerging nations are becoming destabilized and unable to continue providing basic services. Most do not have the luxury of the vast foreign-exchange holdings that are allowing Saudi Arabia to undercut the market.



We do not *yet* appear to be at the point where anyone is going to intervene. The Saudis, the United Arab Emirates and others of O.P.E.C.'s stronger members have made fairly plain that they want market share back and are willing and able to ride out *even lower prices*. For its part, the Federal Reserve did seem to show via its Beige Book report this past week that it is more concerned about the damage the

crude oil collapse, et al are doing than it had been letting on (for my thoughts on all that and more go to http://nationalinvestor.com/576/swiss-national-bank-move-feds-beige-book-suggest-even-dramamine-will-needed-markets/, where I discuss the possibility that the Fed may be at least bringing a two-way market back to oil.)

Apart from this, the second factor of importance here is that the markets need to somehow come to the belief that the physical supply/demand equation will come back into balance. In the near-term, that is going to have to come from cuts to supply; *and that's a problem*. Countries like Libya and Iraq are pumping *more* oil. Iran could be; something the Saudis seem keen on stopping. Russia is reportedly ramping up production, selling oil (and gas) as fast as it can to emerging Asia, etc.

A retrenching of North America's own energy production is quite likely to play out over the coming months. As I write this, the reports of layoffs (paced by a whopping 9,000 pink slips from industry giant Schlumberger alone), abandoned projects, capital spending reductions and more are accumulating. **Most gut wrenching of all will be as companies in their year-end reports for 2014 are forced due to lower prices to recalculate their economic reserves.** Unquestionably, at recent prices, big parts of what *had been* deemed "money in the ground" reserves will be shown to have vaporized. Re-calculations will vindicate those critics (Yours truly among them) who have warned that the markets were being bamboozled all along *by many companies showing reserves unrealistic even at higher prices*. In fact, in one fell swoop by the time new year-end reserves have been calculated, we may well be finding out that much of the story of America's energy renaissance has been a mirage all along. Or that it is, at least, at anything South of $80 a barrel, give or take a little, for oil.

This picture of a much lower likely reserve and production profile for America (and Canada to some extent, though it will be buffered some for as long as the weakness in the loonie persists) will exacerbate the *financial* issues low prices have brought about. With a much lower asset base, many a company will be unable to borrow further. Some will have existing loans and credit lines eliminated or even called in, as they will be in violation of loan covenants requiring certain levels of net assets, production, revenue and so forth. As my old friend Keith Schaefer of the Oil and Gas Investments Bulletin -- http://oilandgas-investments.com/ -- recently wrote, these coming reserve reports "...could be The Next Big Shoe To Drop in the North American energy sector."

So like I said above...though I am also salivating over the current share price of many a good company... and even if we *have* seen about the final low for the oil price...things stand a better than even chance of getting worse before they get better.

Investors who 1. want to believe that this storm is over in the energy patch and 2. as both investors and citizens *hope* that it is, are praying that we have as rapid a turnaround as we have in the past. Recently, *CNBC*'s Bob Pisani reported that there have been five times since 1980 that the price of crude oil has dropped by 50% or more. *In each case up to now, oil has rebounded an average of 52% within six months.* For the health and greater stability of entire countries, we hope the same is true this time around as well.

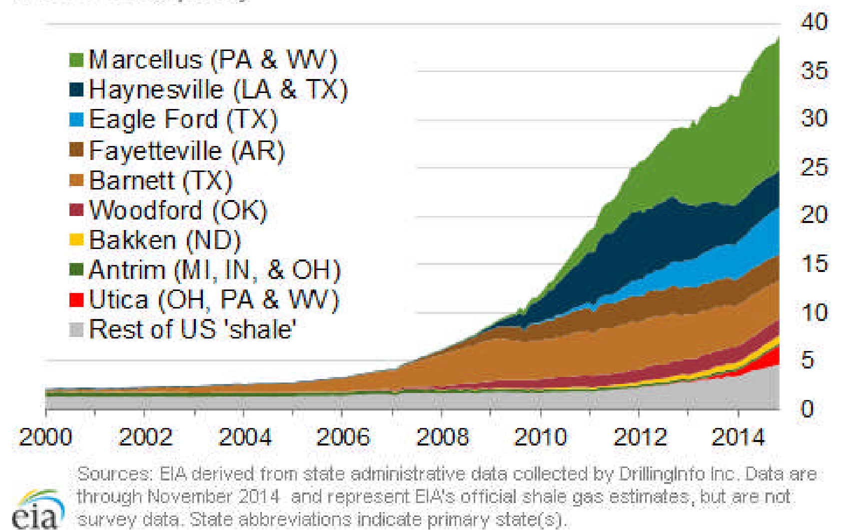
But this time may be different. Even Q.E. efforts seemingly coming from Europe soon in some halting manner...even if the Fed tries to bring down the dollar, eventually by getting more forcefully back into the "Inflate or Die" camp...that all may not be enough. It's increasingly obvious that all those efforts to date have had less and less traction where legitimate economic activity is concerned. All these banks are

doing is keeping more acute *deflationary* environments a bit more at bay than they would be otherwise. All of this added money printing won't help much; at least until it gets so extreme that--as I'll describe further along--commodities in many ways *have* to go up.

I will continue to scrutinize both trading opportunities as well as some *individual* good stories of those companies I think will weather this storm the best, and come out the other side in even better shape.

