postcards *from the florida republic*
An independent and profitable state of mind.

Tuesday, September 12, 2023

SL: The Oil Counternarrative

Garrett Baldwin
Financial Adventurer

Dear Fellow Expat:

I'd prepared a screed on our Department of Energy. The incompetence at the top. The mismanagement of oil output in America.

And how we'll probably screw up what might be the largest global lithium deposit discovery.

But that must wait until tomorrow. There's something FAR more important… RIGHT NOW…

As you know, I'm VERY bullish on the long-term prospects of U.S. oil producers, particularly in the Permian Basin of Texas. When the EV and "greenfication" experiment falters in five years, we'll be begging U.S. producers to drill more oil wells and pump crude.

Index Momentum

S&P 500	**RED**
Nasdaq	**RED**
Russell	**YELLOW**

But today's (September 12) price action in oil worries me that this frenzy may soon pause. If that's the case, I want to urge caution and tell you exactly how to protect your long-term investments in the energy sector.

We'll talk about the fundamentals, the technical rules to follow, and the trade.

But fair warning… there's volatility ahead.

Facing the Fundamentals

Momentum is Red or Yellow across every S&P 500 sector except for energy. This is a big warning sign to me – as it suggests that funds and traders are trying to squeeze every last dime out of a very crowded oil trade.

The headlines are HYPER bullish on oil right now. Forecasts now call for the tightest global supplies since 2007. We're back in speculative alarms around oil pushing the $120 or higher levels.

Forgive me, but I've seen this story before.

I've seen these wild forecasts. I've seen crude projections to one side, only to watch oil sell-off in a surprising momentum drop that fuels a $10 dip in one or two weeks.

Today, oil prices pushed higher on a big momentum move.

As you know, I measure every sector on Equity Momentum.

Energy has been red hot for two months. It's been nearly 60 days of pure gains. And today, the number of energy stocks in breakdown territory hit… Zero… for a short period. This means money is primarily flowing one way.

That flow typically aligns with a brewing top in the market.

This could not be a more crowded trade.

Price Action and Fund Positioning

Despite higher oil prices, the October Gasoil Low Sulphur contract (LFV23) sold off today. That's interesting.

But we have a few other things happening. First, diesel markets remain tight now, so we've seen robust moves from **Valero (VLO)**, **Phillips 66 (PSX)**, and other refinery names over the last few weeks.

It's hurricane season – leaving everyone in the Gulf Coast on edge. But it's also a period of increased maintenance. (*Meanwhile, Nigeria's refining capacity has collapsed*.)

U.S. capacity will all come back online relatively soon. In addition, Europe's refining capacity will expand this fall largely thanks to a quiet maintenance season in August.

As we move past Labor Day, we will also start to see a switch from summer gasoline blends to winter blends.

Hedge funds aren't interested in that narrative.

They’re focused on the ongoing depletion of U.S. crude supplies – particularly in the Strategic Petroleum Reserve (SPR). They’re also playing the story of longer support for production cuts from Saudi Arabia and Russia.

But people aren’t focused much on Russia’s oil story. Russia has been reducing exports and keeping more crude domestically. By keeping lots of crude home, that has reduced costs for diesel for its agricultural harvest AND to keep costs low at home.

Russia’s still pumping crude through every pipeline to China and getting as much moving through the Arctic as possible to continue financing its war.

So hedge funds are very long crude right now. Alongside other money managers, they purchased roughly 98 million barrels of futures and options for the week ending on September 5.

We’ll get an update on their holdings on Friday in the Commitment of Traders report (based on data ending today).

Funds are increasingly bullish – sitting net long about 405 million barrels right now. That’s up from June when no one wanted to touch crude before OPEC’s cut commitment.

Meanwhile, short positions are collapsing. On U.S. NYMEX West Texas Intermediate contracts, shorts are net 30 million barrels, down from 136 million barrels in June.

The short covering is nearly over.

Our Buy and Sell Rule in the Republic

What’s our rule in the Florida Republic?

Buy on the sound of cannons… sell on the sound of trumpets.

There are reasons to listen for the trumpets based on various conversations I’ve had in the last 24 hours.

And look to the technical.

If you’re looking to understand the current condition of U.S. oil equities, there are four technicals that you should follow around one specific fund.

Now – this will be a little wonky. And it’s a little technical.

But I’m showing you an institutional fund used extensively for leverage and hedging among sophisticated traders.

I follow the MicroSectors U.S. Big Oil Index 3X Leveraged ETN (NRGU).

The NRGU aims to provide investors with returns that match triple-leveraged exposure to the underlying performance of the Solactive MicroSectors U.S. Big Oil Index.

The Solactive MicroSectors U.S. Big Oil Index tracks the performance of the ten largest oil equity names in the U.S. markets. Rather than focusing on the overall overbought and oversold metrics of one equity like Exxon Mobil (XOM), this gives a clearer understanding of the biggest players in the U.S. oil industry.

Please pay VERY close attention to the Daily reading for the MACD. The MACD line is in the chart below. Look at the price action on this ETN when the black line falls under the red line.

Look at December 2022, late January 2023, mid-April, and a recent decline to start August. Another negative crossover is coming… We can use other technical metrics to determine a trend…

26.339648, -81.77899

We can see that oil equities are approaching overbought levels by looking at the Relative Strength Index (RSI) and the Money Flow Index (MFI).

We are witnessing an end to short covering.

And we're ripe for a pullback at some point from broad speculation. It doesn't mean that it'll happen in the next 24 hours. But keep a very close eye on the MACD.

But I want to show you what can happen in a negative momentum environment when energy sells off.

Let's Go Back to June 2022

The sentiment is very similar to what happened in June 2022.

Energy stocks were surging. Speculation suggested that oil could surge to $150 per barrel as the war continued.

But then something happened. A pure risk-driven selloff that saw oil stocks collapse. Look at the S&P 500 Energy Select ETF (XLE) performance.

The XLE topped out north of $92.50 on June 9.

Equity momentum turned negative on June 8. The energy sector turned negative (as did the MACD) on June 10.

The XLE plunged from $90 to $70 in two weeks.

Be alert. When energy sells off… it can happen fast.

How to Protect Your Energy Stocks

Energy has experienced a tremendous run since the start of June 2023. That movement aligned with sharp cuts by OPEC+ and large quantitative easing efforts by the Chinese Central Bank.

But we're in a very odd situation with the state of the global economy. Liquidity is choppy, U.S. interest rates MUST move higher (as high as 5.5% on the 10-year), and the U.S. government is facing big hurdles to refinance upwards of $7 trillion in debt in the next 14 to 16 months.

I continue to advocate that *investors* with a long-term focus invest in energy names as if oil will trade somewhere around $75 for the next two years.

If you have several energy stocks – consider going out for a few months (into February or March) and selling calls on top of existing positions. Sell call options 15% to 20% higher in the strike price than the current underlying position. The worst case is that the stocks rally even further and pass the strike price. Then, you'd have to sell at a profit.

If you're more of a trader, you can sell calls on existing positions, and set stops on your oil stocks. If you stop out and momentum remains negative, you will always be able to buy back great companies at a lower price.

It's all about knowing yourself. Here at Postcards, I'm trying to provide you with the best assessment of current events.

I'll let you know if and when the oil sector turns negative.

In addition, keep in mind that our new letter that will launch later this year will include that energy reading every morning.

Stay positive…

Garrett Baldwin
Secretary of Finance
Sign Up on Substack