A Market Note: Eternal Recurrence… (Wheat, CTVA, USDCNH, NORAM.OSL)

On January 20, 1940, Winston Churchill gave a war broadcast and spoke the following:

> *Only Finland-superb, nay, sublime-in the jaws of peril-Finland shows what free men can do. The service rendered by Finland to mankind is magnificent. They have exposed, for all the world to see, the military incapacity of the Red Army and of the Red Air Force.*
>
> *Many illusions about Soviet Russia have been dispelled in these few fierce weeks of fighting in the Arctic Circle. Everyone can see how Communism rots the soul of a nation; how it makes it abject and hungry in peace, and proves it base and abominable in war. We cannot tell what the fate of Finland may be, but no more mournful spectacle could be presented to what is left to civilized mankind than that this splendid Northern race should be at last worn down and reduced to servitude worse than death by the dull brutish force of overwhelming numbers.*

The Bulldog from Britain was talking about the Finnish military's unexpectedly successful repulsion of the Red Army's incursion into their homeland. Russia's invading force had been three times the size and *significantly* better equipped. The Soviet's top strategists expected the fight to last no more than a few weeks, tops.

Stalin's intent was to take over the country and install a puppet government that would allow him to expand Russia's borders, as he deemed Finland too close to Leningrad.

Russia justified the assault by staging a false flag, killing four of their own soldiers along the Soviet-Finnish border, and then pointing the finger at the Finns. They followed this up with claims that they weren't "invading" but rather coming to the defense of "democratic forces" against a "fascist military clique" in charge of Helsinki.

After being dealt a humiliating defeat in the initial assault, Russia regrouped, returned, and threw a lot more artillery, bombs, and bodies at the Finns, until they were forced to plead for peace. Russia gladly accepted as over half their force had been killed or wounded (exact figures are difficult to come by).

This skirmish was dubbed The Winter War and began three months following the outbreak of WW2.

Putin's army has spent the last few months regrouping. He's put his entire country on a war footing, mobilizing his full military and industrial base, as he prepares to kick off a much more aggressive offensive. Translation… a LOT more artillery, missile strikes, and conscripted bodies are about to be lobbed at the Ukrainians.

He's invading to expand territory with the hopes of installing a puppet government… having used a false flag attack and the justifications of needing to thwart "fascists" and "nazis… horribly misjudging a foe and suffering massive military losses as a result… returning with a lot more bodies and bombs to throw at the problem…

That Nietzsche guy may have been on to something with his whole eternal recurrence time is a flat circle idea, I don't know…

Anyways, the nature of this war is about to materially change. As in, it's about to get more conventional, more costly, and much more destructive as Russia does what it historically does, which

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is fight poorly and throw a lot of scared young men and artillery at the enemy until they submit through attrition.

The Russian military force in Ukraine is expected to swell to over 700k by Spring. As a point of reference, they invaded with a force of *less* than 200k amassed along the border.

Now that the late winter has finally brought frozen grounds in which to maneuver tanks and armored vehicles, Putin is pushing his military to get on the offensive and change the momentum of this war.

He knows his window of opportunity to strike with an advantage is closing, as Ukraine will be taking delivery of a number of new western armaments in the coming months. Ukrainian soldiers are in Western countries being trained on many of these now.

According to recent USIC analysis of troop positioning, it's likely the Russians are preparing for a large pincer movement, with the North flank moving southwest from Chernihiv and the southern flank kicking off from Kherson and Melitool, toward the Northeast.

The advantage of this type of movement is that it allows the Russian military to concentrate its forces and dictate the direction and tempo of battle, while the Ukranians are forced to be reactive and risk getting enveloped in the "cauldron".

This is where the West's promise of things like US Bradley Fighting Vehicles, Abrams, and German Leopard tanks, are going to come in handy. The key to countering a well-executed pincer movement is mobility.

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The Ukrainian military will want to disperse into smaller units, giving them more agility and a smaller target profile for the Russian side to gun after, thus turning many of the pincer's strengths into vulnerabilities.

Since this is a *Market Note* and not a *Military Note*, I'll end my mil-strat nerd session here. But, the point I want to drive home, is that this war is only getting started. And it's about to get a lot more violent and destructive.

So basically, expect escalation. Lots of it. On all fronts. Geopolitically, militarily, and economically.

