# Energy & Resources Insider

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## Heading into 2017, Energy is a Show-Me Story

*Market Update*

As we all know by now, OPEC's recently announced production cuts were a boon to the energy sector, helping to keep prices mostly about the $50 per barrel mark, and buoying oil companies. U.S. shale producers have rushed to capitalize on the positive near-term developments for world oil markets by hedging production for the next two years.

OPEC's actions removed more than 1 million barrels per day from an oversupplied system. Even after factoring in the inevitable U.S. shale response to higher crude prices, OPEC's cuts point to what many experts see as a meaningful supply deficit next year. As a result, it looks like WTI prices will likely be in the $60 range for the full year 2017. That price level and the newly-efficient U.S. shale producers could prove problematic beyond 2017 though. Just as natural gas has struggled for years to move meaningfully higher due to the strong output of U.S. frackers, oil may face the same issues on prices of about $50 per barrel.

Improved near-term fundamentals in the oil markets are going to come at a cost to investors. As near-term oil prices recover, this will encourage U.S. shale producers to further ramp up activity so that they eventually replace almost all OPEC barrels which were removed. In other words, increased shale activity means that oil prices are not going to remain elevated for long – thus investors need to position themselves for the reality of over the medium term.

Fundamentally, technology has altered the oil markets permanently by unlocking vast new sources of supply. The industry has a sea of relatively low-cost oil available, and OPEC does not have the enforcement mechanisms available to stem production for long. Temporary OPEC cuts cannot alter this reality. Our long-term oil prices of about $50 per barrel are not sustainable in the medium term.

The analog to this situation is the natural gas markets. Low prices led to temporarily reduced U.S. natural gas production growth

in the near term, but despite a long downturn, prices have never truly recovered to the levels they were at prior to 2010. The sea of low-cost inventory in areas like the Marcellus and Utica is consistent with continued natural gas growth through the end of this decade and beyond. Oil is in a similar boat. Long-term investors in the space can only be successful by identifying those drillers that can thrive in a volatile market with prices averaging in the $45-$55 per barrel range.

Improved productivity and resource potential from the Marcellus and Utica will still let some gas players make money, but the long-term marginal cost for U.S. natural gas is likely to be roughly $3 per thousand cubic feet. In summary, there is ample evidence that U.S. shale producers can survive, and a few will thrive at much lower prices than investors would have previously thought possible.

We have three specific picks for this month that we think present interesting opportunities for investors. More on those in a moment though. First, we want to talk briefly about an asset class that is moving out of favor, and how investors can capitalize on it.

*Bonds Becoming Interesting:*

In the energy bonds space, there may be some opportunities created by short term thinking on the part of the markets. Interest rates on the long end have risen substantially as investors anticipate faster economic growth and higher inflation. All of this has led investors to shift out of bonds and into equities at a rapid pace. This creates some interesting options for investors in the energy space.

Energy bonds these days are often short term debt with only a few years until maturity and relatively high interest rates. The debt for many energy companies is often sub-investment grade as well. Energy investors are making a mistake by giving up on such debt too easily.

While it is true that a rapid rise in interest rates would hurt the value of all existing bonds, energy bonds are probably better insulated than most other bonds. For one thing, by issuing short term debt the bonds have limited exposure to duration risk (i.e. interest rate risk).

More importantly, interest rates are not going to stay elevated unless the economy picks up steam, and if the economy picks up steam then oil prices will rise as well. Oil prices have been low as much because of lackluster demand as because of excess supply, and a stronger economy will help cure that demand shortage. And if oil prices pick up, then that will boost the financial stability of all but the weakest of energy companies which in turn should help lift bond prices.

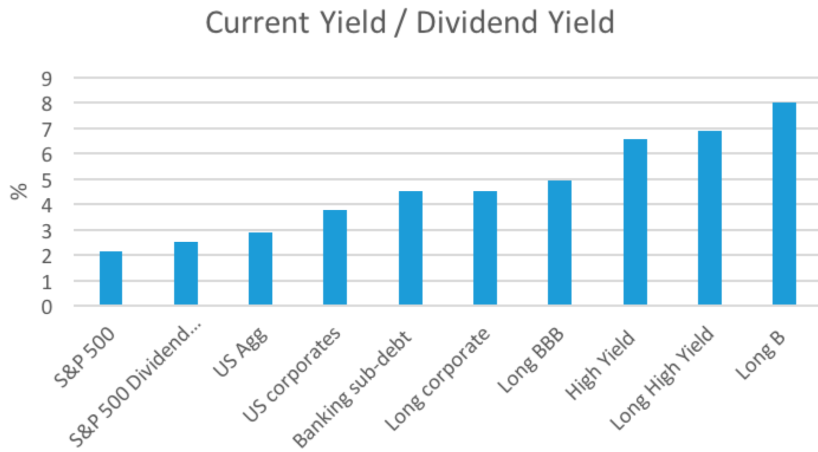
The conclusion one might draw then is that investors in energy debt are in a no-lose situation. If the economy stays weak, any rise in interest rates or inflation will be temporary and limited. As a result, while bonds might lose a bit of value in the short term, in the medium term they should bounce back nicely.