SOME OTHER THOUGHTS

-- Though this subject has not received remotely the press that the crude oil situation has, it won't be long before it is more widely understood that **natural gas is in far more oversupply relative to the market than is oil.**



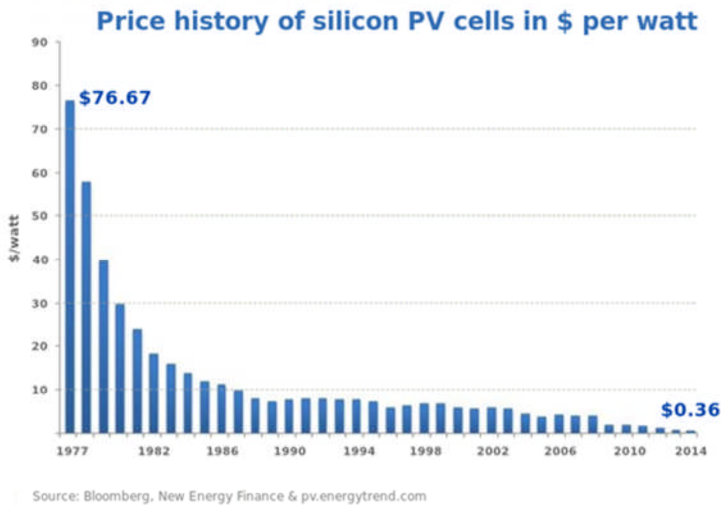
Here again, gas producers have been force-fed *way* more cheap credit and have thus produced more gas than America really needs. Everything I've discussed above when it comes to looming defaults and the rest will likely be seen here as well, especially as a much milder winter this year seems to be exacerbating a long-term oversupply issue.

Wall Street, the shadow banks and others have been hoping that one way they will get bailed out is if this large excess of available(?) gas can be exported*. But mere days after I warned of this in both The National Investor as well as on the Korelin Economics Report, just before Christmas, we heard the news that Asian energy giant Petronas had delayed movement on a $36 billion LNG (liquefied natural gas) export project in British Columbia.* Other big North American projects are rumored to be at risk also; and this whole debate about such a "surplus" of North American energy available for export may look even sillier still once updated reserve reports from the industry show that it's simply all not there to begin with (at least at economically recoverable prices.)

And in any event where gas is concerned, I have pointed out that the recent slew of deals between Russia and countries like China, Turkey—and soon, possibly Japan, which would be a real killer and embarrassment to the U.S.—have **helped to bring down the world-high Asian benchmark prices for natural gas.** If the differential between the cheap North American prices and Asia become compressed in the wake of cut-rate Russian exports to Asia, the *vast* differential needed to justify the monstrous costs to export Canadian and U.S. gas to that region disappear, *and these projects become uneconomic*.

This could be happening at the same time that natural gas production is taking a new upturn, despite the warmer early winter weather now. Having previously shifted from gas to oil production back when natural gas bottomed around $2.00/mcf, shale and other producers are now

looking at going back the other way as oil is in the dumpster. If prospects for exporting gas are diminishing, a glut will ensue; and we could very well be looking at, of all things, another move down to the $2.00/mcf area, which will compound the financial woes of some North American producers (already, as I mentioned a couple issues back, there is such a glut in the northeastern U.S. due to the breakneck pace of Marcellus Shale production that cash gas prices there now are around $1.00/mcf!!)



-- **Solar and some other renewable energies** have run into a wall; at least, in investors' eyes. Right or wrong, it's pretty typical that when oil crashes, *everything* to do with energy does so. Paraphrasing one pundit recently who was decrying this, "At $50 or less oil, the best place for sun and wind is at the beach!"

Historically, I have not paid as much attention to the renewable energy plays—solar, wind and the like—as some have. None the less, I am increasingly persuaded that investors have been overreacting in selling off some of these types of companies. *One example is in the solar energy space*. Among other things, it must be kept in mind that a number of developing nations where solar energy is increasingly becoming a mainstay really don't have much in the way of the traditional oil/gas infrastructure to begin with. Some of them for various reasons are simply moving straight into solar (and nuclear) and bypassing oil-based and coal-based energy, the attendant infrastructure, etc. This has been encouraged by economics as well as environmental/geopolitical concerns: the cost of solar power is not as prohibitive as it once was.

Generally speaking, and as I will continue to articulate in the issues ahead, I think that there is still a bright future for solar, wind and other energy. And I intend to use this present time to more aggressively "bone up" on these industries and the opportunities in them.

-- As you already know, I have become more bullish longer-term on **uranium and nuclear energy**. Here too, we have seen a sizable 2014 rally in the uranium price reversed due to the *overall* energy and economic funk. Producers and explorers alike have seen their share prices wilt; insult added to injury for an industry that has already been in the dumps since the Fukushima disaster in Japan of, now, nearly four years ago.

Yet everywhere you look these days, there are signs of an industry sowing the seeds of a major reversal of fortunes. In one of his many energy-related deals of recent months, Russian President Vladimir Putin just inked a multi-year deal with India's new Prime Minister Narendra Modi which will include the building of numerous new nuclear

power plants, among other things. Russia--which reportedly these days builds the very best state-of-the-art reactors for utilities--has also agreed to build them for other countries, including Turkey and Iran.

China is getting into the act in a bigger way as well. More than most people in the markets realize, that country understands that it needs an even bigger nuclear/renewable component in its own energy mix to--among other things--help mitigate the country's terrible pollution problem.

In the *very* near future I will have a lot more detailed information for you on this subject; an industry which at the present time represents to me the most bullish long-term story in the energy space. For the moment, I expect that the ongoing downward drag for energy *generally* will act to keep the uranium/nuclear sector in check as well. In the end, though, I'm excited about the prospects. The fact that the two most populous countries on the planet will be *aggressively* building their nuclear generation industries sure doesn't hurt!

The above excerpt is taken from the expanded, first regular issue of January, 2015 of *The National Investor.*

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