GAMMA INVESTING
CUSTOM INDEX SMAs

ESG Arbitrage (Part 2)

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I proposed in the previous article that, to participate in the expected capex boom from the electrification of transportation and the renewable energy transformation of our power grid, investing in a basket of copper miners is a better alternative than buying into the overcrowded renewable energy sector. In this article, I will push the ESG arbitrage in an even more controversial direction. The second portfolio idea will embrace Big Oil as an arbitrage on the ESG themed investing.

Conventional thinking pits renewables against hydrocarbons as a zero sum game in our society's quest for a sustainable energy solution. Conversely, I see complementarity of their respective roles during this long energy transition. Before the renewable sources are proven resilient, the old hydrocarbons will continue to deliver reliably. Without hydrocarbons to power the transition and the green capex boom, we may find ourselves heading into intermittent energy crisis.

At present though, the financial market has reached its verdict. Big Oil stock prices already embed an implicit pricing of peak demand for oil to occur around the middle of this decade. This is the consensus scenario which I deem to be a premature conclusion and it forms the basis for the second arbitrage idea. I will present my conclusion with three reasons.

Supply Suppression Has Never Worked

When society wants to ban certain product, the common action is to restrict the supply in hopes of ending its circulation. Episodes of such supply suppression happened to liquor during the 1920s Prohibition era and cannabis (aka marijuana) in recent history. Both attempts to suppress supply, with the full backing of the entire political institution, came to naught because the demand for the prohibited goods continued to grow. Just like liquor and marijuana were classified as illicit goods once upon a time, we may be observing a similar supply suppression of fossil fuels as they are considered the primary cause of climate change.

The Big Oil companies have become the prime targets for the ESG activists in the global transition from hydrocarbon to renewable energy. The anti-oil activism has pushed institutional investors to divest oil stocks and pressured banks to defund oil drilling projects. This movement has directly or indirectly caused a sharp reduction of capital expenditure in the oil and gas industry. A landmark report in recent days from the International Energy Agency says that ending oil and gas exploration immediately is the only viable climate path. While I support the climate centric view of sustainable investing, I see real danger from making drastic changes to supply of fossil fuels before renewable energy is ready to take over. It will take a lot more energy to enable a feasible transition to a cleaner future. The ESG motivated efforts to artificially suppress supply of oil and gas while the underlying demand for energy continues to grow may actually lead to an energy crisis.

I stated in the copper strategy article that only 3% of the current metal use goes into the renewable transition. Similarly, only about 2% of all the automobiles in the world are electric. We should not be misled by the high valuation of the renewable energy themed stocks to begin thinking that the cleaner future is nearly here. No, humans will be living with growing usage of fossil fuels for much of this decade and maybe longer, to power the transition of energy consumption as well as the post-Covid economic recovery. Premature and drastic abandonment of the existing hydrocarbon production capacity may actually extend the 2021 oil price rally.

Green Capex Boom Increases Energy Demand

I started driving a Tesla a year ago and found my electricity bill jumped 20%. In order to enable society's transition to renewables and electrification of transportation, the world will need more energy in the process. Producing all the solar panels, wind power generators, and EV batteries will require more materials and higher energy consumption. Thus, before oil hits peak demand, we may yet see a higher demand curve pushing on an inelastic supply as a result of years of cutback on oil production capacity.

The following chart 1 shows the estimated producing capacity for OPEC and US shale oil rig counts. The supply curve is down but the forward demand is expected to continue growing. The energy market is set up for an unexpected demand crunch, which will come from the synchronized global post-Covid recovery in 2021-2022, and sustained green capex as nations race to lead the global green energy revolution. Chart 2 shows the world's largest oil companies declining value of proven reserves implied in the stock prices.

