Marble Harbor Investment Counsel, LLC
Excerpt from
Fourth Quarter, 2014 Letter

We are pleased to send an excerpt from our fourth quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, Suzanne Coleman, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

Against the prognostications of virtually every forecaster, the stock market had a strong 2014. The S&P 500 returned almost 14%. This caps a nearly uninterrupted run in the market since the Spring of 2009. By any measure, a long and strong bull market. Your stocks also did well, especially toward the end of the year, as investors moved away from riskier companies and toward businesses with more predictable prospects.

The reason for the poor record of pundits is that they are trying to predict outcomes within complex systems. It's easy for us to guess what might happen if we pour a glass of water into a puddle. There will be a splash, the water level in the puddle will rise, and perhaps a little more earth will get wet. We might speculate on other remote, but possible effects – perhaps a piece of sand at the bottom of the puddle will be displaced or the added water will help nourish a plant whose roots now touch the puddle. These "Second Order" effects are interesting, but the consequences of the extra water are minimal and tend to end here.

In complex systems, however, there is a "law" of unintended consequences. Given so many factors that affect, and are affected by, any action, a *comprehensive* prediction of what will happen when one thing changes is educated speculation. Over the past couple of years we have been experiencing just such a phenomenon. Through the discovery of huge "unconventional" oil and gas deposits, the US has been pouring millions of barrels per day (mmbpd) of oil and gas into the world's oil supply puddle.

We have been speaking to you about the development of unconventional oil and gas supplies for more than five years. That said, we didn't anticipate just how widespread the impact of this new source of energy could be. Petroleum production from these sources is prodigious and soon may put the US in a position to be energy self-sufficient. This is an enormous shift from even four years ago and one that no one predicted.

Unlike our simple water and puddle example, this new source of oil supply has meaningful and multi-faceted Second Order effects. It is influencing a huge swath of the global economy as well as the internal politics and international relations for many countries. We've engaged in many months of internal discussion and analysis on these topics, and this scrutiny has informed how we've been investing for quite some time. Because it's such a pervasive issue, we'd like to bring you into our conversation.

The slow progression toward an oil glut is a primary consequence. A few people (the new owner of the Buffalo Bills, for example) and regions (North Dakota) got rich through their exploitation of these new sources of oil and gas. Petroleum prices drifted lower, but remained at a healthy level, while oilfield service companies saw booming business. This was all against a backdrop of slow recovery from the Great Recession, which meant only slowly growing demand for energy worldwide. You'll recall we have discussed often the trend to "on-shoring" of factories back to the US. This has been in no small part facilitated by the lower cost energy available here.

Throughout the world there are countries that rely, almost exclusively, on oil and gas to pay the bills. These range from those familiar names in the Mideast like Iran, Iraq and Kuwait, to some perhaps more surprising ones like Norway, Russia, Qatar, Venezuela, Brazil and Mexico. In all of these places, something interesting happened – in response to our country's gradual trek toward energy self-reliance – they started acting in a manner that, while individually rational, is actually damaging to their collective best interests.

In the face of their own weak economies, and slowly dropping revenues from oil, they maintained production levels even while new supply continued to come on-stream. This behavior was recently topped off by Saudi Arabia's pronouncement that they would continue pumping oil, no matter the price level, which knocked a psychological prop out from under the price.

What are the implications? As we see it, there are manifold "Second Order" effects, and a handful of conclusions we can draw. First, moderate energy costs (not necessarily as low as today, but not very high, either) will be with us for a while. A number of energy sources come from projects that aren't easily or cheaply shuttered. Throw in the strong momentum behind new, alternative energy sources and continued conservation measures, and that suggests that energy costs will remain reasonable, absent a geo-political shock.

Second, economies that have relied on revenues from fossil fuels will be challenged. They have been reaping great benefits from this windfall for decades. In some cases, like Norway, Alaska, Qatar and Kuwait, long-term savings funds have been established to smooth out the ebbs and flows of oil wealth and to provide for future generations who will be born after the oil is gone. While they will be tested, they should do O.K. However, regimes like Brazil, Russia, Venezuela and Iran, who have lived hand-to-mouth, despite the oil riches, will have a much harder time and will be a destabilizing force in the world.

Third, intensive users of energy should benefit. These include the US, China, Malaysia, Singapore, Vietnam, Japan and parts of Europe. For these countries, the energy price drop is a nearly unalloyed benefit. Cheap energy has been associated with economic growth throughout history.

Fourth, capital and consumer spending will likely shift and broaden. This consequence will evolve over time. What we mean is that at first people may spend a bit more on things like holiday gifts, and companies a bit less on easily stopped oil exploration. As they become increasingly convinced that cheap energy will endure, we'll see spending patterns that reflect that expectation – bigger cars and trucks, bigger homes, more driving, trading-up to more expensive food and clothing (all of which should lead to an increased demand for oil, which can cause prices to rise…), and sharp cutbacks in the oil patch, (hurting Texas and North Dakota) alternative energy research (hurting Seattle, Silicon Valley, Massachusetts and China) and conservation efforts (hurting the environment). We'll also see more on-shoring, which will drive job creation for large numbers of high-paying, middle class jobs, but will also lead to wage inflation, resulting from sustained hiring and a shortage of skilled workers.

As you can see, "cross-currents" is probably the best way to characterize what we'll see. And so a grand, "Big Picture" pronouncement is unlikely to be particularly accurate. For us, we find more benefit in breaking it down to the individual industry and business level. We look at how cheap energy will change the environment your companies operate in and determine if it is likely to help or hurt them. In this way, we avoid the impossible task of predicting the unpredictable, and instead focus on what matters to our companies and ultimately, to you.

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