WHAT OIL PRICES ARE TELLING US

It wasn't so long ago that many politicians and central bankers were declaring that the biggest problem was low inflation and that they would be doing "whatever it takes" to ensure that inflation would be at least around the venerable 2% level. Today, inflation is higher by multiples, it is completely out of control, and, as so often happens, the market is again teaching a lesson to those endeavouring to vanquish it.

Inflation is now a subject of everyday conversation and is perhaps even the main topic on the minds not only of investors but also for the majority of households and business people. One of the main motors driving inflation is the price of energy, and in particular the prices of crude oil and natural gas. Let's consider a bit about the price of oil and what it might be telling us.

Is the current price of oil high?

By first appearances it certainly seems so. The present price of crude oil, at around $110 per barrel, is nominally near its all-time high. The previous peak of $140 was reached in the summer of 2008. So that means we are now at the second-highest level. If we look at the oil price in real terms, however, which means after adjusting for inflation, the peak reached in 2008 would in today's dollars correspond to a price of around $200 per barrel. Such a price would then be about 80% higher than it is today. When expressed in real terms, today's crude oil price is right around the same level as it was during the 3 years between 2011 and 2014, and I'm afraid that it still has plenty of potential to rise.

Why should the price of oil rise further?

Because that's what is implied by the supply-and-demand situation. The market may again be getting ready to humble those who fail to respect it. Global demand for crude is today right around 100 million barrels per day. To put that in perspective, it is equivalent to about 6,400 Olympic-size swimming pools that every day need to be filled with oil. One every 14 seconds. That is an enormous number. Important is not only that demand is growing over the long term but also that it will continue to grow for quite a long time. People who imagine that in a few years no crude oil will be needed are being naïve. The world is not just California or Germany. It is above all China, India, Africa, and Latin America. Per-capita energy consumption in those countries is only a fraction of what is consumed by the wealthy West, but these people, too, aspire to substantially raise their living standards. Increased entitlement to consume energy is of course connected with this aspiration, and oil and other fossil fuels will play an irreplaceable role in meeting that demand. And that's not even to mention all the other products produced from crude oil and natural gas ranging from fertilizers and plastics to even medicines. The demand for oil is certainly going to continue to grow.

On the supply side, there are problems to satisfy the growing demand. From a global perspective, there exists today only minimal unutilised capacity. The majority of OPEC countries, for example, are unable to fill their existing drilling quotas. Above ground oil reserves are low as the sector overall suffers from longtime underinvestment in past years.

The entire supply side must continually build new drilling capacity because that in existence is constantly being depleted and its production is falling. Low crude oil prices during 2015–2021 suppressed investment into developing oil production to very low levels. The price of crude oil was simply not high enough to stimulate the supply side.

When will oil prices stop rising?

In principle, it is necessary either that demand will decrease or that supply will increase. There is nothing very complicated about that. So far as demand is concerned, in the medium term it could most easily be reduced by recession. Then the oil market would break out from its presently strained situation and the price of crude oil would fall. The solution would only be transitory, though, because as soon as the recession will abate we will be right back where we are today – with record-high demand and record-low investment into production development.

A much better solution would be if the supply side would more strongly react to the higher price of oil through increased investment and accordingly boosting its capacity. There are two problems, however. Oil producers must see not only that the oil price is sufficiently high today but they also must be convinced that it will remain sufficiently high for sufficiently long such that investments they make will pay off. The second problem is that the time lag from the point of increased investment until that starts to be reflected in growing oil output is long – measurable in years. So, no quick solution will be coming from the supply side.

If the present trends of growing demand and insufficient investment will continue, then it is possible that the solution will be have to come through so-called demand destruction caused by an oil price sufficiently high that, despite the rather inelastic shape of the demand curve, this will cause consumption to decline. In that case, the price of crude oil would have to be still considerably higher than it is today, because at the current price of around USD 110 per barrel (and moreover with record refining margins) we are scarcely able to observe any demand destruction.

Politicians are making the whole situation still worse

The whole political climate and the steps taken by various governments are making the situation still worse. Oil companies are today essentially being pilloried for extracting oil at all, meanwhile banks are refusing to finance the needed investments, and oftentimes even oil companies' own shareholders are pressing them to limit their drilling. All of that is raising the costs of capital in the sector and changing the motivation within the managements of the firms. They are not rushing into any big investments and risks. Then, too, the politicians involve themselves, endeavouring to impose more taxes because they believe exorbitant profits are presently being made. It does not matter to them that in the preceding 8 years the entire sector has had problems even to earn back the costs of capital and a whole range of companies were even routinely losing money. And by the way, I haven't noticed that the politicians were calling for additional taxes in relation to excessive profits at Apple despite the fact that oil companies could only dream of such profits, margins, and free cash flow as Apple enjoys.

In order for the price of oil to fall, we urgently need the oil companies to make large profits over the long term and to be given maximum conditions for investment in production (but also in refineries, pipelines and other infrastructure). Unfortunately, today we are moving in precisely the opposite direction. This can bring only one result. If earlier a long-term oil price of USD 80 was sufficient to convince oil companies to invest, for example, then today they may need to see a price of let´s say USD 120 in order to be equally convinced. If we add in the fact that through their actions governments will still further stimulate demand for oil, then we may expect over the long term a much higher oil price than previously, moreover with the addition of occasional sharp leaps upwards in situations when the entire hard-pressed sector will not be able to satisfy current demand.

