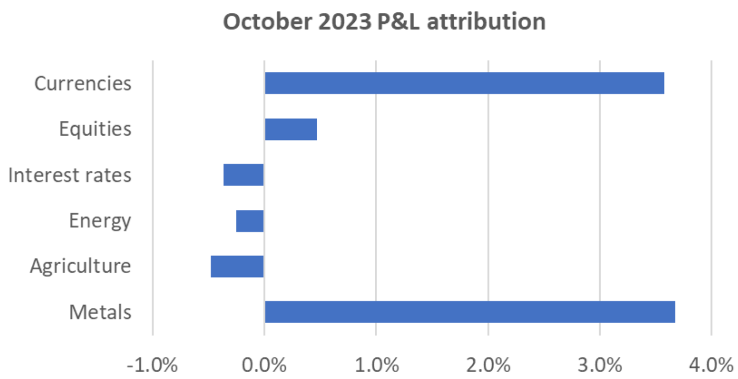
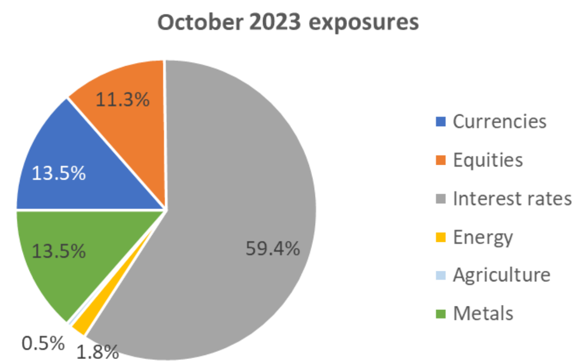
The Discretionary Global Macro Program generated an +7.5% return, net of fees, in October 2023, leaving YTD performance at +0.3%.





In recent letters we've spoken at length about our views on bonds, equities, and gold. So, while we will touch on those briefly before closing this letter, we'll spend more time on a new position that we initiated mid-month before closing it in late October: long crude oil. Even though the position is no longer in the portfolio, we follow the oil market closely and plan on continuing to actively invest in this market in the future. What follows is a quick primer on the oil market before we discuss our recent trade and our bigger picture views.

Crude oil

Examining the oil market is clearly timely due to the outbreak of war in the Middle East. Let's start with a quick historical context before we break apart supply and demand for oil today.

History

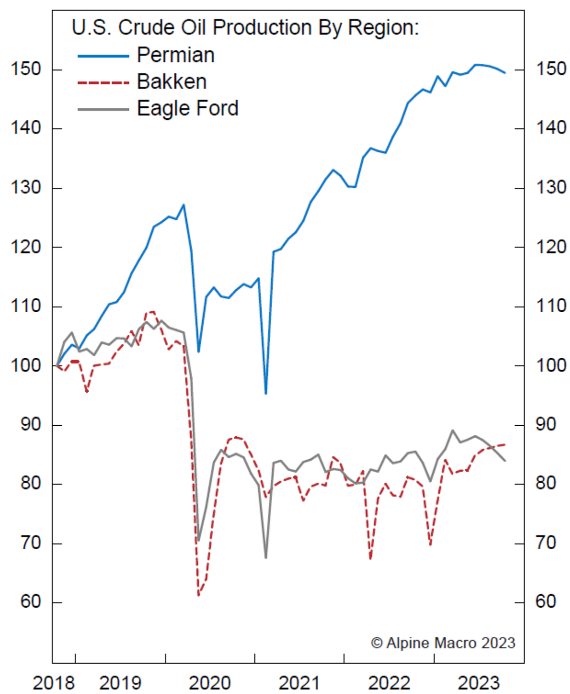
- Oil was $3/barrel in the early 1970s. The combination of the 1973 Arab oil embargo and the 1979 energy crisis in the wake of the Iranian revolution sent oil close to $40/barrel by the end of the decade. The price went up by over 10x in a classic "super cycle".

- After a period of more muted prices in the 1980s and 1990s, the price of oil went from $20 in 1999 to $140 in 2008 – increasing by 7x in another super cycle. Instead of a supply-driven bull market as in the 1970s, this was a demand-pull bull market driven by China's rapid urbanization and development.

- Today, after twice hitting a low of ~$35/barrel[1] in 2016 and again in 2021, the price of oil reached $120 in the wake of Russia's invasion of Ukraine and sits at $81 as we type this letter. The key question for investors is: can oil go up 5x or 10x to a range of $200-$400/barrel in a new, third super cycle? We have an opinion; we'll return to this question later in the letter.

Supply

- Global supply is roughly 101 million barrels/day, split 40% from OPEC+ countries (the Middle East producers & Russia, plus a few other marginal suppliers such as Angola and Mexico) and 60% from non-OPEC producers (The United States, Canada, China, Brazil and others).



Note: All series are rebased to Oct 2018=100; source: EIA

- Almost all global supply growth comes from a handful of West Texas counties in the Permian Basin, an area that is starting to show signs of exhaustion. Other key producing basins in the U.S. (the Bakken and Eagle Ford) peaked years ago and have flatlined in their production (chart at left).

- Finally, it's important to note that unlike the 2007-2008 time period, when global spare capacity was very low and there were genuine concerns of "peak oil" supply, today OPEC+ countries are intentionally holding 4-6 million barrels/day of spare capacity off market in order to elevate the global price of oil and allow them to meet their budgetary needs (particularly in the case of Saudi Arabia).

Demand

- Global demand is also roughly 101 million barrels/day. Unlike global supply – which can be fairly accurately modeled on a country-by-country basis, with detailed projections of spare capacity by oil field – demand is largely guesswork.

