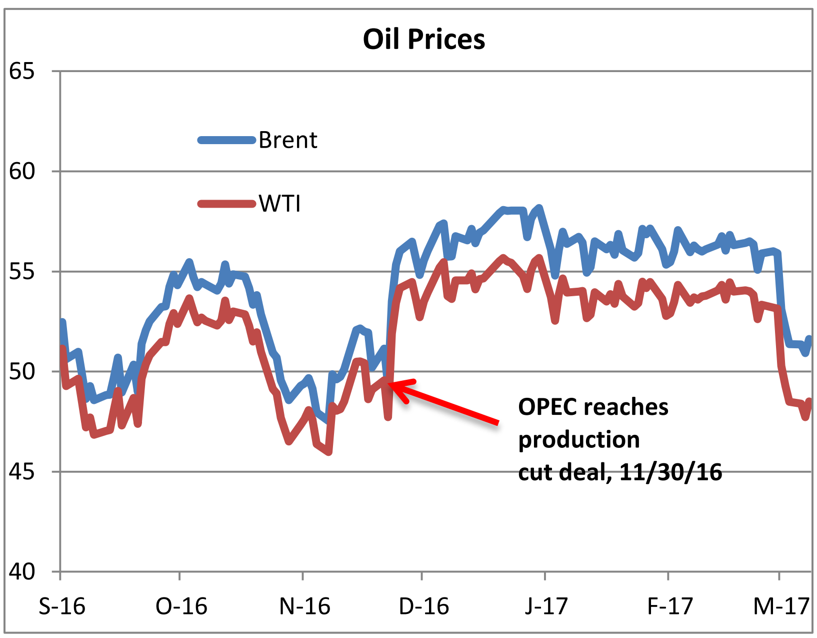
Taking Advantage of Oil's (Not-So) Surprising Downtrade

As inflation traders we are particularly sensitive to the energy markets. Oil price swings are the 800lb gorilla when it comes to near term inflation swings. As such, our outlook on the oil market colors our view on inflation overall, as well as how we position ourselves along the inflation curve. We'll get a little more into that in the latter part of this piece. But first, what is happening in the oil markets?

After trading in about a $3 range since early December, oil rolled over last week, with WTI trading back below $50 for the first time since OPEC reached a production cap agreement at the end of November. This had many analysts and traders scratching their heads, particularly given OPEC's historically high compliance with their agreement and growing optimism for global growth prospects. Indeed, in the bigger picture we see increasing global oil demand and the potential for further OPEC production cut agreements, along with reductions in longer-term capital investment in oil exploration and infrastructure investments as eventually bringing oil inventories into balance. But in the meantime, bullish oil bets got ahead of themselves, underestimating the ongoing rebound in the U.S. shale industry in particular.



Source: Bloomberg

For some background as to why we believe the current trade was largely predictable, [have a look at this piece that our strategist Com Crocker wrote for Forbes] the day after OPEC reached its agreement back in November. Since then, the shale industry has reacted much as expected, but we'd be lying if we told you we expected that OPEC would comply with their own agreement to such a high degree.

According to an S&P Global Platts survey[i] OPEC achieved 98.5% compliance with their agreed cuts in February. The cartel's reported output of 32.1mm bbl/day is down 1.7mm bbl/day YTD and actually 400k bbl/day BELOW the agreed cap. But the agreement excludes Libya, Nigeria, and Iran, all of who are bringing

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production back online following disruptions from war or sanctions. And it doesn't count Indonesia's 700+k bbl/day as they are no longer in the cartel. The 98.5% number is also misleading as six of the ten OPEC nations bound by the agreement are actually well below that number, with Venezuela and Iraq having reduced their production by a mere half of their agreed cuts. The total is pulled higher by Saudi Arabia, which produces less than a third of OPEC's total but was responsible for over half the production cut. Not surprisingly, Saudi Oil Minister Khalid Al-Falih expressed some frustration at the CERAWeek Oil Conference in Houston last week over what he perceives as an unfair burden:

> '"It is not going to be fair or acceptable that some countries will carry the burden for all," he said, referring to how Saudi Arabia is cutting more than it promised. "We've been willing to do it for the front end but we expect our friends and partners to pick up the slack as we move forward." [ii]

But, just as talk has picked up in recent weeks that OPEC may need to extend their cap agreement when they meet again in May, or possibly even reduce production further, senior Saudi oil officials met with U.S. oil executives during conference in Houston and, according to Reuters, told them they, "should not assume OPEC would extend output curbs to offset rising production from U.S. shale fields."[iii]

Speaking of U.S. shale production, from that Forbes article back on December 1st, the day after the OPEC deal:

> "While the number of rigs drilling new wells fell by 80%, actual U.S. oil production only fell by 11%. More critically going forward, the U.S. rig count is already up 50% from its low this past May, and production has started to follow suit. Given ongoing efficiency gains combined with this week's rally in oil prices, these trends are only going to gain momentum, and quickly."[iv]

Indeed they have, as the following charts demonstrate quite clearly. The rig count is now up over 90% off its lows, but still has plenty of room to grow, while U.S. production has erased more than 50% of its peak-to-trough decline ***- since October alone***.