Russia's announcement last week of its plans to cut oil production by half a million barrels is the first time Moscow has *pointedly* telegraphed a specific oil supply cut in response to Western measures. We should expect more moves like these in the coming year.

Welcome to the volatile world of the [Big Cycle] and [Panta Rhei, Extremus…]

Time to harvest…

Long wheat was one of our biggest winners last year. This was a layup as we were one of the few shops [correctly calling on the week] when the invasion would happen. Interestingly, wheat has reversed all of its post-invasion gains (chart below is a daily).

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Now, I don't know much about the fundamentals of wheat. Yeah, I know where it's mostly produced and who the biggest buyers are. But I don't track things like crop yields and weather patterns. I don't have an edge there and don't plan on trying to develop one. I'll leave that for others.

Remember, it's important to know what game it is that you're playing. And ruthlessly stick within those lanes, exploiting your known edges. It's more profitable that way and keeps you from getting run over.

Getting back to wheat, where we have a Trifecta setup.

Price broke out on Friday from a compressed sideways trading range (BB width at 20th percentile).

Sentiment and positioning are bearish with Net Specs in their 10th 5y OI adjusted percentile (orange line). Our Open Interest oscillator is turning up from the zero bounds, indicating returning interest to a dead market (note: the CoT data is from the end of Jan as the CFTC hasn't updated their positioning the last two weeks due to a ransomware attack, though they're expected to release this week).

Its valuation is in the 35th percentile and seasonality turns strongly supportive after this week.

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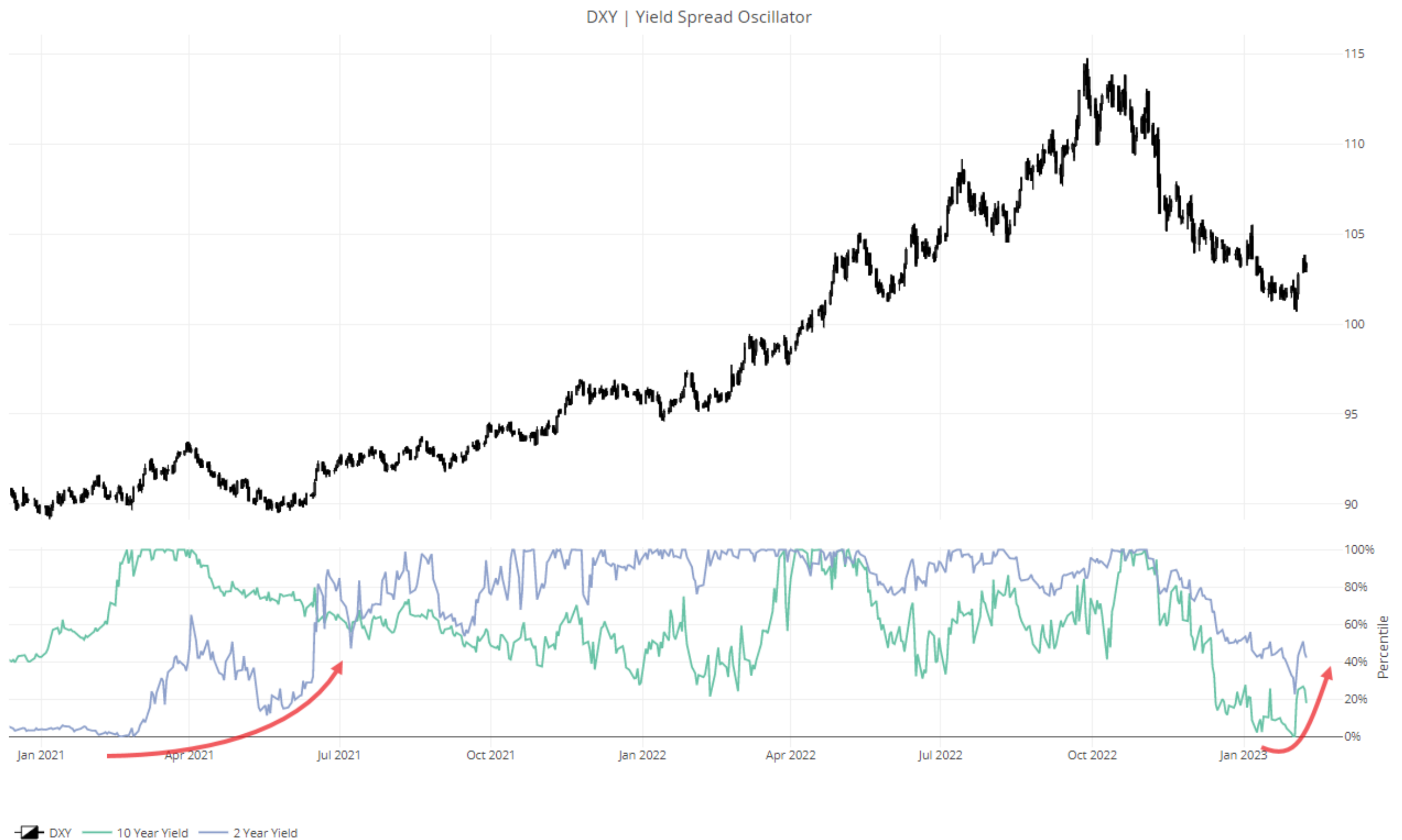
I should also point out that wheat is likely serving as a barometer of the Russo-Ukraine conflict. As the war intensifies, we should expect wheat to trade in kind. So we're interested in getting long wheat here (WEAT is an ETF alt).