Through the 18 years that Vltava Fund has been operating, we have put quite a bit of time and effort into studying commodity markets and extraction companies, and if there is one conclusion we have reached it is that in the short run the price of a commodity is driven by its demand and in the long term by its supply. The supply side today will need a much higher price incentive than it did previously.

Effect on inflation

Why am I writing about all of this? Similar arguments as I have used concerning the oil market could be used also for other commodities. Overall, I presume that we are in the rather early phases of another so-called commodity super cycle, when we can look forward to a longer period of high commodity prices driven by a combination of rapidly growing global demand and longtime underinvestment on the supply side. This means the cards have been dealt such that we can anticipate a rather long period of above-average high inflation. Central banks are more or less everywhere in the world far behind the inflation curve, and so far they are not succeeding to subdue the rising prices. Although inflation will likely soon begin to come down, one nevertheless can anticipate that it will remain rather high for quite some time. The real test will come in the situation when central banks realise they no longer can continue to raise interest rates because they will have reached a level that is intolerable for financing government budget deficits and debts and yet the inflation rate will still be too high. Then they probably will be forced to restart their purchasing in the bond markets in order to push rates lower. They could get a little help in this situation from austerity measures in setting government budgets, but we may never again see anything of that sort. That means we must be prepared for a world in which money will lose its value even quicker than it has up to now.

Changes in the portfolio

We bought shares in Cenovus Energy. This marks the first time in 10 years that an oil producing company has appeared in the Vltava Fund portfolio. Cenovus is a Canadian integrated gas and oil company based in Calgary. It is Canada's third-largest producer of crude oil and natural gas, the country's second-largest refiner, and it combines high-quality and low-cost assets in the oil sands segment and heavy oil with extensive downstream infrastructure.

Investment in this sector is not at all easy. It is a cyclical industry where it is not easy to build a competitive advantage. The investment horizons are long and companies often work with large debt. Many companies face problems creating sufficient free cash flow in the long term. Our experience leads us to the view that it is necessary to give preference to companies that already today are producing at high levels so that they immediately can take advantage of the strong oil prices and need not rely on capacity that will be brought online only in the future. Such a company should have reasonable operating costs, low debt, and very long-term reserves the development of which need not swallow up all the profits that are generated. In our opinion, Cenovus Energy offers all of this and it also has a very shareholder-friendly capital allocation.

But isn't it already too late for this investment? Certainly, it would have been better had we purchased Cenovus perhaps a year earlier. Everything is clearer in hindsight, of course, but we needed some time to come to the conclusion as described above. We are aware that we could be mistaken in our analysis, but we do not think the time is late for this investment. The entire oil and gas sector has a smaller representation in the S&P 500 Index than does Apple alone. Apple is an excellent company, we admire its products, and we also hold its shares through our investment in Berkshire Hathaway. At the same time, though, I must acknowledge that if Apple were to disappear from the world tomorrow not much would happen. Life would go on as normal. If, however, companies producing for oil were to disappear from the world, life would come to a standstill.

That doesn't make much sense. Not only are investors not yet very much invested into the sector but they haven't even begun to think about it much yet. During June I was at two rather large investment conferences, in Madrid and in Zurich. In Madrid, I listened to 17 presentations of individual equity investment opportunities and only one of them had to do with oil exploration and production. In Zurich, there were about 50 of us investors from all over the world and during the course of 3 days many interesting topics were discussed, but oil exploration and production did not even come up. No, this is not a leading topic of interest among investors at the moment.

Even the term structure of oil futures prices reflects this. It is downward sloping and shows that the market anticipates gradually declining oil prices. I think that reflects a sort of majority opinion. Nevertheless, I think that the market is confused on this. I know that is a bold assertion, but such would not be anything unusual. A year ago, that same term structure anticipated that the price of crude today would be around USD 65–70. It is at USD 110. Last year in summer the futures pricing also forecast that at the end of 2024 oil would be at USD 55. Today it already predicts USD 76. Gradually, it is pushing upwards, but still it remains too low. When analysts value oil companies, they generally take the expected oil prices as their starting point. The Cenovus Energy share price itself today implicitly assumes that the oil price will decline in the near and medium term future. We do not think so, and therefore we consider the shares to be undervalued.

We do not enjoy high energy prices any more than we find joy in high inflation. Inflation is in fact a form of hidden taxation – both of property and of income. One of the small things that we can do from that point of view is to adapt some of our investments to that reality. So, the next time you will be at the petrol station and pay a new record price for fuel, you can take some small comfort in the fact that you own an investment that may compensate you in part for that higher cost.

As far as stock (and bond) markets in general are concerned, they have prepared one of the worst first half-years in history for investors this year. In essence, the 6 months alternated between periods of more modest declines and others of steeper and deeper descents. Our fund is doing better than the markets, but it is still a bit of a test of patience. We strive to keep cool heads and look far beyond the horizon of current events. That has usually paid off for us in the past. After 18 years in its existence, Vltava Fund already has been through similar, transitory declines almost too numerous to count, and we can be altogether certain that we also will not avoid them in future.

The historical data concerning our portfolio that we have available show that the last time we saw our shares priced so low as they were at the end of June was in mid-April 2020. From that time through the end of 2021, the prices grew by nearly 60%. In the past 10 years, there have occurred just two very brief times when our shares were priced lower than they are today. The first was Christmas of 2018 and the second was in the covid collapse in March of 2020. In both cases, our portfolio's market value grew robustly thereafter.

Daniel Gladiš, July 2022

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Write to investor@vltavafund.com

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