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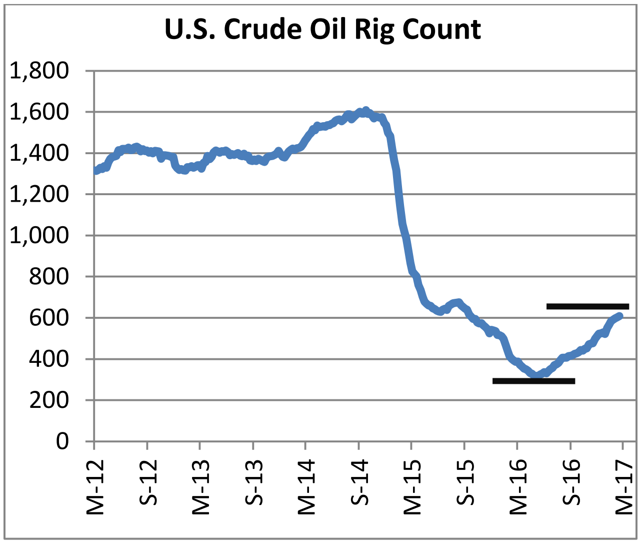
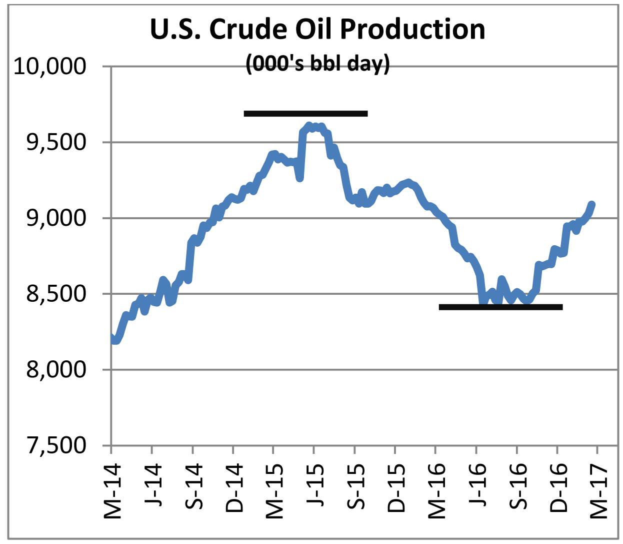
Commentary from New Century Advisors
March 2017

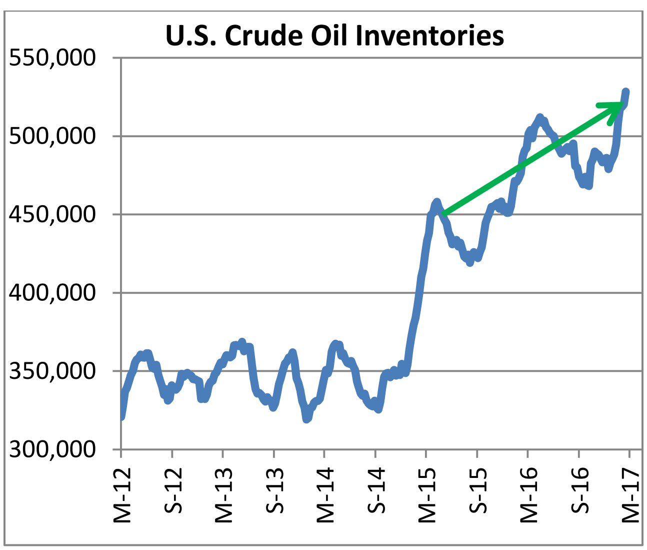


Source: Baker Hughes



Source: U.S. Department of Energy

The U.S. Energy Information Administration announced last Tuesday that it had raised its forecast for average U.S. crude production this year to 9.2mm bbl/day, up by 200k bbl/day over last month's prediction.[v] Oil stockpiles grew by 8.2mm bbl last week, the ninth weekly gain in a row, taking inventories to a new record high.[vi] The 'Glut' isn't just persisting – in the U.S. it's growing.