Chart 1. Estimated oil producing capacity by OPEC and US

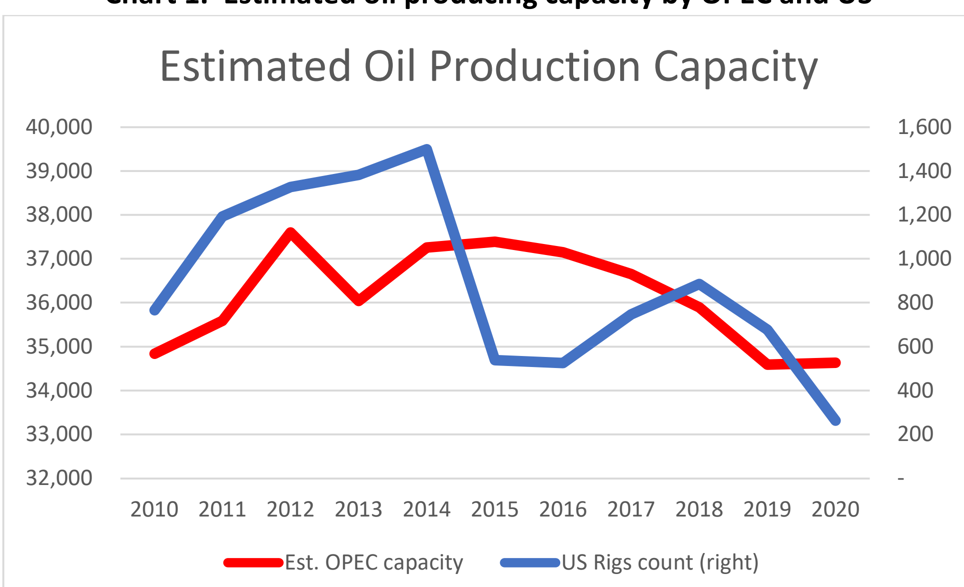
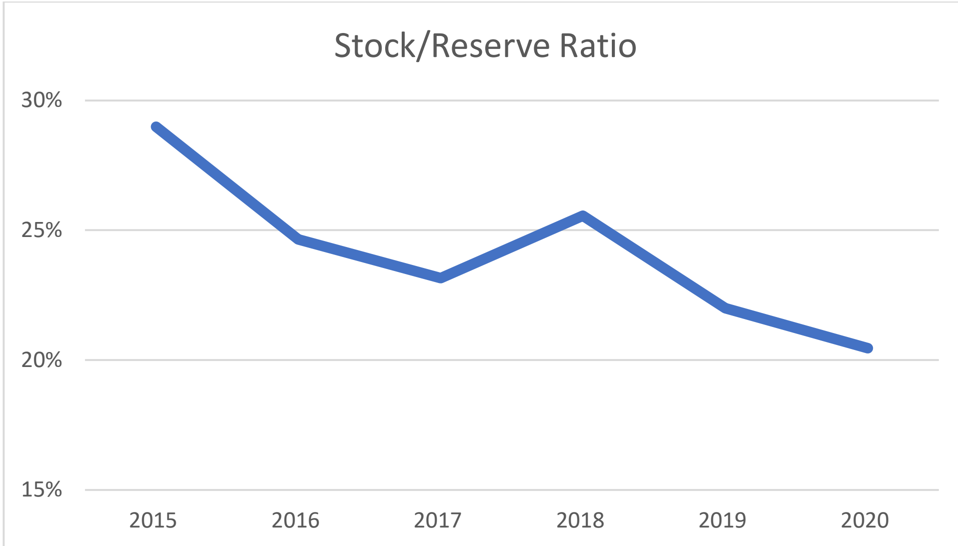


