January 9, 2015

OIL GLUT

Dear Investor:

On August 31, 2014, a barrel of oil cost an average of $100.05 on world markets. Today, as I'm working on this letter, the price is under $50.00 a barrel. That's a drop of over 50% in just four months, which is huge. Prices haven't been this low since early 2009. This will likely have a significant effect on world economies and investor's portfolios in the months ahead.

I thought it would be interesting to present some basic information on world oil markets to give us a better picture of what's going on.

TOTAL WORLD OIL SUPPLY 2013[1]
(Crude Oil and liquid byproducts)

North America	19,324,500
Central & South America	7,925,300
Europe	3,792,800
Eurasia	13,556,600
Middle East	27,179,900
Africa	9,353,100
Asia & Oceania	9,003,900
TOTAL	90,136,100 Barrels Per Day (bpd)

[1] EIA.gov

World production is over 90 million bpd. 2014 estimates are around 92 million bpd. In North America, the US produces over 12,300,000 bpd and is currently number one in the world. Saudi Arabia is number two with over 11,600,000 bpd from the Middle East. Russia is in the Eurasia group. They produce over 10,500,000 bpd, and are third in the world. Saudi Arabia and others greatly expanded their power by forming the OPEC cartel in September 1960. This group of countries produce approximately 40% of the world's oil. The purpose of their cartel is to "co-ordinate and unify petroleum policies among Member Countries."[2] That's a generous definition of their purpose, as many people think their goal is simply to keep prices as high as possible.

OPEC - Organization of Petroleum Exporting Countries
Total Production 2013[1]

Algeria - A	1,762,700
Angola - A	1,889,400
Ecuador - CSA	527,000
Iran - ME	3,192,400
Iraq - ME	3,057,700

Kuwait - ME	2,811,800
Libya – A	983,600
Nigeria - A	2,371,500
Qatar - ME	2,067,300
Saudi Arabia - ME	11,600,400
United Arab Emirates - ME	3,229,600
Venezuela - CSA	2,489,200
TOTAL	35,982,700 Barrels Per Day

A – Africa, CSE – Central & South America, ME – Middle East [1] EIA.gov [2] OPEC.org

We can see that Saudi Arabia is clearly the dominant force in OPEC. They have generally been the "swing producer" who has adjusted their output from time to time to keep things somewhat steady in OPEC and world markets. However, we all know from watching the news, there have been big changes in US production due to fracking. The following will give us an idea of how much things have changed in recent years:

TOTAL WORLD OIL SUPPLY[1]
(In Barrels Per Day)

	2009	2013	Change
North America	15,449,700	19,324,500	25.1%
Canada	3,318,800	4,073,900	22.8%
Mexico	3,000,800	2,907,800	-3.1%
United States	9,130,100	12,342,800	35.2%
Central & South America	7,525,400	7,925,300	5.3%
Europe	4,983,400	3,792,800	-23.9%
Eurasia	12,908,900	13,556,600	5.0%
Middle East	24,830,700	27,179,900	9.5%
Africa	10,461,300	9,353,100	-10.6%
Asia & Oceania	8,791,800	9,003,900	2.4%
WORLD	84,951,200	90,136,100	6.1%

[1] EIA.gov, Keim Asset Management, LLC

We can easily see that the lion's share of growth in world production has come from the United States. Canada has also been experiencing significant growth in the last ten years. These trends continued in 2014, but the final numbers are not yet available. The OPEC cartel still dwarfs the individual production of any nation with approximately 36 million bpd, 40% of supply as previously mentioned. This gives them the ability to have a very big impact on the oil market.

Generally speaking, the price of goods in the world is set by supply and demand. We know that the supply of oil has increased significantly, with most coming from North America. Outside of the US, many of the world's economies are slow, thus we have lower demand. This has led to falling prices and the current oil glut. Some estimates have put the excess supply at 2 million barrels/day. As things stand right now, OPEC has stated they will not trim their production, even if prices continue to drop. We know Russia is producing more than ever. They will not cut back and can't afford to. As the number two exporter in the world, they rely heavily on oil revenue to survive. The ruble has taken a huge hit this year as their revenue is declining rapidly. They will likely be in a recession next year. The US is also continuing production at a high level. Thus we are essentially in a price war, as all the major players are willing to sell the same amount of oil for less money to try and protect their market share.

This has led to several things. The most obvious one is US consumers are enjoying much lower gas prices. This is like a tax cut and is known to stimulate the economy as a lot of the money gets spent. The benefit is progressive and will provide relief for the middle class, who have not done as well in the recovery thus far. This is expected to help stocks in consumer goods and various retail sectors.

Investors have taken a hit on their energy positions in the last several months. The declines have ranged from about -10% to as much as -60% on offshore drillers. The earnings of energy companies will be affected in different degrees by the decline in prices. We have to be patient and as long as we own the high quality companies, I don't expect a problem. Some of the smaller and highly leveraged companies may be in for a very difficult time. Some could go under or be bought out.

The price decline should lower the cost of production in many other industries. We would expect that to have a positive effect on profits and possibly stock prices. Decreasing costs are deflationary, and may also help to keep inflation low. Low inflation makes life easier for all of us, and should help the Fed to adjust interest rates at a gradual pace.

The oil market will correct itself over time. At some point production will be trimmed by the various players or overseas economies will recover and pick up demand. The long term outlook for the energy industry remains strong. In the meantime, I would enjoy the low gas prices. Please feel free to contact me anytime to discuss your portfolio.

Best regards,

David E. Keim

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