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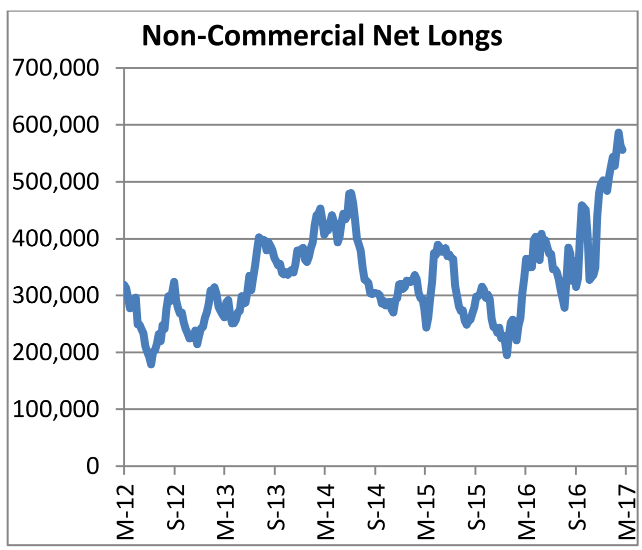

Source: U.S. Commodities Futures Trading Commission

Given this backdrop, it's surprising that speculative traders have positioned themselves at such bullish extremes, as per the CFTC's Non-Commercial Net Longs, shown above. What is perhaps less surprising is that those positions have come under pressure.

What's the Trade in Inflation?

The question is how do we position ourselves to take advantage of potentially weaker energy prices or increased oil volatility? The oversimplified answer might be to sell TIPS, but this ignores a number of fundamentally supportive factors underlying the inflation markets, namely the improving global economic backdrop, the already tight labor market, and the potential for some of the Trump Administration's proposed policies, if passed, to act as a further catalyst to already rising price pressures. In short, without delving further into the bullish inflation case, we want to remain fully invested.

Rather, concern about oil risk leads us to consider either hedging the energy exposure or selling / underweighting positions in shorter-maturity TIPS, namely the 0-2 year sector, as these are the issues whose overall returns are typically more directly tied to oil. For July17 TIPS, which are only exposed to a few more months of inflation, a couple of months of bad carry are a big deal. For Feb47s, the new 30yr TIPS that Treasury issued last month, the impact could be negligible.

More broadly, shorter-dated TIPS, which typically trade cheap to inflation expectations, have enjoyed an excellent run ever since oil - and commodities in general - bottomed in early 2016, and in particular since the U.S. election on November 8th and the OPEC production cut agreement on November 30th. We now view these issues as close to fair value which thus increases their exposure to what could be higher downside energy volatility if the "OPEC floor" fails.

Technicals are also a concern as TIPS ETFs have seen material inflows, leading their AUM to grow by 50% in the past year. The front end has been particularly well supported recently given the strong recovery in CPI and Trump Administration related risks (e.g., BAT). Through the first 11 months of 2016, flows into 0-5yr and 1-5yr TIPS ETFS made up less than 12% of total TIPS ETF inflows. Since December, front end TIPS funds have seen their share of TIPS ETF inflows triple to over 36% of the total.[vii] TIPS dealers are also overweight the front end, having set a record long position in February.[viii] Some of the increased front end demand has likely been driven by concern about the possibility of rising interest rates. But moving in on the curve to reduce duration risk increases energy risk. Up until last week that has been a good trade.

In short, while we don't see TIPS as rich here, we do believe some portfolio adjustments may be warranted, particularly at the front end where the margin of safety against energy volatility or position squaring could weigh on the asset class.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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[i] S&P Global Platts: "OPEC Guide: OPEC achieves 98.5% of agreed cuts in January & February: Platts survey," Herman Wang, Eklavya Gupte, March 6, 2017 http://www.platts.com/news-feature/2017/oil/opec-guide/index

[ii] Bloomberg News: "Saudi Arabia, Russia Offer United Front on Oil Supply Cuts," Javier Blas, Grant Smith, and Margot Habiby, March 7, 2017 https://www.bloomberg.com/news/articles/2017-03-07/saudi-energy-minister-says-yet-to-decide-on-extending-cuts

[iii] Reuters: "Exclusive – Saudis tell U.S. oil: OPEC won't extend cuts to offset shale – source," Ron Bousso, March 9, 2017 http://www.reuters.com/article/us-ceraweek-saudi-shale-idUSKBN16G2TJ

[iv] Forbes: "OPEC's Dead Cat Bounce," Com Crocker, December 1, 2016, https://www.forbes.com/sites/comcrocker/2016/12/01/opecs-dead-cat-bounce/#6a5085333ed5

[v] U.S. Energy Information Administration: Short Term Energy Oulook, March 2017 https://www.eia.gov/outlooks/steo/pdf/steo_full.pdf

[vi] U.S. Department of Energy: Weekly Petroleum Status Report, March 8, 2017 https://www.eia.gov/petroleum/supply/weekly/

[vii] Based on New Century Advisor's own analysis of ETF AUM and shares outstanding data as available on Bloomberg.

[viii] TIPS dealers held $10.3bn in TIPS positions <6yrs in the week ended February 15, 2017, according to the Federal Reserve Bank of New York https://www.newyorkfed.org/markets/primarydealers