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Investment Advisors

CM Advisors
Family of Funds



# CM Outlook for Oil - January 2016

- U.S. oil production is on the decline.
- Global demand for oil is increasing.
- Lower oil prices are helping to bring the supply and demand back to equilibrium. We believe this will occur within 6 to 9 months.
- We believe oil could trade near $70 per barrel, roughly double its current price, by year's end.
- While we expect to see continued volatility in the prices of many energy stocks during the first half of 2016, we believe we will see much higher stock prices for many oil companies in the second half of the year.

## SUPPLY

Lower oil prices have curtailed investment for current as well as future production. In the U.S., oil production peaked in April 2015 at 9.6 million barrels per day and has been declining ever since with production now running at approximately 9 million barrels per day. With hedges against falling oil prices expiring, the lack of available financing for new projects, declining cash flows from existing projects, along with the current lower price of oil, we believe U.S. oil production declines will continue to accelerate.

Outside the U.S., production declines have been offset by OPEC producing "all out", leaving OPEC with virtually zero spare capacity (i.e. roughly 1 million barrels per day spare capacity as opposed to the 16 million barrels per day back in 1983). At the same time, because of lower oil prices, as well as the high cost of their various social programs, OPEC member countries are suffering significant budgetary deficits that are highly likely to impact their future production. For example, in 2015 Iraq informed its energy-related service providers to prepare for dramatically lower capital spending and investment in 2016. This should result in a reduction of its production capacity. Already, Iraq has reduced its rig count by roughly 50% this past year. In addition, Iraq has been producing all out, has likely seen the peak of its production capacity, and is facing a growing budgetary deficit.

***Lower oil prices will reduce the oil supply around the world, while at the same time there is virtually no spare capacity.***

## DEMAND

On the demand side, both the International Energy Agency (IEA) and the Energy Information Administration (EIA) estimate world demand using a formula based on gross domestic product. In their methodologies, the price of oil plays no part in their demand estimates. A review of their demand estimate revisions shows they have consistently underestimated oil demand going back to 2011 and by increasing amounts as oil has declined in price. The EIA, for example, has retroactively revised world oil demand higher between 1.0 to 1.5 million barrels per day, for each of the last 5 years, with the degree of underestimated demand increasing as the price of crude decreased.



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We believe not using the price of oil in their forecasts is a big variable in the inaccuracy of the reports. For example, lower oil prices have led to cheaper gasoline prices, which in turn have led to higher sales of less fuel efficient trucks and SUV's versus passenger cars, which in turn have increased the demand for oil/gasoline. According to the EIA, during the first 9 months of 2015, the actual weekly change in gasoline demand was up 3.64%. Additionally, lower oil prices have impacted driving habits. According to the U.S. Department of Transportation, in 2015 the vehicle miles driven were up 3.7%. These same trends are occurring all over the world.

***Regardless of the headlines, the global demand for oil continues to rise.***

## INVENTORY

The rapid growth of U.S shale production over the last four years and the recent step-up in OPEC production led to global oil production outpacing global oil demand, resulting in above normal inventory levels by the end of 2015. The oversupply environment is in the process of reversing as low prices are bringing down production while demand remains healthy. In 2016, we see oil production declining below demand levels.

With that said, during the first quarter of 2016, while U.S. oil production is declining from April 2015 peak levels, we still expect to see oil inventory building as supply should remain slightly above demand. However, as world oil production continues its decline and demand for oil continues to rise, inventories should begin to decline in the second quarter of 2016 and continue to decline into 2017. **By year's end and into 2017, we expect the world will face an undersupply of oil and tighter inventory with little to no spare capacity. This in turn should drive oil prices higher. Our best estimate is that the price of oil ends the year close to $70. With a 90% correlation between the oil service index and the price of oil, we believe, under this scenario, energy stocks will outperform many sectors of the market in 2016 and even more so in 2017.**

Thank you for your continued trust and confidence.

| Arnold Van Den Berg,<br>Founder, Portfolio Manager | Scott Van Den Berg, CFP®<br>President, Portfolio Manager | Jim Brilliant, CFA®<br>Chief Investment Officer<br>Portfolio Manager |
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***See Disclosures on next page***



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