- During a garden variety recession, like 2001, demand may flatline but doesn't drop much. During a rare, deep recession, like 2008, demand outright drops.

[1] Technically the price of oil briefly went negative during the early 2020 Covid lockdowns, as there was nowhere to store oil and demand completely collapsed. We ignore this artificial price for our analysis as it was not indicative of the overall state of the oil market.

- Adding to the complication of understanding demand is estimating when green investments in new energy technologies and a shift to electric vehicles will cause peak oil demand. To give you a sense for how wide the analyst community's thoughts are here, one of our research vendors sees global peak oil demand occurring in the next year or two, and a steady erosion of oil usage with a long tail in the decades ahead. Another analyst we follow sees global oil usage increasing year-over-year for a few *decades* to come, and a total oil market of over 200 million barrels/day in the year 2050.

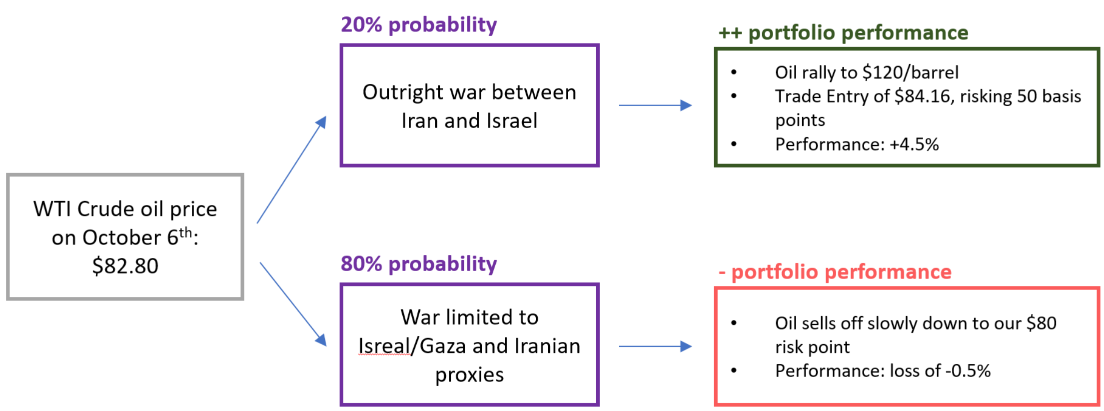
With the analyst community split to the point that you can drive the proverbial truck through their demand forecasts, it's important to have our own opinion on what drives oil supply and demand and devise an approach to trading oil over the course of this decade.

Our oil trading approach

<u>Short-term: war in the Middle East</u>

Let's quickly address the long oil trade that we placed in early-October and which we covered on the penultimate day of the month. Our overall assessment of the global economy is that we are set for a hard economic landing, an outcome at odds with the "soft landing" narrative that has become prevalent. Our base case was therefore somewhat bearish on oil, given that a recession could easily negate the 20% rally that oil has had from July 2023 – September 2023, a rally driven by OPEC+ supply cuts.

The outbreak of war in Israel gave us an opportunity to put on a defined-risk, tactical trade. Our calculus was that oil would not move much based on any military action by Israel to go after Hamas. But any escalation in the region that directly involved war between the U.S. / Israel against Iran, whether that led to the closure of the Strait of Hormuz or otherwise, had the potential to send oil spiking above $100 very quickly. The trade was worth putting on even though it was a low probability event. Here's the math:



The weighted average payoff here is a gain of 0.2 * 4.5 + 0.8 * (-0.5) = +0.5. As it was, we closed the trade out for a loss of 27 basis points, ahead of our risk point, as the price action was weak and didn't reflect the scenario of a wider conflict.

Long-term: grinding bull market driven by lack of CapEx

Our long-term view on oil (next 3-5 years) is one where a lack of Capital Expenditure (CapEx) by most large oil companies – and a desire by those companies to return free cash flow to shareholders – will lead to a grinding bull market in oil for years to come.

- We do not believe that oil can sustainably reach $300 or $400/barrel. That seems unrealistic, as demand destruction will kick in and pull prices down. Therefore, we are not in the camp that believes we are about to embark on a third grand super cycle. Instead, we foresee a more muted bull market in oil that grinds to perhaps $150-200, driven by the aforementioned lack of CapEx, a resolve by OPEC producers to balance their budgets with higher oil prices, and a lack of global supply growth ex-OPEC, as U.S. shales finally tap out.

- We firmly believe that the demand side of the equation will support such a move over a multi-year period: oil is irreplaceable. It goes into everything we wear, live in, and use as a species, from plastics to make-up to medicine to housing and transportation. Light duty cars and trucks only account for 20-25% of oil demand. Even if this demand segment were to drop precipitously, global growth in emerging markets such as India would ensure an increasing demand for oil, at least for the next decade or two.

Therefore, as we look past any coming recession, our investment view is bullish crude oil, just less so than the super cycle folks. We will look to take another long position sometime next year, most likely in the back part of the oil futures curve, as the curve trades in backwardation, incentivizing us to buy longer-dated contracts.

Portfolio in October

We continue to expect a hard-landing recession. Our short Nasdaq 100 and long gold positions contributed the most to our October performance. Our long position in 2-year Treasuries treaded water but looks poised to increase in value in the months ahead. We believe the market is sniffing out not only the end of Fed interest rate hikes but the probability of potential cuts – cuts that will likely need to be deeper and more aggressive than many think as the lagged impact of Fed rate hikes continues to catch up with small businesses, commercial real estate, and the bottom half of U.S. consumers.

Sincerely,
AG Capital