We're also looking at some option structures on the large Agtech company Corteva (CTVA), which remains in a strong long-term uptrend and recently saw some sizable buying from their CEO.

We'll send out a trade alert with more when we make the trades.

Long, short, long again…

Long USD looks attractive to me for a swing. Specs are crowded long (82% 5yOIadj) in EURUSD. DXY's aggregate 2 and 10yr yield spread oscillator shows momentum is starting to pick up from low levels.



Long USDCNH here looks like our best candidate.

The pair is reversing up from a double-bottom base. Tensions with China are likely to escalate as tensions with Russia intensify throughout the year.

We were long USDCNH for most of last year. Then flipped short in the Fall. And now it looks like a

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good spot to get long again.

Stocks and bonds…

The bear call we made on Bonds three weeks ago (here and here) is still in effect.

All our leads on yields continue to point higher (see slide 15 in Trifecta Chart pack).

What's important here isn't the level, as much as the speed at which yields get to certain levels. If bonds sell off hard and fast like they did last Fall, then it quickly becomes difficult to maintain our bullish SPX stance, as rising yields will put the pinch on risk sentiment.

We'll just have to watch and see with that. But, in general, the data continues to confirm our thesis about a more resilient US econ and an overly bearish consensus. And while the market is slowly coming over to our side, it's still got a bit more ways to go.

We saw the shakeout in stocks that I said was likely last week in *Reality Distortion Field*. The SPX is near a level where it should bounce if this rally is going to continue. The evidence still leans bullish but, as I said, the rise in yields needs to be watched closely.

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Lastly, we took half profits on our long oil trade which quickly ran to our first target. We plan to sit on, and hopefully add to, the rest of the position if we get a confirmed breakout above its current sideways compression regime.

Speaking of oil, here's Brandon with a dig into an E&P we're thinking of adding to the books.

Your Macro Operator,

Alex

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Portfolio Intelligence Report (PIR): NORAM Drilling (NORAM.OSL)

Competition Demystified is one of my favorite investing books. Its supply-side analysis framework stands in stark contrast to today's analysts obsessed with "growth" and forecasting demand to the nearest decimal.

Towards the end of the book, Greenwald shares an interesting story about the gasoline additives business. He explained how an industry with these characteristics generated *exceptional* shareholder returns for those wise enough to look past all the hair (from the book):

- ➢ Commodity product
- ➢ Substantial overcapacity
- ➢ Demand guaranteed to rapidly decline
- ➢ Bad press and bad marks from government agencies, and public interest groups

The US Shale industry is having its 1970s gasoline additive moment. Investors – worried about production declines and increased offshore drilling activity – have abandoned the industry altogether.

The first part of this report dives deeper into the gasoline additives mental model. We then use that model to uncover a highly asymmetric opportunity in NORAM Drilling (NORAM.OSL).

The debt-free onshore drilling company owns 11 super-spec rigs and specializes in the Permian Basin. NORAM currently trades at a 15% discount to replacement costs. This likely understates the actual cost of reactivating/building new rigs to meet increased demand. The company is a low-cost operator with around $16K in daily costs.

