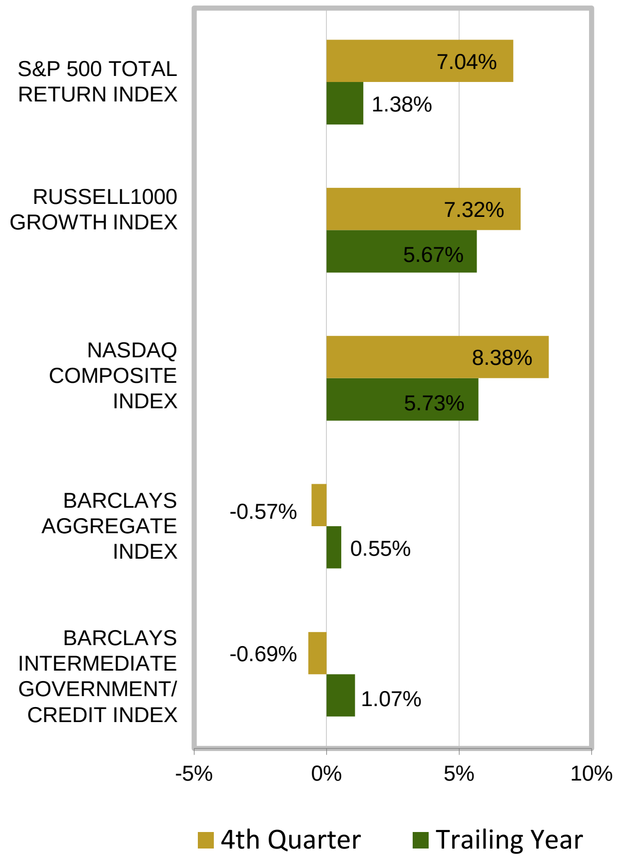
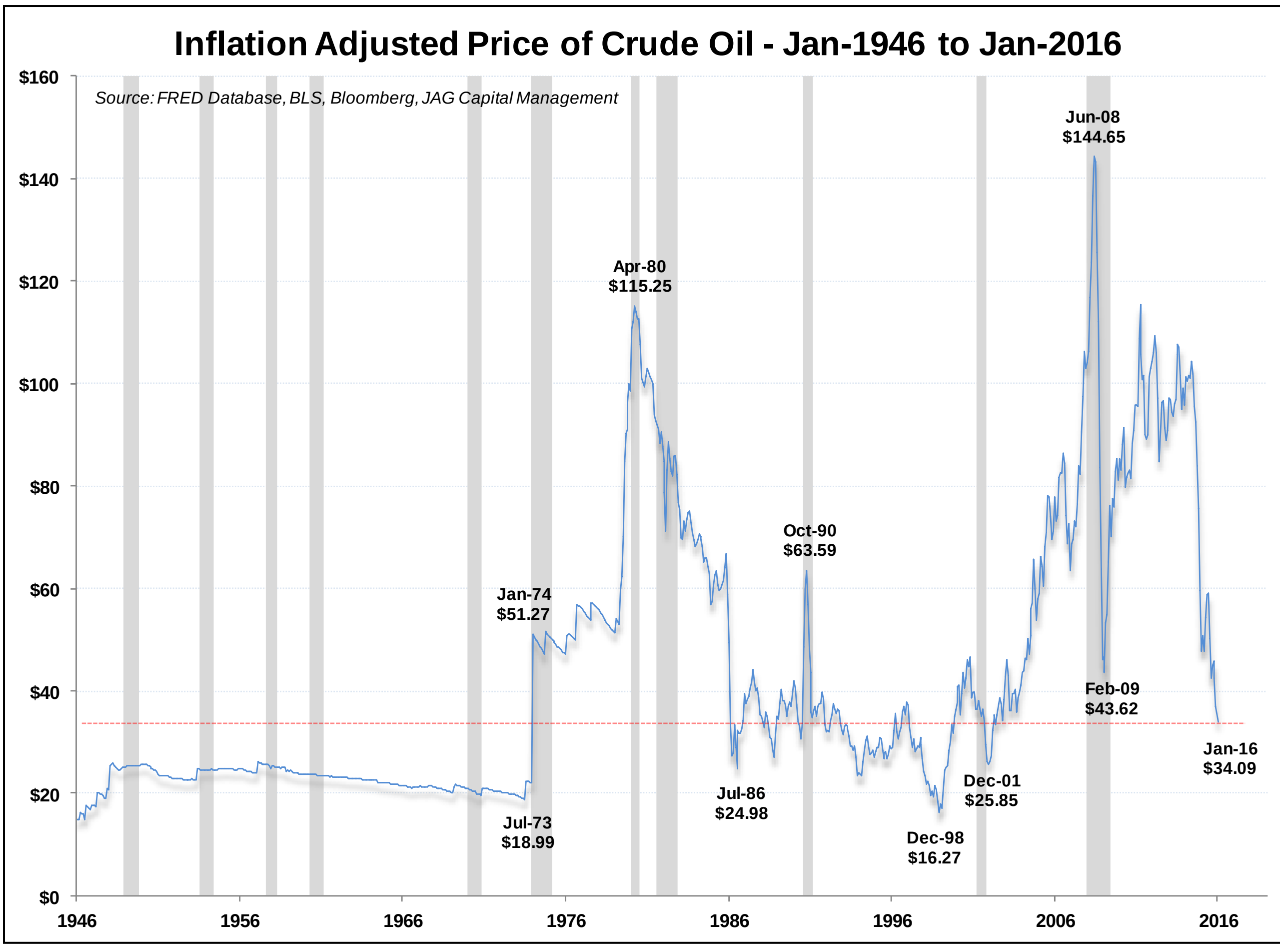


