THE BEAR TRAPS REPORT
INVESTMENT RESEARCH PUBLICATION
In Cooperation with ACG ANALYTICS

08/18/2017

Capitulation Climax in Energy

Buy 1/3 XLE Energy Select Sector SPDR Fund

(full 3/3 position now)

Buy 1/3 XOP S&P Oil & Gas Exploration & Production

(2/3 position now)

Over the last 12-months, the "lower for longer" view of oil prices has been broadly accepted. One by one, nearly every sell-side financial institution has thrown in the towel. The 2010-14 "good old days" mantra, "the global economy (BRICs) can support $100 a barrel oil indefinitely" is history.

In the August Monthly Oil Report, the IEA doubled down on their outlook. They believe **U.S. production growth will pick up steam in 2018** to more than 1mmbd, up from 0.6mmbd this year. WTI has traded between $42-54 and averaged $48/b, yet U.S. oil production has increased by more than 710mbd. Bears make the case that U.S. production can grow by near 1mbd per year indefinitely at $45-50/b. We disagree with the IEA assessment and explain our thesis below.

"The rebalancing of the oil market desired by the leading producers has been a stubborn process and it takes time for the numbers to confirm what many observers instinctively feel has already happened. Sure enough, new data suggests that in 2Q17 global stocks fell by 0.5 mb/d and preliminary data for July, particularly in the United States where stocks fell by 790 kb/d, is supportive. Even so, we must not forget that they are falling from a very great height in volume terms. At the end of 2Q17, OECD commercial stocks, which are the component of the global total for which we have the most visibility, stood at 3 021 million barrels, still more than 219 mb above the five-year average although they have now fallen below 2016 levels. As an exercise, if OECD stocks fell by 0.5 mb/d until the end of 1Q18 when the current output agreements expire they would still be about 60 mb above the five-year average."