Here's the exciting part. NORAM is signing contracts at $30K+ day rates for ~$15K/day profit. The company has immense torque on oil prices. Higher oil prices could send day rates north of **$35-$40K/day.**

At a $40K day rate, the company would generate its entire market cap in free cash flow in <3 years while paying a 20%+ dividend yield along the way. NORAM has zero debt and spent the last few years upgrading its fleet. It has minimal capex requirements and can use the FCF to buy back stock and passive large dividends.

Finally, nobody is talking about this stock. Headquartered in Norway, it listed its shares on the Oslo Exchange, off the path for most US investors.

NORAM offers us an opportunity to buy a **simple-to-understand asset at a 15% discount to the replacement cost** with a **legitimate path of generating its entire market cap in FCF over the next three years**.

It's possible that the company signs >$40K day rates and generates over $100M in annual FCF. At a modest 5x FCF multiple, **the current price represents >100% upside price appreciation and a 23% dividend yield** (assuming zero buybacks).

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Growth Is Overrated: How To Mint Money in Dying Industries

There were four leading players in the gasoline additives industry during the early 1970s:

- Ethyl
- Dupont
- PPG
- Nalco

These companies produced billions of pounds of chemical products (additives) and made decent profits. That all changed in 1975.

In 1975, the Environmental Protection Agency (EPA) started enforcing its 1970 "Clean Air Act." The regulation's goal was to slowly eliminate the need for gasoline additives in cars. In 1975, car manufacturers were required to install catalytic converters to reduce toxic emissions.

But there was a problem. The converters couldn't operate properly with the current additive-filled gasoline. It was a death sentence for the entire industry. Let's dive into the book (emphasis added):

> *"The billion pounds of additives sold in the mid-1970s was reduced to around 200 million pounds ten years later, and to almost nothing by 1996. Part of the drop came as cars sold before 1975 grew old and left the roads; part came from the regulations on grams of lead per gallon."*

Billions of production were reduced to nothing in two decades.

Here's the most crucial part of this entire saga and why I draw a comparison to today's oil and gas space (emphasis added):

> *"Barriers to entry are another story.* ***An insurmountable barrier protected the four firms in the business.*** *The EPA's regulatory announcement in 1973 posted an unmistakable 'Do Not Trespass' sign for any firms contemplating entering the lead-based additive industry."*

Sound familiar yet? Back to the book (emphasis mine):

> *"By putting the industry on a certain path to extinction, the EPA ensured that the existing firms would have the business to themselves,* ***to profit as best they could during the slow path to disappearance.****"*

External forces like the EPA set the death date for the industry. But instead of killing it, it gave the existing competitors a chance to milk their industry for every profit dollar possible.

The companies minted money in a dying industry by producing less, competing less, and focusing on maximizing profits over volumes (back to the book, emphasis added):

> *"Even when barred from using some of the specific tactics the additive makers had employed to curb their own competitive juices, they continued to be masters of the prisoner's dilemma game … The industry continued its mandated decline and the procured continued to earn*

> *money even as they sold less of the additives. In 1981, Ethyl's additive business accounted for 17% of its sales and 33% of its profits. Since the capital employed had no substantial liquidation value, the return on assets were extraordinary."*

Eventually, the industry shrank to just two competitors, Ethyl and Octel. They generated huge profits until the very end. For example, check out how good Octel's additives business was a few years before the industry died (emphasis mine):

> *"Octel remained in the business for one reason: it was highly profitable. In 1994, Octel earned $240M of operating profit on sales of $520M, a margin of almost 47%. All the rest of Great Lakes Chemicals [parent company] earned $162M on revenues of $1,480M, a margin of 11%. Great Lakes used its profits from the lead-based additives to make acquisitions, preparing for the day when the lead business would be entirely gone."*

Ethyl also generated supernormal returns from its dying "no growth" additives business (emphasis added):

> *"In 1998, after its additive revenues had declined to $117M,* ***Ethyl still made $51M in operating profits, a 44% margin****. The rest of the company had operating margins of 11%."*

Here's why all of that matters. The current US onshore shale industry resembles much of the 1970s gasoline additives industry. And if the remaining competitors play it right, they can enjoy supernormal profits until the dying end.