Some investors may be concerned about inflation, but that's mostly a red herring. Inflation is directly correlated to economic growth at low levels – that is weak growth is correlated with weak inflation and strong growth is correlated with strong inflation. This breaks down at higher levels of inflation – such as what Venezuela or Iran has seen lately – but that's not a situation that's relevant to the U.S. or the developed world.

If the economy really does start growing faster under Trump, then energy companies will be direct beneficiaries. The industry is one of the few with excess capacity, and many oil companies would fare dramatically better over the next few years if the broader economy were growing at 3 percent instead of 1.5 percent.

To capitalize on opportunities in this space, investors should consider some of the bond ETFs that are available. Aggregated bond ETFs can offer investors attractive yields based on the level of risk one is willing to take. The data from

Barclays below illustrates this.



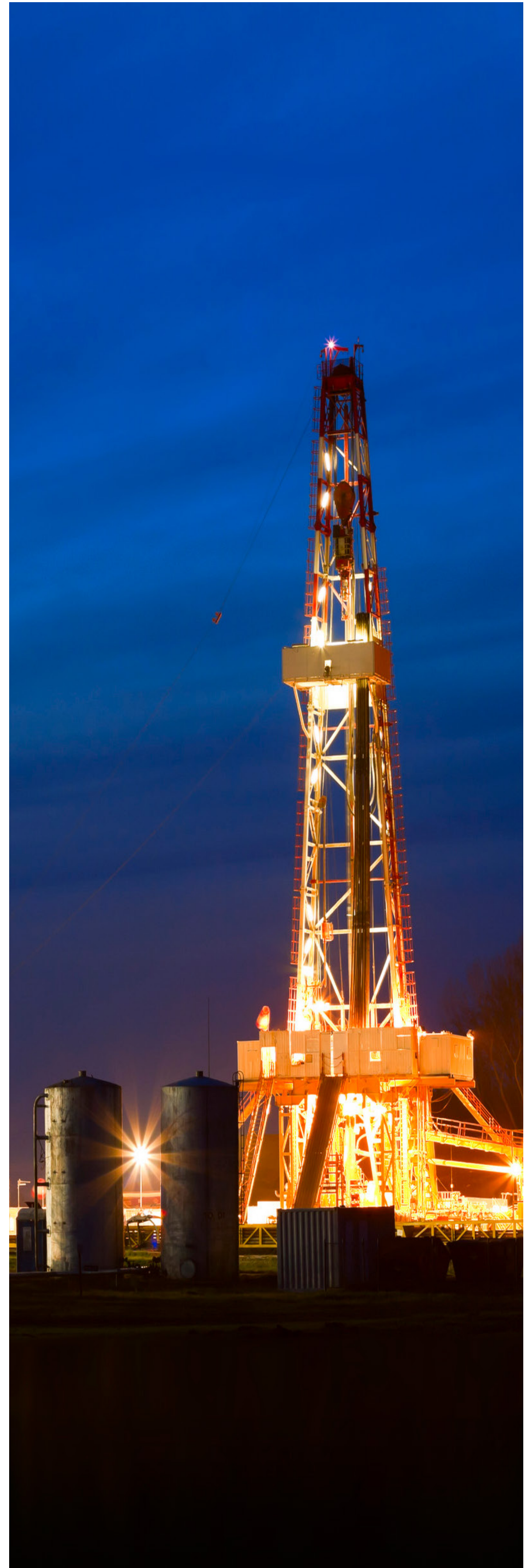

For those who are confident of an improving economy and rising rates, one interesting opportunity in the fixed income space at this point is in floating rate notes. Floating rate notes for the energy sector are not all that common, but there are a few. Floating rate senior bank loans in the energy sector for instance can be accessed indirectly through various bank loan ETFs like those from Powershares and Blackrock.

