ANOTHER BEAR MARKET?

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SYNOPSIS

- This week, oil fell into its sixth bear market in the last four years.
- Oil has been a big story and market-mover since Saudi Arabia started a price war back in 2014.
- Saudi Arabia will regret the day they started this price war.

BEAR MARKET

This week, oil fell into its sixth bear market in the last four years. A bear market is defined as a decline of 20% or more in price since a recent peak, and there are few things the financial media loves more than a bear market. Hence, this news made the front page and consumed hours of live coverage by the networks.

Oil has been a big story and market-mover since Saudi Arabia started a price war back in mid-2014. Back then, oil was trading in triple digits, and the Kingdom was concerned about losing market share to the energy revolution that was well underway in the U.S.

Their goal was simple - cut prices to attract more business and cause high-cost U.S. producers to go under. Saudi Arabia has one of the lowest production costs in the world, so they felt that they could withstand a prolonged period of low prices. Once the U.S. producers left the market, they would then raise prices to regain their old profits.

This is a classic competitive strategy ploy attempted in nearly every industry. For example, imagine an established chain of ice cream stores that is large enough to buy supplies in bulk at a cheaper cost and pay lower rents because leases were signed several years ago.

Then one day, a small competitor opens down the street from one of its locations. The incumbent decides to kill off the competition by dropping its price for ice cream to a level that cannot be matched by smaller stores. Eventually, the challenger goes out of business, and the incumbent restores prices back to their original level.

The problem for Saudi Arabia is that their master plan has not unfolded as they had hoped, but before we discuss the implications of this new bear market, it's important to understand why this price war will end up being a mistake of epic proportions.

DARWINISM IN BUSINESS

Business is a lot like the wild, where only the strongest survive. Prior to Saudi Arabia's price war, oil producers were making a killing because nearly all known oil reserves were profitable with crude selling above $100/barrel.

> *"Business is a lot like the wild, where only the strongest survive."*

An ample food supply attracts predators, and big profits do the same for capitalists. New oil companies were being formed overnight, and they all were so anxious to grow as fast as possible that most threw financial discipline out the door. As the price war began and times got tough, natural selection became the only force that could bring harmony back to the sector.

The strong were those with disciplined managers, diverse operations, and relatively sound financials. These companies represented the smarter and healthier gene pool in the wild.

The weak were those who took on way too much debt, did not manage costs properly and had bad management teams. These companies represented an injured buffalo in an ecosystem that offers no protection from the imminent dangers that hunt them.

Ultimately, the weak cannot survive. The cruelty pervasive throughout financial markets does not allow them to remain in business. Some filed for bankruptcy and others got acquired by the strong, but in any event, they had to go before order could be restored.

Simply put, the price war ultimately benefitted the U.S. energy sector because it thinned out the herd and forced survivors to become stronger.

HUGE MISTAKE

Fast forward to today, and Saudi Arabia is starting to realize that Darwinism and capitalism are inextricably linked, and there is no country in the world that thrives on capitalism more than the U.S.

Since the U.S. energy revolution began, the strong companies have been reinvesting billions back into their businesses to lower their cost of production. Rigs are now run by computers, and costs have been cut to the point where they have not only learned how to survive with cheap oil but become profitable.

Data supports this conclusion. Drilling in the U.S. has been rising this year, and a company is not going to increase production if they cannot charge more for a product than it costs to produce it.

But what is most compelling about this new bear market is the impact to the Organization of the Petroleum Exporting Countries (OPEC) cartel. Almost a year ago, OPEC agreed to cut production to boost the price of oil higher. Saudi Arabia and many other members' economies are heavily reliant on oil revenues, and the pain experienced by the 70%+ drop in the price of oil became too much to bear.

The fact that oil is now moving opposite to the wishes of the cartel is an incredible sign that the cartel that has controlled the price of oil for decades appears to have finally lost their grip. This will be a very big deal for the rest of the world because now the market will decide the price rather than a small group of self-interested and complacent governments.

IMPLICATIONS FOR INVESTORS

Saudi Arabia could have avoided a lot of pain and misery if they had just spent a few hours reading through economic history to assess the success rate of price wars. The short version is that they almost never work.

The irony behind their decision is that they have done nothing but better position our economy for the long run. The absolute best possible outcome for the U.S. is an extended period of cheap energy. We pay less at the pump, and companies here pay less for their input costs.

If the bear market deepens further, we may see some equity market volatility, but it will not last. What will persist are the continued efforts of U.S. producers as they drive down their production costs further.

The loser will be OPEC because cutting prices is easy, but raising them can be incredibly difficult. This is a lesson they are learning right now, and they will most likely pay the consequences that come from failing to diversify their economy away from oil.

The bottom line is that not all bear markets are bad, and we should be thanking Saudi Arabia for thinning out the herd rather than concerning ourselves over periodic equity market volatility.

Sincerely,

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