

October 7, 2021

Dear Client:

For much of the past decade, the operative word in the energy sector was *abundance*. An industry that had for decades rationed production in order to keep prices high, was overrun by the U.S. shale boom, which introduced a new source of supply, as well as structural price deflation. Recently however, it is a shortage rather than an abundance that has caught investors' attention, and pinching consumers purchasing power.

Last year's pandemic-related lockdowns caused oil prices to plunge. There are myriad reasons for commodity price volatility -- a truism that existed long before a global pandemic delivered a crushing blow to fuel demand (recall oil traded at *negative* \$37.63/barrel on 4/20/20). When demand came roaring back, supply could not keep pace, and explains why oil hovers near \$80, 100% higher than one year ago. Putting the pretext of snarled sea-borne logistics aside, this failure to meet demand exposes an underlying factor that may make scarcity a new normal: a sustained investment slump in critical energy infrastructure. This is a partly a result from the long period of abundance, with years of over-investment giving rise to capital discipline. The result however is that we will produce two million fewer barrels in 2021 than in 2019 even as consumption grows.

Energy is as capital-intensive an industry as there is, requiring constant re-investment just to stand still. An industry rule of thumb posits that a company needs to allocate ~80% of its annual capital expenditure just to replace reserves. However, current data reveals that annual industry capex has fallen a steep 55% since 2014 -- well below replacement requirements, let alone reserve growth. The impact of underinvestment in energy will eventually catch up to the market and the economy but, for better or for worse, energy companies have shifted their stance from production growth to shareholder friendly capital distributions. So, while global oil demand steadily increases, one super-major just distributed 80% of a \$9.5 billion asset sale to shareholders as a special dividend, to go along with annual dividends which consume ~30% of cash flow from operations. That is good news for energy investors, but bad news for everyone else as less investment in supply makes the overall energy complex more susceptible to shocks and acts as a tax on consumption. The Street used to reward output growth beyond all else, but now rewards stingy capital allocation and plumb payouts.

However, oil scarcity is only part of the energy story. Lower investment in oil has a spillover effect on the output of natural gas, which is a by-product of oil production and the feedstock for a hefty 40% of national electricity generation. Accordingly, the price of natural gas has gapped +141% in the past year which has, in turn, spilled over into the availability of plastics, chemicals, and agriculture, where natural gas is cracked into various fertilizer components. The price spike in key agricultural distillates is especially alarming, with the cost of potash +211% and ammonia +170%. We expect to see this cost-push inflation in upcoming quarterly earnings reports.

The world is facing high energy prices for the foreseeable future as oil producers resist the urge to drill. According to one of the super-major CEOs, "there are things that are interfering with market signals right now that we haven't seen before. Eventually things work out, but eventually can be a long time". We have to admit, a fossil fuel renaissance was not high on our list of worries going into 2021, but it will be going into 2022.

Regards,



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