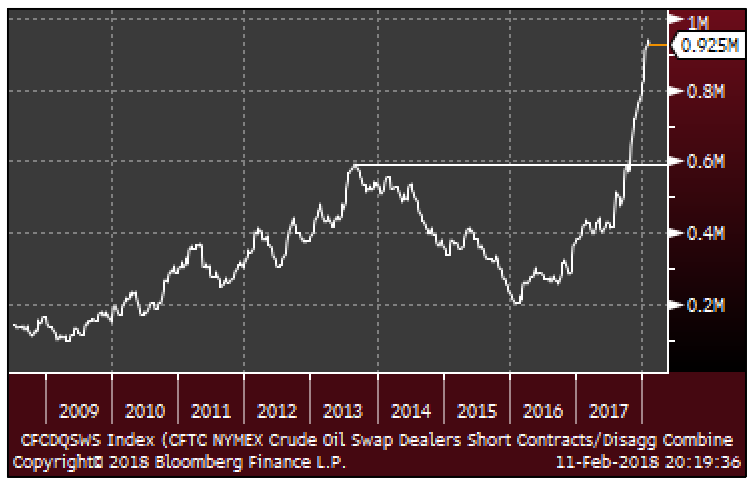
Opportunity in Energy

The long awaited 10% stock market correction came from unwinding a segment of the short volatility strategy. If we have truly entered a bull market in volatility and a bear market in Treasuries, then the entire equity asset class will face enormous headwinds, and worse. However, if technical support levels in the major indices withstand the selling pressure of this event, then this pullback qualifies as a healthy correction within the secular bull market. If that is your line of thinking, then there's great risk/reward opportunities in oil stocks, and the commodity itself.

OIL MARKET

The oil market is healthy. Last week's 9.5% drop, given the surrounding market conditions, was entirely justified. Oil had rallied from $42 to $65 (58%) in six months. OPEC production cuts shaved 1.8 million barrels per day off crude supplies and are having their desired effect. The Saudi's are leading that charge with their Saudi Aramco IPO, valued at $100B (5% of the potential $2T entity) on the 2018 calendar, if not set in stone.

Structure has flipped from contango to backwardation. That carry factor has attracted a tidal wave of speculation. Independent oil analyst Arthur Berman counted every speculative petroleum contract in the Commitment of Traders report and found longs outnumber shorts by a ratio of 11:1. (SOURCE: KunstlerCast #299.)



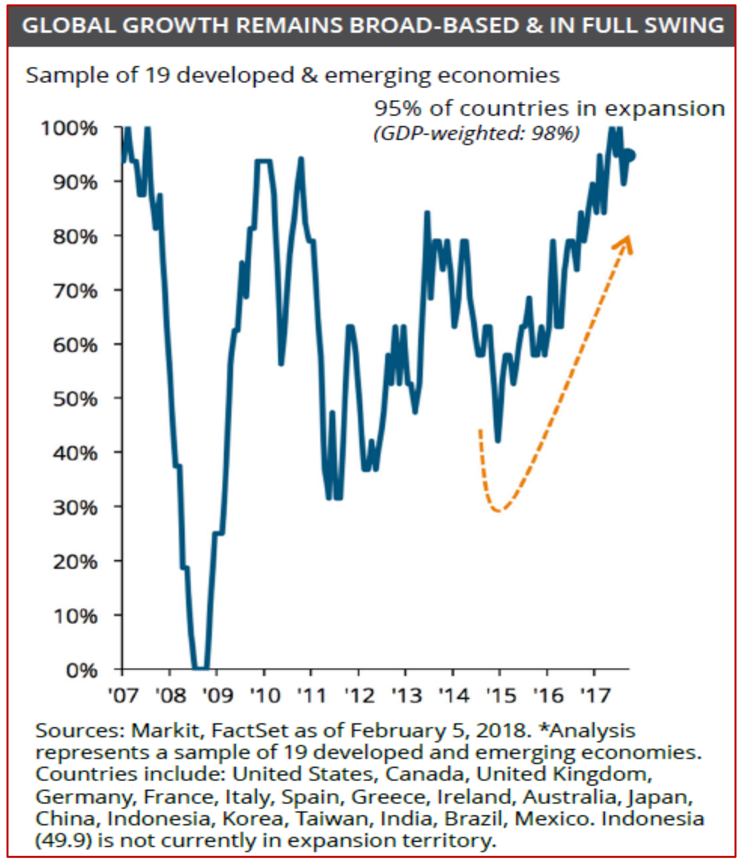
In the background, U.S. production has surged to 10.25 million barrels per day and is forecast to top 11 million by November of this year. Who would be shocked if that data point caused a pullback? Baker Hughes rig count just rose by 26 rigs to 791 illustrating producers taking advantage of price.

Swap dealer short contracts in the oil market are piling up toward 1 million (chart top right.) Oil producers use banks (swap dealers) to hedge forward production, and they're hedging at a historic pace. More oil has been hedged, or pre-sold, into the market than ever before. There's not as much immediate supply as meets the eye. Speculators took on all that selling in the run from $55 to $65.