NORAM Drilling (NORAM.OSL): A Cash Cow In A Low-Growth Industry

NORAM operates 11 super-spec oil rigs in Texas's Permian Basin. The Permian is the US's number one oil-producing resource. For reference, the region makes ~5M barrels of oil per day versus the ~1M from the next closest area (see below).

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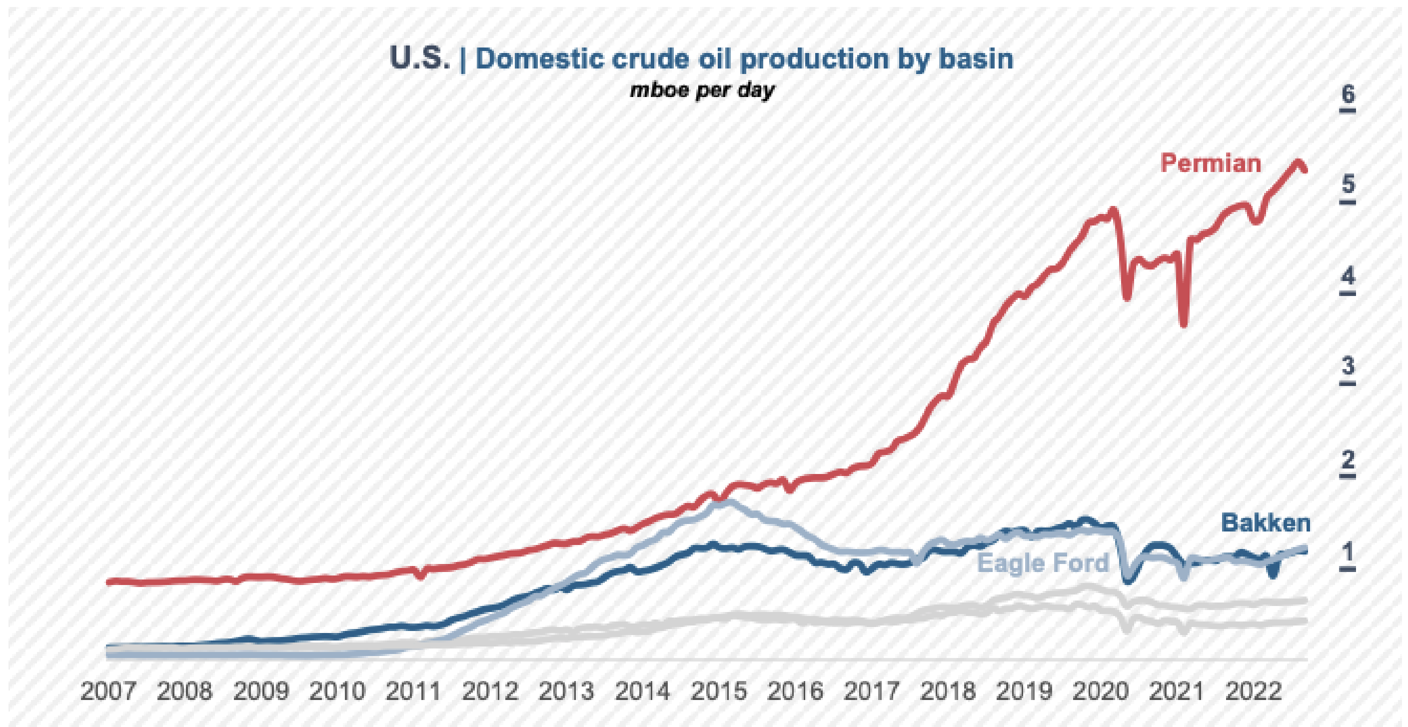

The consensus bet with the Permian is that they have enough supply to produce ~5M barrels per day for the next decade. However, one of my favorite oil investors, Shubham Garg, takes a different view. His take is that the Permian Basin's oil production will decline rapidly from years of overproduction during the 2014-2016 boom.

In other words, most oil investors expect a standard bell curve for production decline. Shubham sees production falling off a cliff (see below).

In response, oil investors are flocking to offshore space. They see the above production declines and think, "fuck that, I'm gonna go where there's growth and runway."

However, our variant perception is that decline rates don't matter because NORAM's structural advantages allow the company to gush cash even in rapidly declining environments. There are three reasons why we hold this perception.