These floating rate energy sector bank loans will get a double boost from a successful Trump Presidency. Higher interest rates will lead to higher levels of income and a stronger economy will make energy companies able to afford higher levels of interest.

The converse of course is that if the economy fails to strengthen as expected, floating rate notes will lose value due to interest rates falling back, and energy companies will be left with a weak demand environment. For now, floating rate notes look very compelling though as their rates are often based on LIBOR which has been rising consistently in recent months.

**Pick #1: SHORT Direxion Bearish 3X Russia ETF (Short: RUSS)**

Russia is not a popular country with many in the U.S. these days, but it could be a great investing opportunity. Put simply, the Russian market is cheap. The market has a 5.1 Cyclically Adjusted P/E ratio (CAPE) and an 8.1 P/E ratio. The average Russian equity trades at an average of 0.9x book value. The average dividend yield on Russian stocks is 4.1%. In other words, things cannot get much worse for Russian equities as a whole. Yet Russia could have a lot of upside.



Russia of course is highly leveraged to the energy markets and as a result, any increase in oil prices, even a temporary one should be a boon to the many Russian energy giants and more importantly to the country's economy as a whole.

In addition, Donald Trump's administration appears poised to be much friendlier to Russia as a whole. President Trump is likely to lift some Russian sanctions and look for opportunities to work with Putin. All of this could help bolster Russia's economy.

Individual Russian equities still face considerable idiosyncratic risks thanks to the Russian political system as well as the vagaries of the original second world economy. As a result, it's probably too risky to own almost any individual Russian stock. But the Russian market as a whole is much more compelling.

For investors looking for a long position, the VanEck and iShares Russian ETFs are good options (RSX and ERUS). Both are reasonably inexpensive – annual fees are 0.57% and 0.63%. ERUS offers a great dividend – 4.70%, and both have a reasonably well diversified underlying set of holdings.

There is an even better way to make a bullish bet on Russia though. It requires that investors be slightly more sophisticated, but it's a great option for those comfortable shorting stocks for long periods. The Direxion Daily Russia Bear 3X Shares ETF (RUSS) is a leveraged ETF that makes use of liquid futures to create a levered short position on Russian securities.

RUSS CHART:

By and large, leveraged ETFs are flawed products. They are expensive. They rarely work as advertised including exhibiting high tracking errors. And they have persistent adverse medium-term returns. Shorting RUSS is equivalent to a bullish bet on Russia and it has the structural advantage of being based on a product class which consistently loses money for investors that go long the product. RUSS has fallen considerably over the last year, but there is still more downside to come. Eventually RUSS will probably go almost to zero after which time Direxion will delist the ETF and then start over with a new product to repeat the process. It's a cycle we have already seen in various leveraged oil ETFs. Shorting RUSS is an excellent opportunity for investors.

**Pick #2: VanEck Vectors Oil Services ETF (OIH)**

The year 2017 should be a good year for oil. It's likely that shale producers will wait until after data confirm that OPEC is cutting production and prices are going to hold firm before they start making major new investments. That means rig counts will likely be slow to rise until sometime later in Q1.

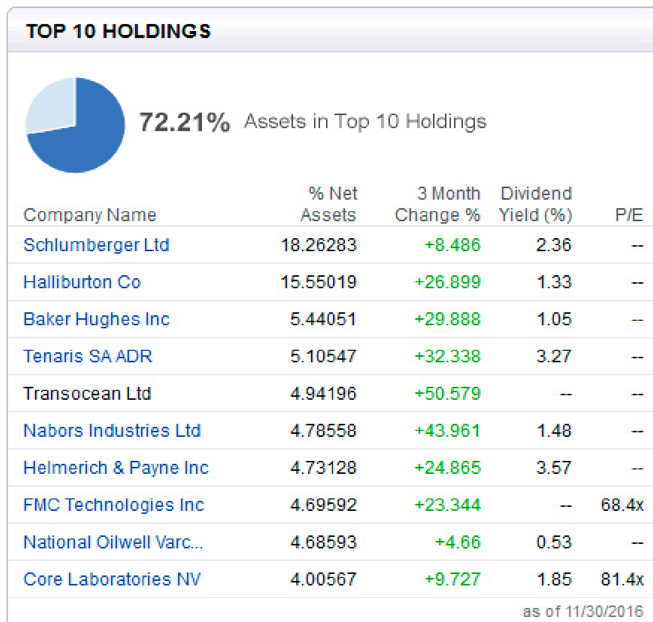
U.S. production growth will lag any increase in rig activity by six to nine months. But once the industry begins moving in that direction, shale production should start to grow briskly. As a result, softer industry trends are going to remerge overtime if OPEC unwinds its production cuts in six months or a year based on new US shale production.