4th Quarter 2015: Wishes Do Come True (…but read the fine print)

Since we last discussed the decline in oil prices in our Quarterly Comments last spring (1st Quarter 2015: Unexpected Abundance), the oil uber-bear market has worsened. In the process, it has become even more central to financial markets and has likely contributed substantially to recent equity and bond market volatility. Before we share our thoughts on the long-term implications of this situation, let's first take a trip down memory lane.

From 1950 through the early 1970's, oil prices traded in a narrow range between $20 and $25/barrel (adjusted for inflation). But after American oil production peaked in 1970, the U.S. became increasingly dependent upon oil sourced from the Middle East and other OPEC member nations to support our domestic needs for energy. Our first unpleasant taste of foreign oil dependence came in the 1970's when OPEC imposed an embargo on the U.S. in retaliation for our government's decision to assist Israel during the 1973 Arab-Israeli War. Oil prices almost tripled, which resulted in long gas lines across the country and contributed to the 1973-1974 recession. The Iran-Iraq War caused another series of supply disruptions, ultimately driving a near-doubling in oil prices, which (again) helped push the U.S. economy into two early '80's recessions. Iraq's invasion of Kuwait in 1990 spiked oil prices and helped kick off another (you guessed it!) recession. There is a pattern here that we think is instructive. Dependence upon oil drilled in a dangerous area of the world can be very risky indeed.

