Heartwood
Investment Management

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Investment Insight

Weekly Insight

Oil supply constraints should be supportive to energy equities

Global energy equities underperformed the MSCI World Index in 2017, despite a recovery in the oil price and steady earnings growth. Energy stocks have started to outperform more recently, rising in line with the more cyclical areas of the market. We believe that this trend can persist in the medium term based on the following drivers:

- **OPEC-led production cuts.** Crude oil prices have risen to a four-year high as the oil supply/demand imbalance has been redressed. However, the ongoing impact of OPEC cuts - agreed until the end of 2018 - is expected to lead to a shortfall in oil supply, which some analysts expect could last several years.
- **The lack of investment places further constraints on oil supply.** Balance sheet repair following the oil price collapse in 2015 has led to the oil majors restraining their investment in new projects. This, together with OPEC production cuts and rising global demand for oil, should limit supply and thus add support to the oil price.
- **Saudi Arabia's political will to maintain a high oil price: "If we have to overbalance the oil market…then so be it" (Saudi Energy Minister, Khalid Al-Falih).** The Saudi regime is currently embarking on a programme of sweeping economic reforms – 'Vision 2030' – which includes the potentially record-breaking initial public offering of its state oil company, Saudi Aramco, at the end of this year. Higher crude prices would help to secure a valuation for Saudi Aramco closer to the $2 trillion envisaged by Saudi Arabia's Crown Prince.
- **Merger and acquisition opportunities** prompted either by US tax changes and/or structural industry changes. With higher oil prices helping to ease dividend concerns for the oil majors, their focus is now shifting to growth opportunities. Breaking with the past, though, the oil majors are refraining from investing in traditional long-cycle projects and instead looking to invest in shorter-term shale projects, which are viewed as more profitable.
- **Geopolitical risks.** The risk premium for oil is likely to be maintained by heightened risks in the Middle East, whether stemming from the ensuing Syria conflict or the current US Administration's more hostile stance towards Iran. Concerns around falling Venezuelan production have also supported investor demand for oil.

What about the threats from electric vehicles and US shale?

Demand is clearly growing for electric vehicles (EV), but we do not believe this trend is overly concerning for the oil price yet. EV is still very much a developed-economy phenomenon, while global demand for oil continues to be driven by those emerging economies which are increasing their share of global GDP. However, it is something to monitor over the longer term.

A more immediate threat may come from perceived risks around increasing US shale production. While US shale production has been rising since the end of 2016, we have been reassured by the resilience of the oil price. Furthermore, we think that rising production is unlikely to make-up the shortfall from the OPEC production cuts. Unlike in 2015, the US shale industry is under increasing funding pressures from operators who need to spend a lot of capital to grow production. Investors are also demanding that US exploration and production companies improve cash returns rather than expanding for growth at any cost. Both of these factors will be investor-friendly and should result in a more stable oil price.

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

How is our view being reflected in portfolios?

We have been incrementally adding to US exploration and production companies at the expense of the broader US equity market. In addition, we have been building a position in a broad commodities index, which we believe will benefit from both an improving oil price and the general improvement in global economic growth in the second half of 2018.

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