The June18/December18 crude oil spread (chart bottom right) illustrates that even through commodity index calendar rollovers last week, which put pressure on front-month, and the de-risking event - the trajectory of the crude oil market tightening on less supply has not changed.

I remain bullish oil because there's real demand to balance the supply story. U.S. oil shipments to China are surging. They imported a record 9.5 million barrels of imported oil per day in January. They saw huge heating demand during the winter months. They're refineries are inhaling oil to meet demand but remain environmentally compliant. Most importantly, China just raised their 2018 crude oil import quota for their independent refiners by 55% in 2017. FIFTY FIVE PERCENT. China can, and will, import a lot more oil.

As WTI speculative length expanded to 500K contracts, the oil rally to $66 formed a double top. Goldman Sachs lead a lot of investors into the energy sector with a poorly timed bullish call. They raised their 3-month forecast to $75, 6-month forecast to $82.50, and 12-month forecast to $75 with the return to backwardated structure and a balanced oil market. There was plenty of time for longs to top off their tank, and then *Volmageddon* blew up the last in.



Sources: Markit, FactSet as of February 5, 2018. *Analysis represents a sample of 19 developed and emerging economies. Countries include: United States, Canada, United Kingdom, Germany, France, Italy, Spain, Greece, Ireland, Australia, Japan, China, Indonesia, Korea, Taiwan, India, Brazil, Mexico. Indonesia (49.9) is not currently in expansion territory.

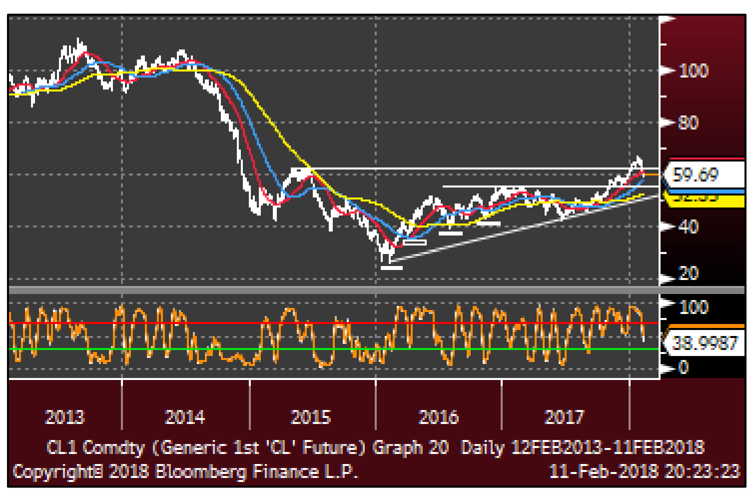
The economic underpinnings of the oil rally are intact. For only the 7th time in 30 years did every economy in the G20 finish with positive GDP growth. It's the best economic run rate since 2011. The chart at right from Markit FactSet (February 5th) illustrates 98% of 19 developed economies including the US, Canada, UK, Germany, France, Italy, Spain, Greece, Ireland, Australia, Japan, and China are expanding. Purchasing Managers Indexes in the G10 are humming along above 50, GDP growth has been steady, and inflation is under control. It would be foolish to believe that the recent economic growth in the U.S. and Europe is about to nosedive into recession.

No matter what happens to the short volatility strategy, oil market dynamics are still supportive of price. Fade the oil rally at your peril.

Oil Market Technicals

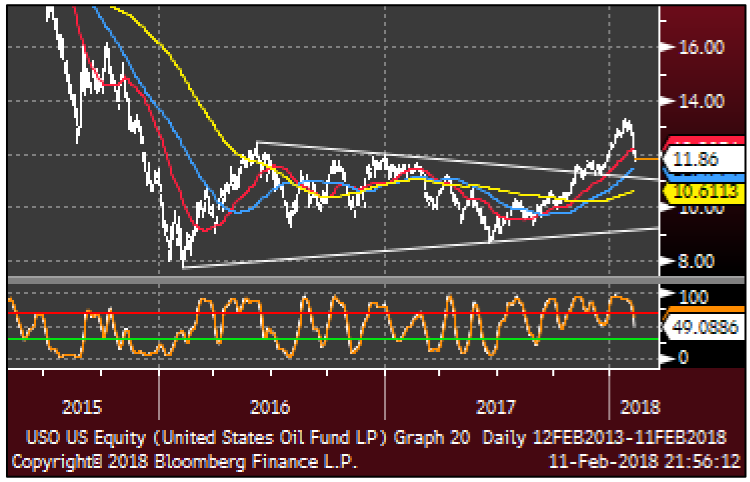
From a technical perspective, there's support in WTI crude oil all the way down. CTA's that missed the move will probably be waiting to enter oil positions at one or more of the following support levels:

- 57.25 - 100-day moving average
- $55 – the 2016 and 2017 highs
- $52.35 – the 200-day moving average
- $50 – the ascending trend-line and psychological support



If we can subscribe to the idea that crude oil will hold this support band from $50 to $57 and resume the technical rally, then we should be looking to buy USO and/or healthy oil companies on the dip with sensible stop losses. I'll highlight the trade setup in USO first and then pick 1 refiner, 1 E&P, and 1 oil field services chart that have great risk reward and a lot of upside potential.