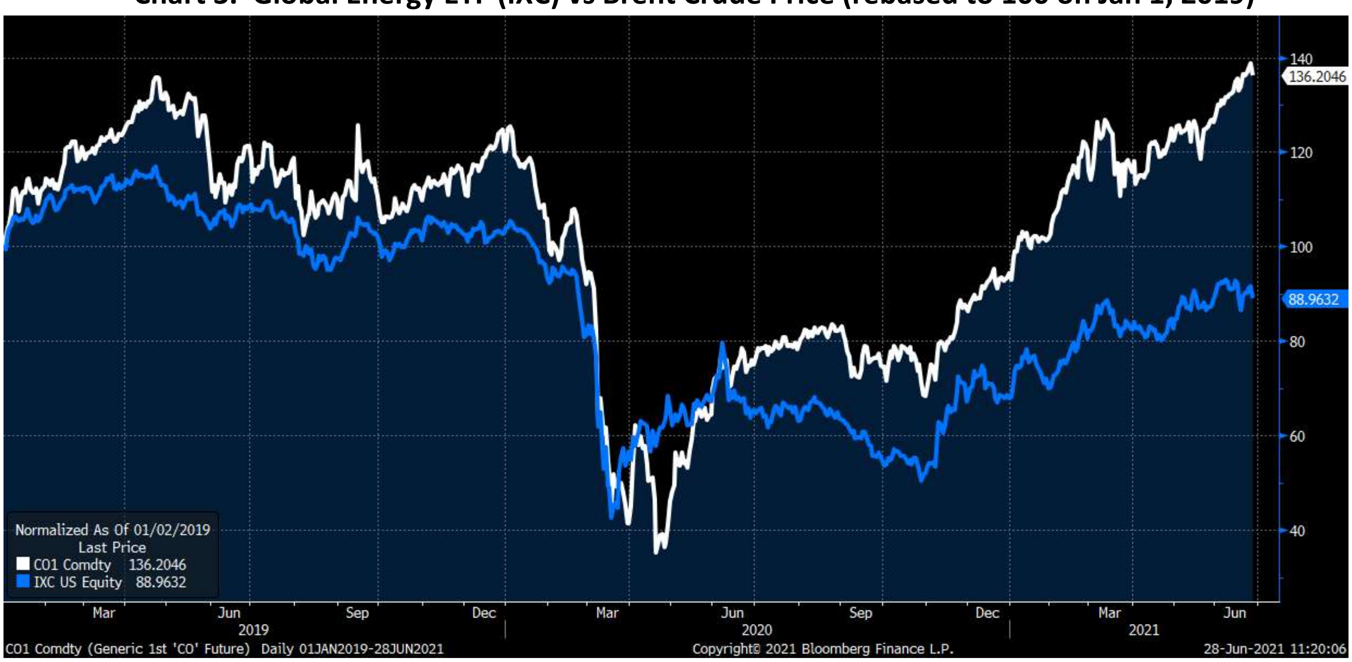
Chart 2. Big Oil Companies Market Capitalization to Proven Reserves Ratio



Traditional Energy Sector Still Cheap

Despite the recent price rally, the oil companies are still trading at 12% below the level at the start of 2019, even though the oil spot price has fully recovered to the high point of 2019. Compared to the crude price, the oil producers are lagging by almost 50% on a relative price basis. This discount is likely due to the investors' worry about long term viability of oil as renewables are expected to take over. This is the arbitrage thesis for my bullish view on this sector.

Chart 3. Global Energy ETF (IXC) vs Brent Crude Price (rebased to 100 on Jan 1, 2019)



The Path Forward As I See It

It's worth repeating that climate goals are to be adhered to, if we are to have a chance of decarbonizing our global economy. What I don't agree with regarding the current practices is the supply suppression strategy, advocated by misguided ESG ideas. Guided by free market principles, I see higher energy prices inclusive of carbon taxes to be embedded in fossil fuels as the best tool to converge demand with sustainable energy supply.

As a conclusion, I see a necessary "Green Inflation" to come as a result of fully pricing carbon in all the commodities. By green inflation, I mean higher prices for copper, oil, gas, and a host of inputs necessary to drive the energy transformation over the next decades. As a consequence, both copper miners and Big Oil will benefit from the initial wave of price increases necessary to incentivize more production, so that the renewable transition can succeed. Higher cost push inflation for "green enabling commodities" will also recalibrate the society's demand for the right kind of energy to meet the supply of the new sources of energy.

My deductions lead me to predict a bull market for commodities to go on until the middle of this decade. When we look back at this period, we may call this the Green Commodities Supercycle, which is a period of higher inflation that is necessary to pay for the energy transformation.

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