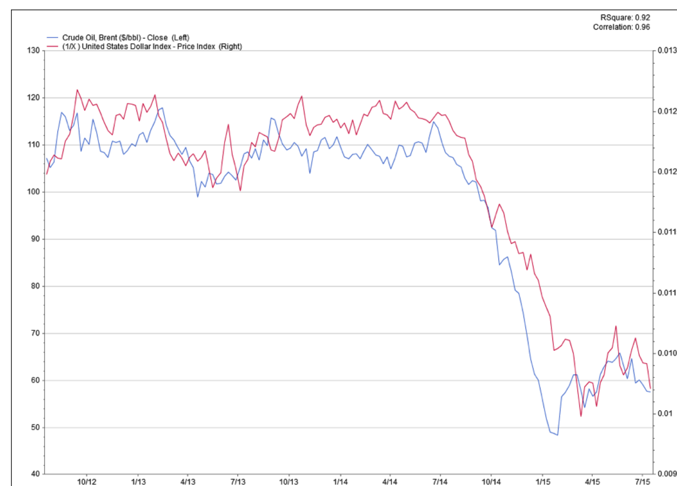
ENERGY OUTLOOK

REGIONS
INVESTMENT MANAGEMENT

July 2015

Figure 1: Brent oil (Blue) vs inverted Dollar Index (red, right axis) over 3 years



Source: FactSet, RIM

The announcement of the Iran nuclear deal had surprisingly little impact on oil prices. The deal may lead to an immediate increase in barrels sold out of floating storage. Iran already has about 40 million barrels on cargo ships waiting to be moved. However, a larger impact on oil won't be felt until Iran has time to ramp up production. This usually takes about 6 months or more for production from any additional drilling plans to be felt by the market. Thus, analysts are saying we could see an extra 500-800 thousand bbl/d (barrels per day) come out of Iran in early 2016 compared to where they are now. This number isn't anything too unmanageable by itself but the global oil market is already oversupplied by about 2 million bbl/d. Add that we are about to exit peak seasonal demand in August and the additional Iranian barrels become a negative data point.

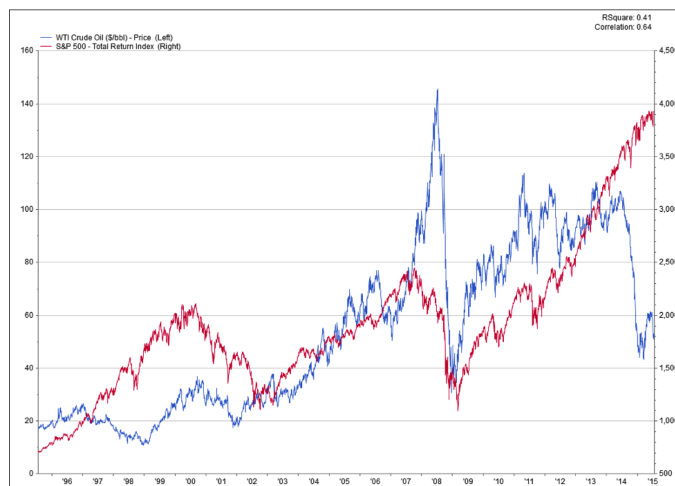
So how does this 2+ million bbl/d oversupply situation rectify? There are surprisingly only two options. Firstly by an increase in demand. In a time of peak seasonal demand, countries have been filling their strategic petroleum reserves, China most significantly, as oil is cheap. However, this merely pulls demand forward rather than serving as a lasting increase. Secondly, by a cut to production. But who would cut first? Surely not the Saudis who are currently ramping their production to its highest levels ever in order to preserve market share, or Iran who just got the green light to start ramping their production again. Not Russia, whose state owned Rosneft just pledged to increase production by over 1 million bbl/d by 2020. And much less would we expect a voluntary cut from any of the economically weaker OPEC nations who are struggling for funds as it is given where oil prices are now. So that really leaves the US, but our companies are driven entirely by profits. Which is to say, any company that can produce profitably surely will and will do so at the highest quantity at which they are able. Even the companies who can't produce profitably will continue to produce because debt is still cheap (for now) and oil prices are sure to go up again sometime down the line once we get past this bust right? Bust. That's an interesting term for a downcycle. Maybe they call it a bust because no one will cut production voluntarily so the down part of the cycle doesn't end until someone can't afford to stay in business? Or a lot of someones perhaps? Some Wall Street estimates show if the US were to lose 1 million bbl/d of unconventional production or about 1/4th of total volume that would equate to roughly 50% of the sector gone (bankrupt or consolidated). Recall that we are globally oversupplied by more than 2 million bb/d and rising.

Of course the fundamentals can say and do anything they want, but when oil has a three year 96% correlation to what the dollar is doing that's really a bigger driver (see Figure 1). If Greece/Eurozone further melt down and there's a big flight to safety drastically increasing the value of the dollar, oil is very likely going to go down regardless of what the supply/demand situation looks like. Conversely, if the Fed can overpower what Europe, China & Japan are doing and is successful in devaluing the dollar to protect our GDP growth, then oil prices will rise.

Sentiment among energy companies is that we're in for more pain before we get to the next upcycle – possibly a lot more. When we first saw the price crash last fall, we thought it would last until the supply/demand equation was fixed by some combination of bankruptcies and M&A at least in the US. Hindsight is starting to show that the rebound in oil prices earlier this year was more of a technical bounce related to short covering and currency moves and we are still not yet at the bottom of the cycle. Therefore, the expectation of M&A and/or bankruptcies is still in play. The commentary from oil company executives is also spectacularly unenthusiastic, implying we are still on the downslope rather than having bottomed. Specifically, the tug of war between service companies and producing companies is about to come to a head as we have heard several executives from services companies who were calling a bottom in their pricing.

Not the markets, but their price concessions to the producers. They are confident in calling a bottom to service cost pricing, not because demand is looking better but because service companies have cut pricing so far that any further cuts would mean they're running at negative cash flows. That's not something they're prepared to do. However, LOTS of producers are running at negative cash flows for a variety of reasons. Some need to pay towards their debt, others have drilling requirements in order to maintain their leases, a few may even be betting oil prices will recover soon enough that the negative cash flows are only temporary. Which is why any additional downswing in oil prices will likely lead to the carnage we were expecting to be necessary to mark an end to the bust part of the cycle. Wall Street commentary as to why oil prices have to rebound immediately remains to be exclusively because companies aren't profitable at these oil price levels and we need to see a move back to the $70-80/bbl range to be sustainable going forward. To us that is flawed and dangerous logic because it ignores the very real possibility of bankruptcy. No one on the Street has yet offered a rationale as to why companies can't or won't be going out of business to get us back on track toward a balanced supply/demand situation. Given where prices are and look to be heading we feel caution is very much warranted in the energy space.

Figure 2: WTI oil spot price in (blue) vs S&P 500 total return (red, right axis) over 20 years



Source: FactSet, RIM

As bad as it looks for a near term entry point, long term oil still looks like a great investment (see Figure 2). No one thinks we're going back to $10 oil we had in '99, but of course no one in '99 thought it would eclipse $140 in less than a decade either. This continues to be a boom/bust cyclical industry and unless you are truly a long term focused investor capable of completely ignoring the cycle and staying in the highest quality companies, timing is everything. ▲

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