International Energy Agency

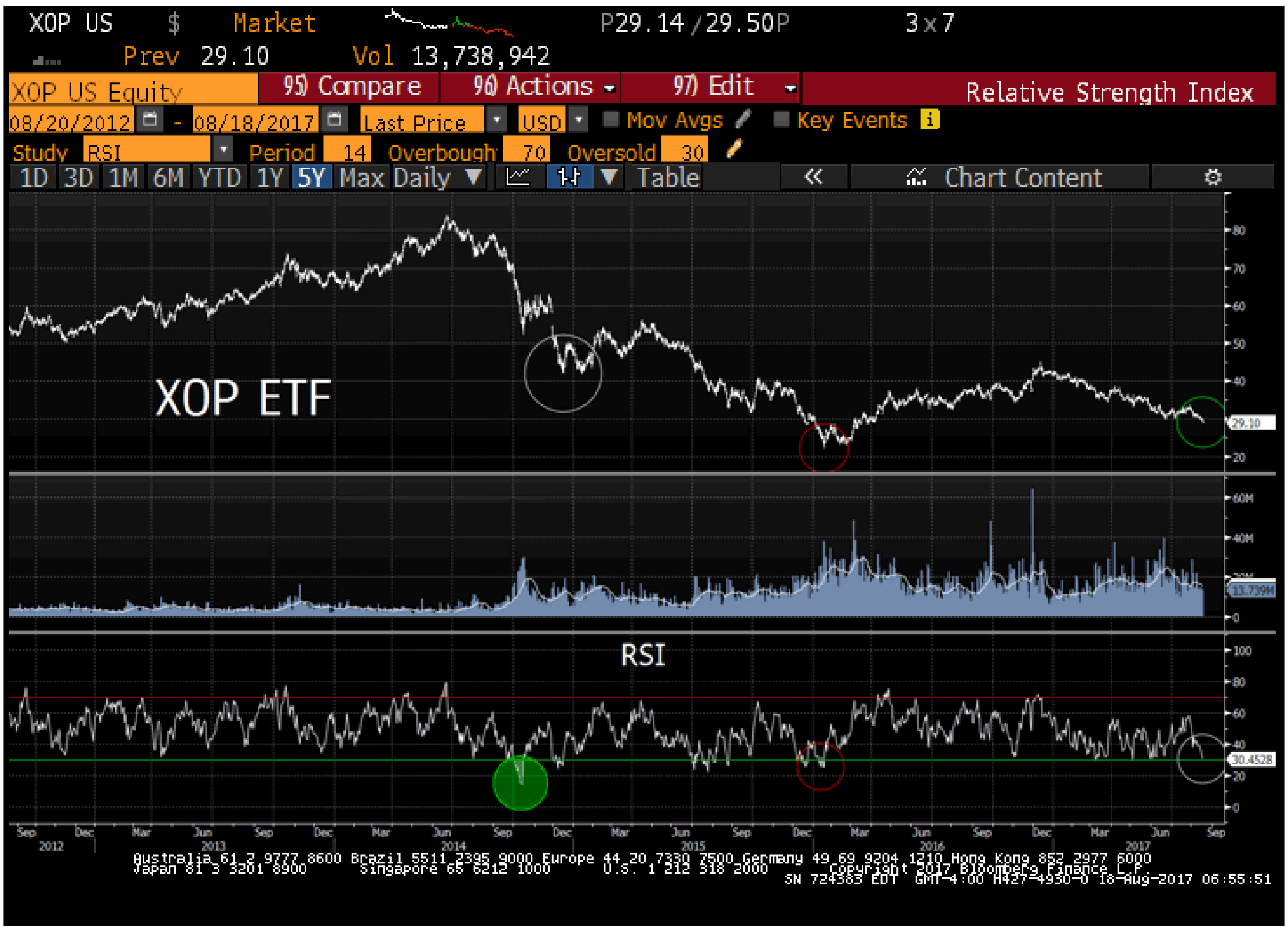
High Capitulation in Energy

We're seeing several capitulation climax signals in energy. Relative strength (RSI above) has rarely been weaker. In recent days, sellers have out-numbered buyers four to one. In our seven-factor model, we're receiving a strong capitulation buy on equities in the energy patch.

Capital Markets Exhaustion

We see the IEA forecast as far too rosy in terms of production coming onboard over the next twelve months. If you take out the 190mbd of TTM growth that has come from the U.S. Gulf of Mexico, we don't see near-term start-up projects adding to the supply glut this year. Over the last year, as oil prices recovered - capital expenditures and the rig count surged to the upside. We believe oil sectorcapex was $100B over that time period. It's clear to us, the onshore rig count has rolled over this quarter. After licking their wounds, E&P companies have started to reduce capex. Over the next three months, this will be price supportive - winner is the XLE in our view.