Reason 1: NORAM Only Has 11 Rigs

NORAM is a small company that operates 11 super spec rigs. The company doesn't need substantial production levels to reach near 100% utilization rates.

If production does collapse, larger players will consolidate and deactivate rigs. In the meantime, NORAM can keep its 11 rigs running at 100% capacity, all at above-average day rates, due to supply constraints from their larger competitors.

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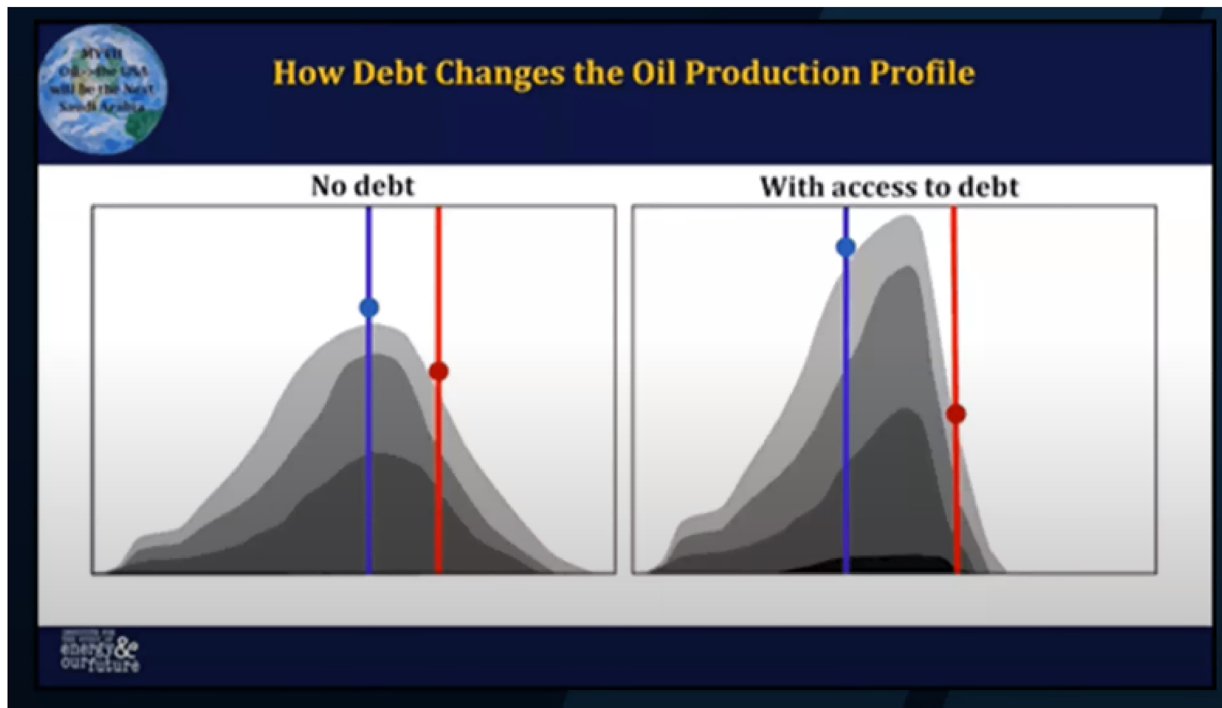

Reason 2: NORAM Already Upgraded Its Fleet

NORAM spent the last three years upgrading its rigs to meet the latest super specifications.

This enables the company to sign contracts at high day rates without investing in upgrades to keep the rigs operating.

Moreover, upgrades cost over $6M per rig. Such an investment requires higher oil prices to justify drillers spending that money.

Reason 3: No Labor Force Issues

NORAM's CEO explained in an investor presentation that the biggest issue in the oilfield industry is labor participation. He mentioned that (paraphrasing):

> *"The hardest thing we have to deal with now isn't the supply chain. It isn't driller capacity, it isn't the rigs.* ***It's labor.*** *It takes probably 25 guys to work one of our rigs. Out of those 25 people,* ***we need to interview at least 300 to fill those 25 spots****. And that's just for one rig. We're fortunate to have our labor in place and everyone working. I don't know how we'd do it if we had to find labor again."*

People aren't applying for drilling jobs. And why should they? Oil has been the social pariah of the last decade. Who wants to tell their friends they work for "Big Bad" oil?