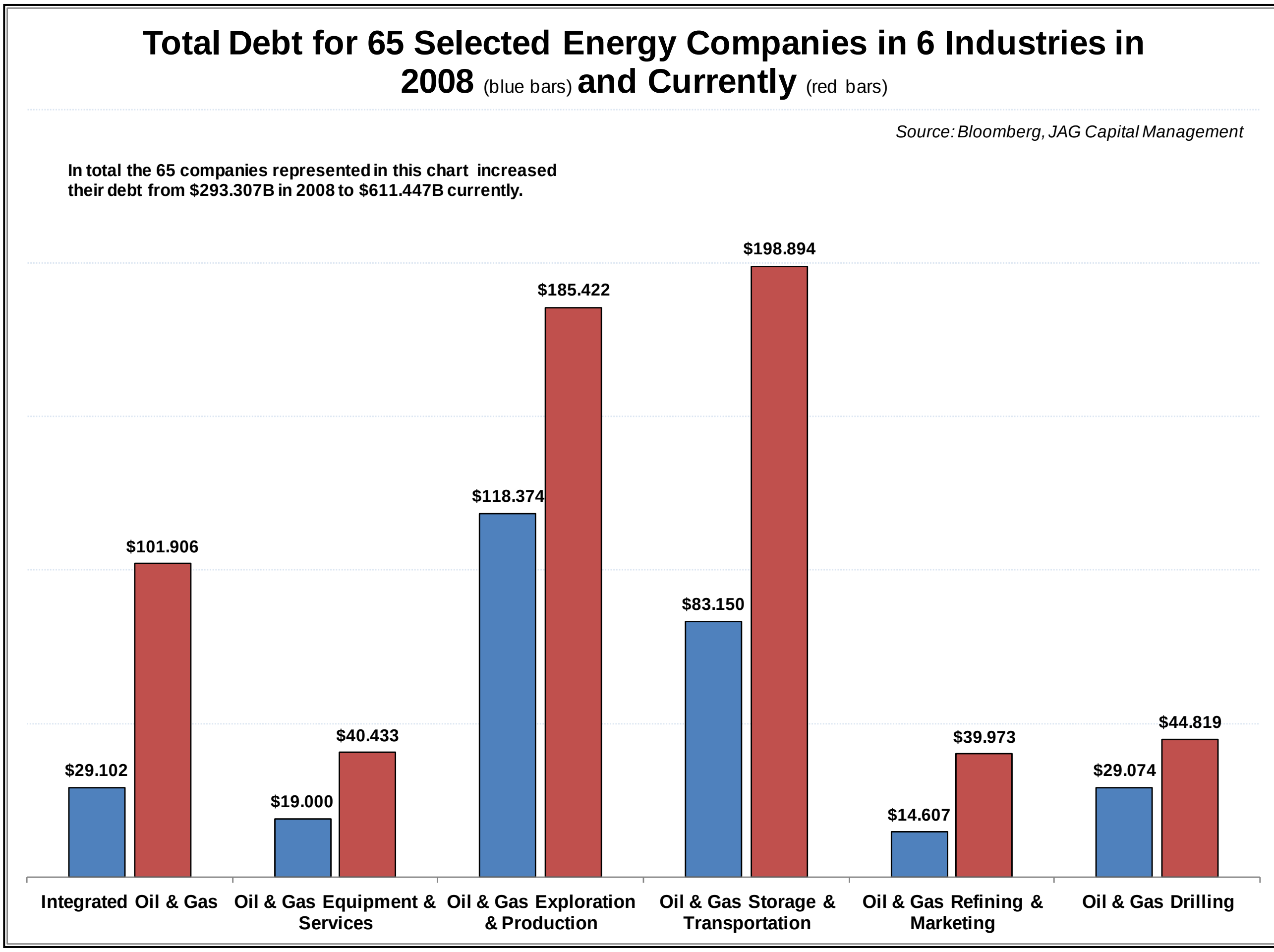


After the 2001-2002 recession, oil prices embarked on a prolonged ramp that eventually peaked at an inflation adjusted price of $144.65/barrel in June 2008, bringing sky-high gasoline prices to consumers just as the financial crisis and Great Recession got rolling. By then, lots of smart people were convinced that higher oil prices were henceforth going to be a permanent fixture in the markets. These "Peak Oil" theorists postulated that the world was running short of oil, and that therefore oil prices had reached a permanently high plateau. Since essentially *everyone* in the world consumes energy to one extent or another, it seemed inevitable that we were all destined for a long ride on the road to perdition, fueled by $4+/gallon gasoline.

Thankfully, things didn't turn out that way. We humans have an amazing capacity to innovate our way out of big, hairy challenges. Faced with skyrocketing oil prices, engineers rolled up their sleeves and got busy perfecting modern hydraulic fracturing (i.e. "fracking") technology. As a reminder, fracking allows oil and natural gas to be pulled out of subterranean shale formations that are inaccessible via traditional drilling methods. Thanks largely to the fracking revolution, U.S. oil production almost doubled between 2009 and 2014, which allowed the U.S. to overtake Saudi Arabia as the world's largest oil producer. At the same time, decades of work by the alternative energy industry to make solar and wind cheaper and more efficient were finally paying off in the form of utility-scale projects that provide clean power at more competitive prices. By late 2014, OPEC had been effectively de-fanged, and our "wish" for energy independence had finally come true. If this were a feel-good movie, the credits would roll, and the audience would stroll out of the theater beaming at yet another amazing story of the power of American ingenuity.

In real life, even happy endings are complicated. Make no mistake – over the long term, lower oil prices are clearly positive for consumers. Economist Donald Luskin has noted that the 70% decline in oil prices since mid-2014 has given global consumers a "tax cut" that amounts to $7.8 billion dollars every day – which equates to $2.9 trillion over the course of a full year. The rub is that this massive cut in consumers' costs is being extracted directly from the revenue streams of corporations that make their livings producing oil. Complicating matters further is the fact that many of these entities built their business plans around the assumption that oil prices would remain high as far as the eye could see. This fact, combined with extremely low interest rates that have prevailed around the world since 2009, drove them to raise significant amounts of debt to fund their drilling projects. Now they are stuck not only with unexpectedly low oil prices, but also with significantly higher debt loads and interest payments.