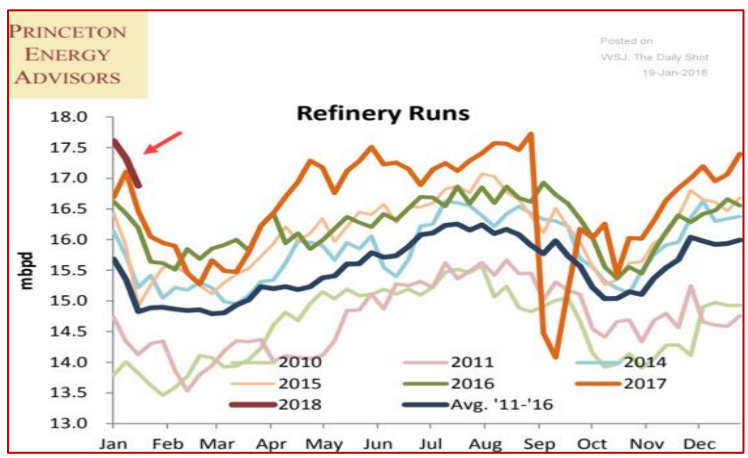
The USO setup is as follows:



Buy a dip to the support zone between USO's 100dma at $11.50 and 200dma at $10.60 looking for a rally beyond recent highs at $13.60. Momentum traders can buy strength on a recovery of the 50-day moving average at $12.20 and use the 100-day moving average at $11.50 as a stop-loss.

Big picture – if you can risk a close below $10.50, looking for oil to quickly recover on the continuation of fundamental and technical strength, you might get a look at $15 ($70 oil) by the time this move is over.

1 Refiner – Marathon Petroleum (MPC)



We're getting a great technical opportunity to buy into oil refiners, which have been running out ahead of the economic recovery story. They've been fueled on record capacity and strong margins. The most recent price rally in oil has slightly cut into those margins, but refiners are headed toward peak seasonal demand in the summer. As the middle chart illustrates, 2017 (in orange) was a banner year for refinery utilization. Natural gas prices remain low, keeping refinery costs in check. I expect the trend to continue into the new year as the President pivots toward an infrastructure plan. I like Marathon Petroleum, ticker MPC.

This is unfortunately also a big 'Street' favorite. There are 16 BUY, 6 HOLD, and zero SELL ratings on the Marathon. The average of all target prices is $83. Hopefully this will embolden the bulls.

You won't need to convince the technicians. There's great risk reward lined up in MPC (chart bottom right.) This pullback left it into support between the 2015 highs ($60), the 200dma ($58), and the entire post-election UP trend (white line.) The stock now faces 50-day moving average resistance at $67.30, but through that level, the $31B refiner can resume its bullish trajectory.

1 Oil Services Company – Helmerich & Payn (HP)

In the oil field services Helmerich & Payn (HP chart right) has illustrated the most technical stability. Aggressive traders can risk 100dma support at $59.50. Longer term traders can risk the 200dma support at $58.80 looking for a retest of the highs at $75 and beyond.

Analysts on Wall Street disagree. There are 4 BUY, 17 HOLD, and 10 SELL ratings on the stock. The short interest is rather large at 15.3 million shares. That's 14.4% of the HP float and would take 7.4 days at average volume to cover. With just the right amount of pessimism, I'll take my chances buying Helmerich and Payn on this dip into technical support. I like to own oil services with rig count ticking meaningfully higher last week.

1 Exploration & Production Company – Occidental Petroleum (OXY)

For max exposure to a pending infrastructure package I want to buy an E&P specialty company. Occidental Petroleum engages in oil and gas exploration and production, but they also make basic chemicals and plastics. Occidental owns Oxy Vinyls, the #1 maker of polyvinyl chloride (PVC) resin in North America. You can't pass an infrastructure plan without PVC.

There are 7 BUY, 20 HOLD, and zero SELL rankings on the stock. Short interest is toward the higher end of the range at 11.4 million shares, but not excessively large at 3 days to cover. This trade goes with my price action gut. Friday's low never really tested the 2017 high and 200-day moving average at $65. The low was $65.71, and OXY came roaring back to settle at $68.18.

Conclusion

In conclusion, if the oil market can maintain the bullish case I've laid out, and hold technical support on the dip, I think the energy sector offers a great investment opportunity. I've laid out the case for an oil trade and 3 stocks in each sub-sector.

If we just experienced a 10% correction in the stock market, and the worst of the short volatility explosion is behind us, those who embrace risk might consider having all 4 positions on.

Long USO, MPC, HP, and OXY. How's that for a Texas Hedge?