



The Strong Will Survive

SYNOPSIS

- The energy sector has been a major source of volatility in the equity market over the past 18 months.
- Only the strong survive in the wild, and the same applies in the business world. Too many weak oil producers exist and must be eliminated.
- Expect bankruptcies and acquisitions in the energy sector to ramp up, but keep in mind that it's a good outcome for the industry and our economy.

I NEVER WATCHED THE LION KING

Despite heavy resistance to my wife's suggestion of a safari for our honeymoon last year, I ultimately caved and subsequently spent a full day flying to the other side of the world to what I had initially assumed to be nothing more than a fancy zoo.

I don't get along with Mother Nature at all, so the notion of spending my honeymoon in a locale where bees can sting through Kevlar and spiders are regularly confused for livestock, did not resonate well with me.

I kicked and screamed for months leading up to our departure, but after finally arriving in the "bush," I quickly realized that I had never been so wrong. The trip was life altering and came back with two very important lessons learned: (1) push my boundaries and (2) there's no upside from arguing with my wife.

On our very first drive, we approached a pride of lions, patiently hunting an injured cape buffalo that had fallen back from the rest of its herd. Two female lions eventually made their move and attacked not 50-feet from our vehicle.

Words cannot explain the exhilaration of watching this hunt go down, so I won't even try. However, our

excitement did not last long because watching an animal endure that amount of pain became very real, very quick.

After a few minutes, I tapped Nick, our guide, on the shoulder and asked him to leave because neither of us could endure another minute of the gore. Before starting the engine, he took the time to explain to us the importance of this hunt because it was clear to him that we were missing the big picture.

Ultimately, the weak will not survive.

The lions get food and live to fight another day. Weak buffalo are eliminated, which helps the gene pool by leaving only the strong to mate. The ecosystem benefits from the predators controlling the buffalo population, since these grazers eat most of the grass and plants.

This entire process ensures "harmony" in nature, where balance is achieved over time. For example, if lions were eliminated, then the buffalo population could explode and damage the land from too much grazing.

Armed with the proper context, my wife and I were then able to properly assess the situation. What initially seemed gruesome became a matter of fact, and this frame of mind changed the way we viewed the predators and the pervasive cruelty in this environment.

THE JUNGLE BACK HOME

Earlier this week, I took a break from researching global energy markets to look through a few of the photos from the honeymoon. One of my favorite shots is below, courtesy of my wife's phenomenal timing with a camera (he is approximately eight feet from our vehicle).



Source: My camera

As I returned to my work, I could not help but juxtapose the current state of the energy sector to my time observing the savage brutality in the wild. Doing so led me to the inexorable conclusion that the oil market is quite similar to the bush.

Sound crazy? Perhaps, but let's rewind the clock back to when oil prices were well north of \$100/barrel. Oil producers were making a killing because nearly all known oil reserves were profitable with crude selling above triple digits.

An ample food supply attracts predators, and potential for big profits does 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.

Fast forward to today, and this huge flood of supply has far exceeded demand and caused oil to crash. Times are now tough, and natural selection is the only force that is capable of bringing harmony back to this sector.

Investors have been frantically analyzing companies to separate the strong from the weak. The strong are those with seasoned and disciplined managers, diverse operations, and relatively sound financials. These companies represent the smarter and healthier gene pool.

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

Ultimately, the weak will not survive. The cruelty pervasive throughout financial markets will not allow them to remain in business. Some will file for bankruptcy and others will get acquired by the strong, but in any event, they must go before order can be restored.

Although this unavoidable outcome may sound as harsh as the fate of the wounded buffalo, it's just as important to establish balance in financial markets as it is in the wild.

IMPLICATIONS FOR INVESTORS

Why was Nick's perspective so much different than ours? How was he able to watch such a brutal act of violence, thinking that it was completely natural, even indispensable to the bush?

Nick had been a safari guide for over a decade, witnessed hundreds if not thousands of kills, and earned university degrees in animal behavior. He was not only trained, but also carried the experience to know how to properly assess the situation using logic rather than emotion.

On the other hand, we arrived in South Africa with no experience or training. In the absence of perspective, the unfamiliar violence triggered the instinctive response of fear and compassion. We had nothing else at our disposal.

Believe it or not, the very same human behavior is pervasive throughout financial markets. For example, think about how most investors will react to the news of a bankrupt oil company. Bankruptcy carries a negative connotation and can instill fear, particularly in a sector that has been hit so hard for so long.

The media will only make matters worse because they love to sell to these emotions. They will invite the fear mongers on their programs to talk about how this is the beginning of the end. Emotions will soon run high and cause many to make poor investment decisions.

In order to avoid this emotional trap, remember two very important facts once the headlines become plastered with bankruptcies and acquisition announcements:

1. **The Problem Is Getting Fixed:** The volatility is a result of the uncertainty around which producers are weak and which are strong. Once more clarity arrives, volatility and prices should stabilize as the market rebalances.
2. **The Strong Get Stronger:** Those who are buying the weak are also the ones using technology and operational efficiencies to drive down their cost of production. As the cycle turns, these players will emerge far stronger than when they entered.

Those who panic will do so because they will be unable to see what is really happening. Don't fall victim to the same behavior. Remember the story of the buffalo and why it's so important for these failure to happen.

The bottom line is that oil is not going to zero, and investors should welcome this impending wave of bankruptcies in the energy sector because it will likely signal the beginning of the end to the short-term pain that the sector has inflicted on the broader economy for the last 18 months.

Sincerely,



Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com

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