JAG recently put together a table of 65 of the largest U.S.-based energy companies to examine this issue in greater detail. Collectively, this group has a total stock market capitalization of roughly $1.3 trillion (down from over $2 trillion in 2014) and carries total debt of approximately $611 billion. The most striking figure to us is the fact that this debt load has more than doubled from $293 billion at the end of 2008. Almost all of this additional $318 billion in debt was taken out when oil prices were much higher than they are today, so now it is left to the borrowers to figure out a way to service their interest payments in a much more restrictive price environment than they ever imagined they would face. In almost all cases, they will attempt to square this circle the way any company does when faced with lower income and/or higher expenses: they will tighten their belts through layoffs, reduced capital spending, and a myriad of other ways to ensure their organizations are running as leanly as possible.



Cost-cutting by the Energy sector is causing pain in other sectors of the economy. Any company involved in manufacturing components used in drilling or transporting oil or natural gas will clearly feel the pinch, as will their suppliers, and their supplier's suppliers, and so on. This is probably why we have seen some softening in recent economic indicators such as Industrial Production, Factory Orders, and the ISM Manufacturing Index (PMI). We think the pain in the oil patch is also a proximate cause of the stock market volatility we have experienced since the end of last summer.

Looking forward, we do not expect a rip-roaring recovery in oil prices back to $100/barrel. To paraphrase the old saying, one cannot "put the genie back in the bottle." Fracking and alternative energy are here to stay, and they will only get better over the coming decades. Although we will continue to need fossil fuels for the duration of all of our lifetimes, we will need incrementally less of them as time marches forward. This combination of ample and increasing energy supplies and tapered demand growth is likely to keep a cap on the long-term prices for fossil fuels.

JAG CAPITAL MANAGEMENT LLC

2016 Outlook

Generations of investors (including yours truly) have been wired to view rising commodity prices as a risk to markets and the economy. This is because traditionally, higher natural resource prices tend to lead to higher inflation, which eventually spurs the Fed to tighten interest rate policy, which eventually increases the risks of a recession. On the other hand, lower commodity prices have generally been welcomed by investors, as lower input costs help drive stronger corporate profit margins and earnings, all while providing a boost to consumer spending.

Contrary to this past experience, the stock market has recently exhibited noticeably positive correlation with the commodity markets. To use oil as our primary example, stocks have been trading in the same general direction as oil prices on a day-to-day and week-to-week basis. When oil has stabilized or rallied, stocks have followed suit. When oil has dipped, it has dragged down stocks along with it. This means we are living in a bit of an upside-down world as we enter 2016.

As famed economist Herb Stein said, "If something cannot go on forever, it will stop." Since we think the stock market's weird infatuation with falling commodity prices is unsustainable, we think it is unlikely to persist. As we have already discussed, lower oil prices represent a material tax cut to consumers and companies. This is a good thing for our economy, especially if (as we expect) oil prices stay contained in a lower price range for the next several years. At some point, and we think sooner rather than later, the market will tire of its fixation with commodity prices. This will probably come coincident with reduced market volatility and a potentially meaningful rally in stock prices.

At times like this, we also find it helpful to remind ourselves that we have seen this "movie" before. For better or for worse, markets have a nasty and persistent habit of developing weird fixations. Less than five years ago, during a rolling series of European debt crises, our stock market became hostage to politicians in the Eurozone. For a time, investors in high-quality, growing U.S. companies quite literally began to take their purchase and sale cues from the mutterings of German parliamentarians, Greek prime ministers, and midlevel government functionaries in Finland. To put it bluntly, this was crazy! Eventually, investors collectively decided that there were other more-important factors that needed their attention. As they moved on, the volatility passed, and the stock market stabilized.

More broadly, we note a high level of pessimism in the markets and the investment media as we enter the New Year. After a disappointing and volatile year for stocks globally, continued concerns over the growth rate (or lack thereof) of the Chinese economy, a contentious Presidential election cycle, declining commodity prices, and speculation over the path of future Fed rate hikes, investors as a whole are feeling less confident about the future. We have no special insight into the short-term path of stocks for the next several months, but generally we have been well-served by leaning against the herd when pessimism reaches a fever pitch. Our educated guess is that the markets will see better times ahead in 2016, probably when most observers least expect them to do so.

Norm Conley
CEO & CIO
January 2015

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