OGIB BULLETIN #164 - March 30th, 2015

TRADE IDEA
SHORT USO-NYSE
THE ETF THAT FOLLOWS WTI

Here is a very counter-intuitive trade idea. It follows in my 2015 themes--
1. small bets
2. NOBODY knows where oil prices are going
3. but generally, US production stays a little bit stronger for a little bit longer than the Market expects

This morning I shorted 1000 shares of USO-NYSE at $17.13.

The two largest energy ETFs in the United States are **USO-NYSE** (for oil) and **UNG-NYSE** (for natural gas). They are both sponsored by United States Commodity Funds, LLC.

They are very simple and deeply flawed ETFs—which makes them great shorts in this kind of oil market where there is steep contango in the futures curve. It reduced downside risk to almost zero and sets up a great opportunity to profit big from a small drop in the price of oil.

USO (whose official name is United States Oil Fund LP) tries to mirror spot oil prices. But they don't own any physical oil--ever. What they do is—buy futures contracts, and then roll them over each and every month. They even publicize when they sell the existing month's contract (the *front month*) and buy the next one (*second month*).

They do this because the sponsors make money on the volume of the fund's units, not how well oil does or how well their fund accurately follows oil. That's a good thing for them, as the fund is horrible at mirroring oil. *You see, they actually WANT you to short their product—because it's just volume.* For any of you that have any moral hiccups about shorting, this is one time you can put them down.

And their publicity and transparency around this issue allows investors to "game" the roll as well.

I think this is a good trade right now because the high contango in oil prices now—where the price of future months is higher than the spot price--mitigates the fund's value moving up if the oil price abruptly turns north. And if the price of oil goes down, the contango increases the amount/speed at which USO's value declines (which is more money in my jeans).

In fact, you will be surprised (because I was) to learn that USO underperforms against oil the worst when oil prices start to move up. *In fact, as spot crude prices increased over 110% from the end of 2008 to the end of 2010--USO increased by just 17.8%.* That's what I call downside protection!

It makes for a compelling short scenario, and USO is very liquid. It only costs 1% to borrow the stock for a short.

CONTANGO 101

I'm going to try to keep this very simple. In the futures markets—which both producers and now speculators use to guess the future price of many things, there is contango and backwardation. Contango is where prices are higher in the future, and backwardation is where they are lower. Backwardation is considered bullish, and contango is considered bearish.

In a chart form, contango makes for an upward slanting curve left to right. Backwardation creates a downward sloping curve.

USO must sell its current front month contract before it expires (because it does NOT want to ever take physical delivery) and buy the next month's contract. In a contango market like there is now—where the second month out is more expensive—by definition USO is selling low and buying high. That loses value for unitholders.

WHAT'S HAPPENING NOW

My (somewhat limited) research shows that so far in 2015, front-month WTI crude oil futures are running at a 2.28% average discount to second-month futures. And USO has underperformed the front-month WTI crude oil

futures price by 5.70% in the first couple months this year.

Historically—over the past five years—front-month WTI crude oil futures have traded at an average discount of .44% to second-month futures.

That has resulted in USO underperforming spot WTI crude oil prices by just under 6% the last five years. (Since USO inception it's just under 13.5%).

What could make this trade special in 2015 is the much steeper than average contango that exists now.

Futures prices are now suggesting the USO will underperform front-month crude futures by 3.5% over the next month and average roughly 2.25% per month through year end.

And the contango could go higher, which makes this an even better trade.

Ironically, it could happen if oil starts go up, as speculators jump into the oil futures market in a big way and buy a big speculative long position. That actually protects the short trade even more.

But certainly, if the WTI oil price spikes up--and quickly--USO will still go up. As it sits now though, oil has to go up 3-4% a month for USO to go up in this steep contango market. A bull rush into oil would steepen that curve and increase the cost of the roll for USO, dampening performance.

There have been three years where spot WTI crude prices increased by more than 10% (2007, 2009 and 2010) and shares of the USO underperformed spot crude prices by an average of 30.54% these three years.

The reports I read suggest that WTI (which is what USO follows, not Brent) could go to $60 a barrel through October (it's about $48.50 now) and USO would be flat. That's with USO losing 3-4% each month*, compounded*.

If WTI goes to US$35 by October, USO could go as low as $8—a double from here at $17.13. And there aren't too many risk-reward trades like that in the energy market these days.

	USO Share Price Scenarios - October 2015								
	0.00%	1.00%	2.00%	3.00%	4.00%	5.00%	6.00%	7.00%	8.00%
$ 70.00	24.74	23.06	21.48	19.99	18.59	17.28	16.04	14.89	13.80
$ 65.00	22.97	21.41	19.95	18.56	17.26	16.04	14.90	13.82	12.82
$ 60.00	21.21	19.77	18.41	17.14	15.94	14.81	13.75	12.76	11.83
$ 55.00	19.44	18.12	16.88	15.71	14.61	13.58	12.61	11.70	10.84
$ 50.00	17.67	16.47	15.34	14.28	13.28	12.34	11.46	10.63	9.86
$ 45.00	15.91	14.83	13.81	12.85	11.95	11.11	10.31	9.57	8.87
$ 40.00	14.14	13.18	12.27	11.42	10.62	9.87	9.17	8.51	7.89
$ 35.00	12.37	11.53	10.74	10.00	9.30	8.64	8.02	7.44	6.90
$ 30.00	10.60	9.88	9.21	8.57	7.97	7.41	6.88	6.38	5.92

Generally, I don't like investing in ETFs. It's the only gambling there is in the Market. But the features of USO and the oil price structure today skew the risk-reward greatly in favour of a short trade now.