E&P Pain

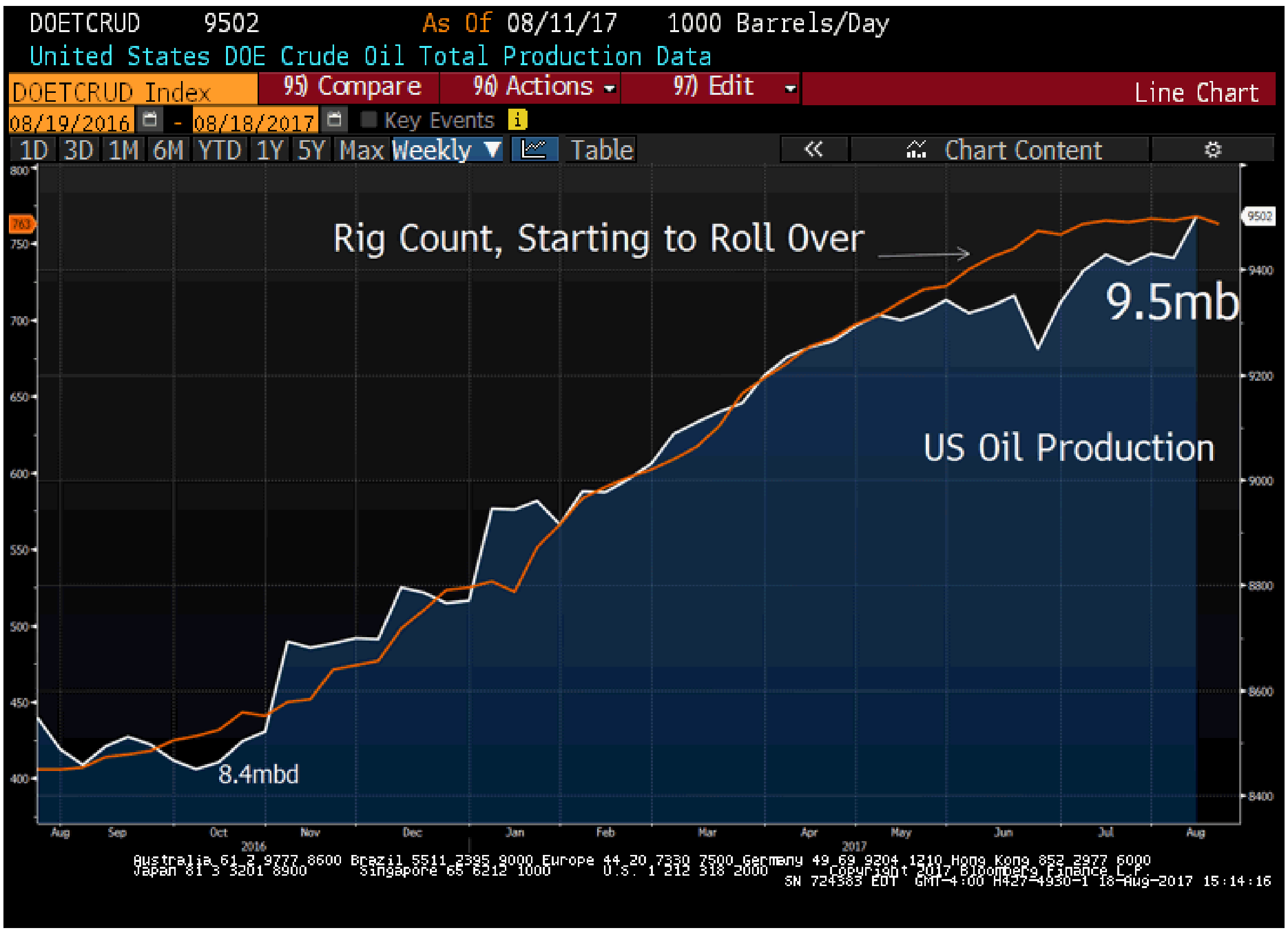


Similar to the Energy Select Sector SPDR Fund XLE, the Exploration & Production (XOP) space is under substantial selling pressure. Sellers are jumping over the seats - swinging on the chandeliers, trying to get out through the bathroom window. Let us help them out of their shares and step in and buy fear. This is the most significant capitulation since the Jan - Feb 2016 lows - we expect significant sector rotation into this space in Q3 and Q4.

Credit Saturation Point

In terms of capex, nearly 80% of the growth **has been externally financed** (thank you, Janet Yellen). Our theory all along has been the Fed's easy money gravy train has kept a lid on oil prices. If you look at the record level of capital markets activity (bond and equity issuance) in 2H16, **without it** U.S. onshore production growth would be closer to 150mmbd. **In 2017, the oil patch has reached a saturation point in terms of credit availability - this is a core belief we hold.** This will start to put pressure on U.S. supply in the second half of 2017 - oil sector equities will be supported. Likewise, we believe as the Fed tightens monetary policy (pulls back accommodation / initiates balance sheet reduction) - the oil patch will likely be a near term winner. Less easy cash = less near term supply expectations.

Rig Count Rollover



In March of 2016, the Fed rolled over. Four promised rate hikes that year became 1 and triggered one of the largest explosions of capital markets activity- easy money - for the oil patch took hold. The net result, the Rig Count (see above) surged and U.S. supply kept oil prices in check. The new $100 a barrel became $50.

Looking into next year, for U.S. production to grow 1mbd per the IEA forecast, the industry would need to spend $140B, in our view. With oil near $50, this translates into a nearly 80% outspend dynamic - not happening in our view. If you look at 2017's capital markets activity, we've only seen $7.5B in E&P secondary raises - a far cry from 2016. In our view, there's no way on God's green earth energy investors will be able to swallow another $70B+ of easy cash for the oil patch. **The IEA production growth assumption is dependant on WIDE OPEN capital markets - we don't see it.**

Tale of the Tape

- Oil Sector burned through $110B over the last year - a capital expenditure orgy.
- Over $65B needed to maintain production at the July 2016 level of 7mmbd.
- Over $45B is needed to grow production.
- Nearly 80% of the growth has been externally financed.
- Record level of capital markets activity in 2016 kept the production dream alive.

Nasdaq 100 Crushing Energy

Over the last five years, the Nasdaq 100 QQQ is up 106% while the oil service sector OIH is off nearly 20%. We believe there is a high probability of a sector rotation in the second half of 2017. This beating above is HIGHLY unsustainable.

Winners and Losers

Incredible divergence in 2017. The once loved energy sector has been relegated to the dustbin.

Up from the 2016 Lows

OIH +6.2%
XLE +24.1%
XOP +31.9%

The oil service sector carries more leverage, this has suffered the most - only 6% above the 2016 lows. We'll be out with a more detailed energy note soon.

Best Regards,

The Bear Traps Report Team

Larry McDonald is the New York Times bestselling author of "A Colossal Failure of Common Sense," CNBC contributor and Political Risk Expert. He is the Editor of The Bear Traps Report, a weekly independent investment letter focusing on global political and systemic risk with actionable trade ideas. Former Head of U.S. Macro Strategy at Societe Generale and former vice president of distress debt and convertible securities at Lehman Brothers. He is one of the most well-respected risk managers on Wall Street.

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