Oil Gloom, Doom and Boom

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The price of oil has collapsed from $100 per barrel in July to around $45 today. Investors do not like being caught off guard; so when the price of a commodity gets cut by more than 50% in six months, panic sets in. However, investors need to ask themselves why the price of oil has collapsed? What does it mean? And how can profits be made from this sell off?

Oil is a commodity, and like any commodity it always comes back to supply vs demand. In terms of supply, it was not that long ago that many were talking about "peak oil theory," the idea that the world was running out of oil and alternative sources of fuel such as wind, solar and nuclear were the future. Now, with the advent of horizontal drilling, and the discovery of shale in the US, the world is awash in oil. In 2011, the US was producing about 5.5 million barrels of oil per day. Today it's closer to 9.5 million, and rising! This is not a surprise. It's been well documented how much oil and natural gas reserves the US sits on; the problem is that it's finally here and above the ground! Actions by OPEC have not helped the situation either. Led by Saudi Arabia, OPEC has chosen not to cut production to stabilize the price of oil, something it has typically done. Their motives are plentiful, from geopolitical to competitive. Either way, until OPEC capitulates and US drilling comes to a standstill, lower oil prices will be here for a while. This spells bad news for companies that rely on higher oil prices to make money, such as drillers, oil service operators, and exploration and production companies. Their stock prices reflect it.

Now the demand side of the equation. For the past ten years, led by the awesome growth of China and other emerging market nations, the demand for oil has grown almost every year. As the world population grows, and industrialization expands, more oil gets used. However, China's GDP is not growing at 10% anymore. Some even question the 7% that the government states. This has had a ripple effect throughout the global economy, particularly the developing countries, which rely on China's demand for raw materials to support their own expansion. If the world, excluding the US, continues to slow down, or worse, falls into recession, the demand growth for oil will decrease and the price will continue to go lower.

How should investors be positioned? Investors should be celebrating the drop in oil, not fretting about the increased volatility it has created it the stock market. This will provide a short term economic stimulus more powerful than anything a central bank or government could create. It will prove to be a boost to GDP and corporate earnings. We think a company like Ford (F) will benefit very nicely from the collapse in oil. Ford is rolling out its new F-150, which is made from aluminum not steel, so the truck is reportedly 700lbs lighter. With the construction market rebounding, and the price at the pump down, the demand for SUVs will rise. Ford also has a 3.3% dividend yield and a very strong balance sheet.

Secondly, the price of oil is not going to zero. There will be a bottom. Just as in early 2008, the price of oil did not reach $200 per barrel as some predicted. In building a well-diversified portfolio with exposure to commodities, investors should buy when the price is low and sell when the price is high. In theory this sounds simple, but psychologically not easy to execute. Although poorly financed, small and mid-cap oil companies will be hurt from the collapse in oil, some may even go bankrupt, the Super Major's, like Chevron (CVX), should be able to weather the storm. CVX has already committed to cutting its capital expenditure program. It has a solid balance sheet and will do what is necessary to maintain its dividend, which is currently around 4%. So, despite the stock price sell off, long term investors should be rewarded for buying CVX at today's prices. Also, it is likely that companies such as CVX are contemplating an acquisition strategy for certain US oil and gas companies whose stock prices have been crushed by the recent sell off, which have strategic oil fields in high growth areas.

Bottom line. There will be winners and losers from the collapse in the price of oil. Investors need to approach the situation understanding this fact. However, the lesson learned from such a sharp drop in oil is that portfolios should always be focused on diversification first, to protect against unexpected events.

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