Oil storage congestion is expected to peak in late May-early June, so that could be the time for me to close out the trade if I enter it this week.

OTHER MISCELLANEOUS THOUGHTS

Now, as for the UNG—Natural Gas ETF: The contango isn't as great so it's not as good a trade IMHO.

By the way, I would repeat here that I'm not as bearish on natural gas as I was before. I touched on this during the conference call. There are a few groups calling for a peak in Marcellus production this year—a couple

as early as this summer. The Marcellus is only responsible for just over half the natgas growth in the US. And given there is a 1000 (one thousand) well backlog in the Marcellus now, production could likely be sustained at current 18-19 bcf/d for at least a couple years.

But of course, investors must remember (just as in oil) how quickly these wells decline. So if I do short UNG, I may consider a paired trade where I'm also long a high-beta gas stock like **Chesapeake (CHK-NYSE)**.

When doing a paired trade like this I don't want to own the best natgas stocks, like **Cabot (COG-NYSE)**, I want the highest beta without sacrificing too much quality.

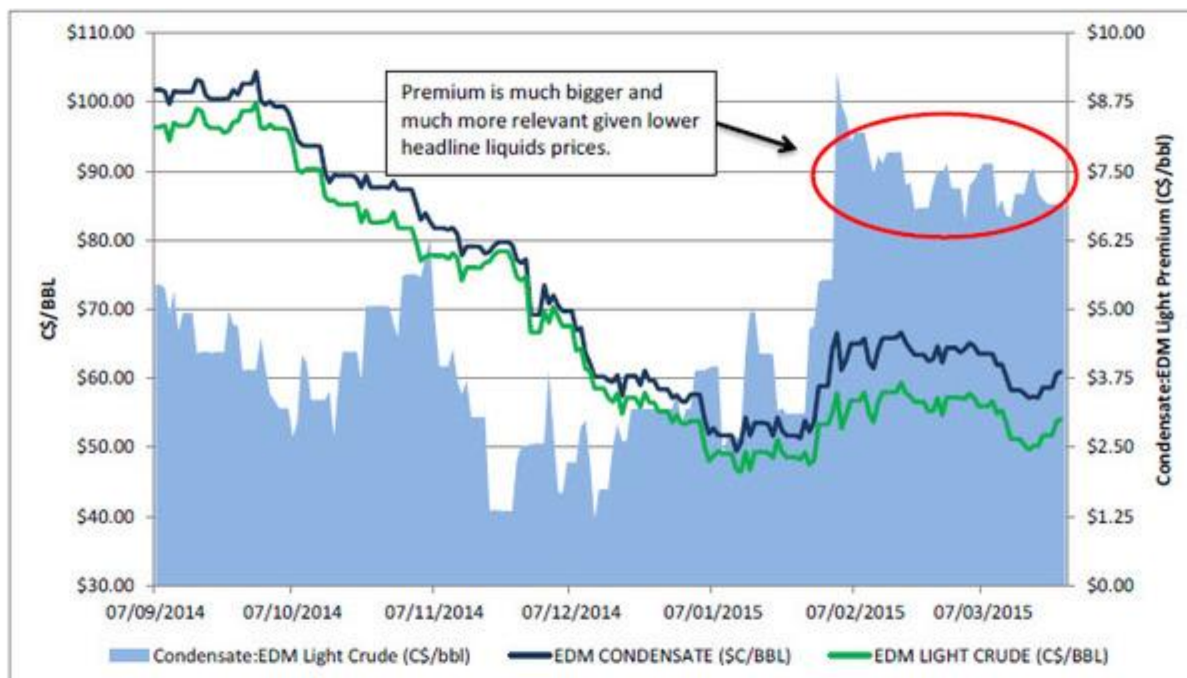
For that reason, this doesn't really change my mind about buying gas stocks right now. I'm thinking natgas stays slightly above $2 ($2.10-$2.25 mcf ???) vs. spending time below $2.

In Canada however, I still think gas could trade down to below $2/mcf due to transportation costs and being at the far end of the pipe. The Market also knows this (my calls suggest that Calgary is pretty universally bearish on natgas this year)--so why are Canadian natgas stocks still trading really well--with historically high multiples?

One reason is the low Loonie, but another is that most of the leading natgas producers in Canada are what is called liquid-rich; they have lots of NGLs, or Natural Gas Liquids in their production. And as I have written many times (subscribers should be well trained by now in this mantra...) condensate, or C5, is the only one that has held its pricing power.

Think of condensate as a heavy gas or a light liquid--it's around 50 API. It is very versatile, but in Canada is used to dilute the heavy oil going into pipelines. I believe producers use as much as 1/3rd condensate in their heavy oil to get it to pipeline spec.

It has traded within a couple dollars of oil for most of the last few years, but now is trading at a significant $7-8/barrel premium. See this chart from Canadian arm of brokerage firm Raymond James:



Source: Bloomberg, Raymond James Ltd.

A $2/barrel difference on oil at $90 oil is just over a 2% difference. At CAD$60/barrel that $7.50 or so is a 12.5% difference--huge.

That still doesn't make ME want to go out and buy Canadian liquid rich natgas stocks, but it does help explain why they're trading so much better than I think they should be.

On other miscellaneous notes, I have been trading calls with **Powder Mountain CEO Bruce Murray**. One well hit, and one didn't on their initial foray into that SE Saskatchewan ground.

-Keith