As a quick recap, here are the three reasons why we think NORAM is well positioned to thrive in a declining Permian Basin environment:

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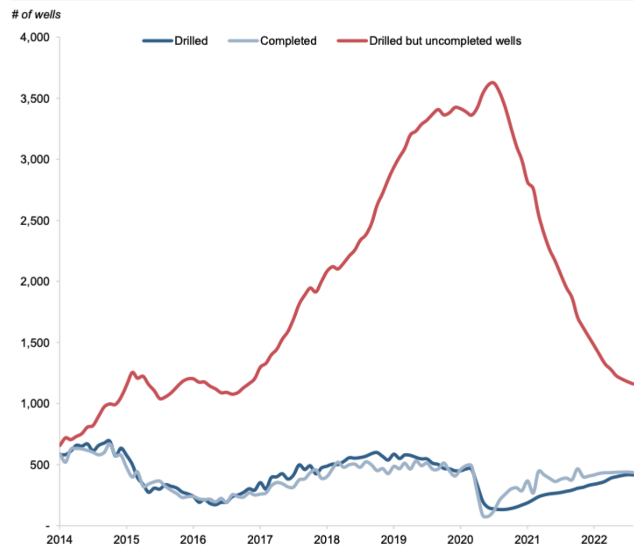
1) **NORAM is a small operator with only 11 rigs** allowing it to quickly reach max utilization rates
2) **The company already upgraded its fleet** and only needs to spend on maintenance capex
3) **NORAM has no labor force issues** and employs a full crew for each of its 11 rigs

The other significant factor is the Permian's need for increased drill activity. We see this through the region's declining "Drilled but Uncompleted" wells or "DUCs" (below).



To understand this chart, we need to define some oil lingo. After drilling, a "completed" well is ready for production (or injection).

As the chart above shows, the Permian is draining its DUC inventory. It will eventually need to either drill new wells or risk massively cutting production. Interestingly enough, a significant decrease in output from the Permian would be bullish for our long oil futures position. So we're hedged either way here.

At current DUC decline rates, the Permian will *need* to drill more wells to keep producing. Which will raise demand for drilling companies like NORAM.

The other option is that the Permian simply stops producing as much oil. Maybe there's not much high-quality drillable land left? Or offshore takes the baton and never looks back.

Even in that scenario, we believe NORAM can mint money as it can leverage its small size and minimal capex requirements to service whatever's left of production.

What else could harm our thesis besides a total Permian Basin collapse? **Overproduction**. Our variant perception, however, is that onshore drillers will steal a page from the 1970s gasoline additive companies to control production. NORAM's CEO explained this strategy on the investor call (emphasis added):

> *"I've spent over 25 years in this industry and have made tons of mistakes. What I am seeing now is something that hasn't been done too often in this industry. Oil companies are determined on reducing debt, paying dividends, and buying back stock. They are not using these profits to invest in more production and flooding the market with more barrels. That's just not where the money is going this time. This time it's going back to the shareholders."*

That could certainly change. But so far, the four worst words in investing ("this time it's different") seem to be true.

Thinking About Valuation

NORAM currently trades at a ~15% discount to replacement value (assuming ~$30M per rig). The company has a strong balance sheet with no long-term debt and operates at a near 100% utilization rate.

As mentioned earlier, NORAM has already spent the money to upgrade its fleet. With no interest payments, it is free to use all FCF to pay dividends (current yield of ~23%) and buy back stock.

Any contract NORAM signs above $30K/day is highly accretive. It will allow the company to generate its market cap in FCF within three years. The company noticed that more customers are signing longer contracts (usually a year, which in the onshore space, is a long time).

That might mean E&Ps expect significantly higher day rates and are willing to take the duration risk for a lower contracted day rate. If that is the case, NORAM is better off signing shorter-term, higher-value contracts since its nimble asset base can quickly move between projects.

The current stock price looks wildly cheap based on an optimistic view of oil looking out 12-18 months. We think $40-$50K day rates are possible, giving NORAM an equity value north of $550M or over 100% higher than current prices.

Portfolio Performance Update (as of 02/10)

- February: -2.19%
- Q1 2023: +7.05%
- YTD: +7.05%

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