Given current 2017 supply/demand fundamentals, the United States should see 500 rigs in service by the end of 1H2017 which will help to bolster service firms across the sector. The horizontal tight oil rig count has room to increase 30% from the roughly 380 rigs currently in use over the next six months.

All of this volatility in the markets creates a significant opportunity for a resurgent business in the oil services sector. The sector will likely see consolidation as smaller less-efficient servicers get bought out by larger more efficient players. Over time though the servicing market is likely to thrive in the new

oil regime. Shale fracking requires much more frequent drilling of wells than traditional oil production does, and the revival of U.S. unconventional production should lead to a similar revival in the fortunes of servicers.

The best way to play the macro-theme of an improving oil services market is through an ETF on the market. Our favorite is the VanEck oil services ETF trading under ticker symbol OIH. The ETF has good exposure to the largest and most efficient players in the services space, so it should disproportionately benefit from greater economic efficiency over time.


TOP 10 HOLDINGS

72.21% Assets in Top 10 Holdings

| Company Name | % Net Assets | 3 Month Change % | Dividend Yield (%) | P/E |
|---|---|---|---|---|
| Schlumberger Ltd | 18.26283 | +8.486 | 2.36 | -- |
| Halliburton Co | 15.55019 | +26.899 | 1.33 | -- |
| Baker Hughes Inc | 5.44051 | +29.888 | 1.05 | -- |
| Tenaris SA ADR | 5.10547 | +32.338 | 3.27 | -- |
| Transocean Ltd | 4.94196 | +50.579 | -- | -- |
| Nabors Industries Ltd | 4.78558 | +43.961 | 1.48 | -- |
| Helmerich & Payne Inc | 4.73128 | +24.865 | 3.57 | -- |
| FMC Technologies Inc | 4.69592 | +23.344 | -- | 68.4x |
| National Oilwell Varc... | 4.68593 | +4.66 | 0.53 | -- |
| Core Laboratories NV | 4.00567 | +9.727 | 1.85 | 81.4x |

as of 11/30/2016

The other factor playing in OIH's favor is the election of President Trump which should lead to looser regulation over far-flung difficult to drill areas. The incremental barrel of oil being produced is increasingly coming from areas (deep water, oil shale, the Arctic) that demand more services expertise and technology. This fact will become even truer under the Trump administration. That reality supports healthy long-term industry trends and pricing. On the whole, we like OIH as a way to play on the macro trends of an improving U.S. oil market.

**Pick #3: Magellan Petroleum (MPET)**

Our third pick is a complex short-term investment based on a pair of recent corporate actions. Magellan Petroleum, trading under ticker MPET, is a tiny energy infrastructure player. The firm has a market cap of just $67M. However, earlier this year, MPET announced that it would merge with a private company called Tellurian Investments which is an LNG developer.

The Tellurian/MPET merger is complex and hard to value precisely, but it will clearly be a boon for MPET. Under the terms of the deal, MPET says it will issue ~122M shares of common stock to Tellurian shareholder, and each existing share of Tellurian will be converted into the right to receive 1.3 shares of MPET. In other words, Tellurian's assets will now be accessible through MPET. Tellurian is a very well run firm with significant pedigree among its executive team; it is led by Charif Souki, former founder, chairman and CEO of Cheniere Energy and Martin Houston, former COO of BG Group.

By itself, the MPET/Tellurian deal would be an interesting investment, but then another recent move made the investment even more compelling. A couple of weeks ago, just before Christmas, oil major Total SA announced that it was buying 23% of Tellurian for $207M. Simple math suggests that the combined MPET/Tellurian company is worth $900M based on the Total SA investment then.

MPET has been spiking since that deal. The stock is not as good an investment as it was a week ago, but it should still have some upside. The complexity of this deal combined with the holiday period when it was announced have delayed full appreciation for the transaction. Back of the envelope calculations suggest that MPET is probably worth around $14 per share at this point. Investors with a short term time horizon should look at the stock, but be prepared to exit in the next couple of months once the merger gets closed to completion. Those investors willing to take more risk might also consider holding MPET for the next year on the distinct possibility of a full buyout by Total once the merger with Tellurian is complete.