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»Energy markets are becoming more political (and more volatile)

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Update: Our view on energy markets

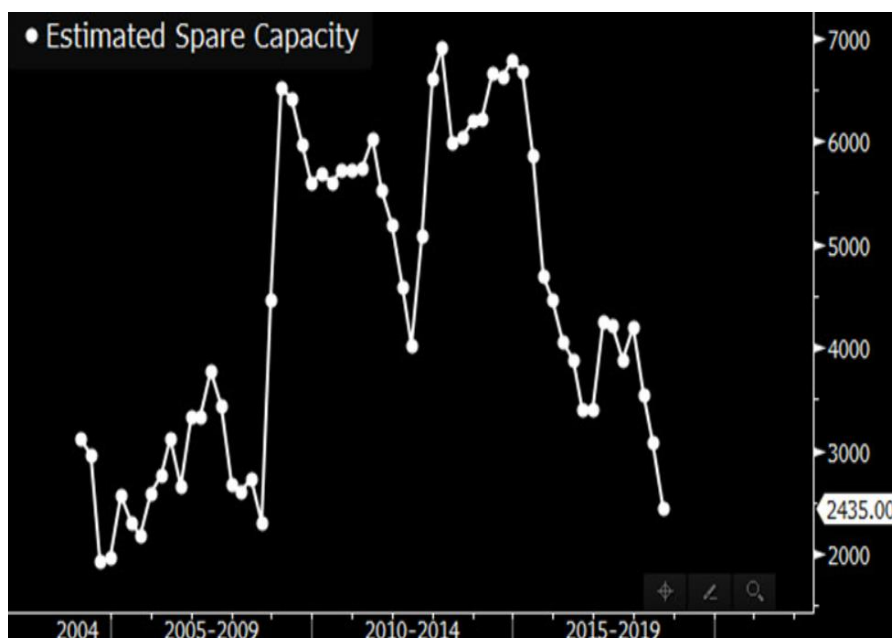
— What are the key drivers behind the recent oil price drop?
— Why are natural gas and oil prices not correlated?
— What does the oil sentiment shift mean for our energy holdings?
— How are we positioned?

What are the key drivers behind the recent oil price drop?

Volatility has returned to oil markets and we believe it is here to stay in the short- to medium-term. In the past five weeks, global crude oil prices have moved from 4-year highs into a bear market, triggered by political actions clouding near-term supply visibility and by a softening global macroeconomic outlook.

How have we gotten to this point so quickly? Oil markets have enjoyed a price rally since early 2016, primarily benefiting from OPEC+ (OPEC plus non-OPEC nations that are part of the global oil production curbs agreement) production cuts and a benign global macroeconomic environment, resulting in a reduction in global oil inventories. This upward price pressure was further boosted earlier this year by reintroduced US sanctions against Iran, one of the global top oil producers. With expectations of Iran sanctions becoming effective from 5 November, and OPEC+ members gradually raising output since June, thereby leaving limited spare capacity (see Figure 1), the near-term prospects for oil prices were positive. Just a few weeks ago, prices of USD 100 or higher per barrel were often mentioned by energy analysts.

Figure 1: Global spare capacity estimates



Source Bloomberg, October 2018

However, recent political developments have turned the oil story upside down. While being in the off-peak season, characterized by rising oil inventories, OPEC+ members made a U-turn and switched to an 'as much as you can' production policy, as advised by the US administration to mitigate the negative supply impact from Iran sanctions. In addition, the US government tried to bring oil prices down ahead of elections by releasing oil from the strategic reserves, and providing temporary exemptions to the eight largest buyers of Iran oil, thereby creating a perfect storm for crude oil prices.

Suddenly, we have moved from a world of global oil supply vulnerable to any disruptions, such as geopolitical risks in Venezuela, Libya, Nigeria or the Middle East, and capacity bottle necks in Canada and the US (and potential unforeseen accidents anywhere else) due to the lowest spare capacity in a decade to a well-supplied global oil market with the prospect of major global oil importers buying Iranian oil again.

The oil futures curves (Figure 2) have reflected those political actions by moving from a steep backwardation curve (spot prices significantly above future prices suggesting a tight oil market) to a relatively flat curve with a contango (spot prices lower than future prices suggesting an oversupplied current market) in the front end.

Figure 2: WTI crude oil curves showing different price actions at the front end and long end over the last month (blue) and last six months (green) vs. current spot price (orange line)

Source Bloomberg, 14 November 2018

Why are natural gas and oil prices not correlated?

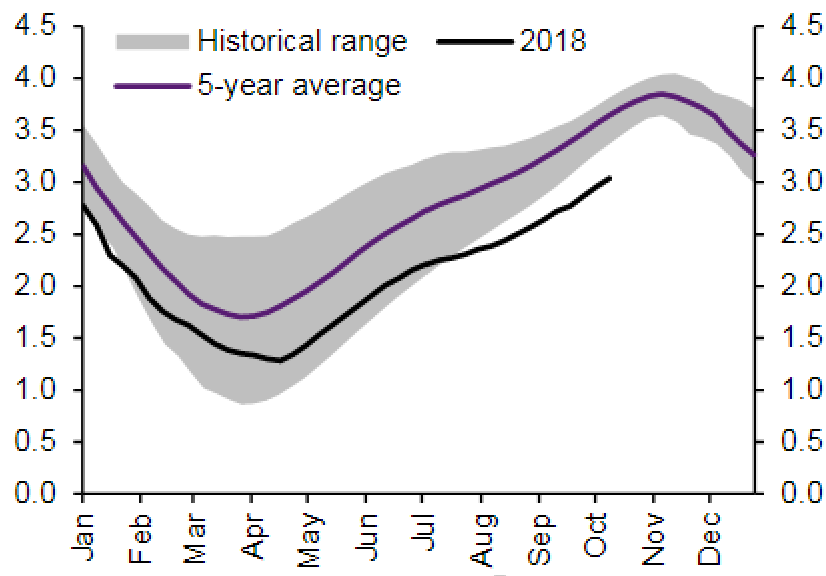
While natural gas production is to a certain degree connected with oil production, the demand side follows different seasonal and secular patterns. The seasonal gas demand is just starting to rise with the winter heating season, where cold weather fronts can lead to natural gas price spikes (see Figure 3). In addition, demand for LNG (liquefied natural gas) is in a secular upward trend, with Chinese imports rising by 40-50% this year driven by the government's new environmental policy. Natural gas is a fossil fuel, but it burns cleaner than oil or coal. LNG demand is also growing in other Asian countries and in Europe. In Asia, governments support switching electricity production from coal or nuclear, while Europe, in addition to the environmental aspects, tries to diversify from its dependency on Russian gas. The US LNG export capacity is

significantly higher than its oil export capacity, with additional large export facilities expected to be added in the coming months. These factors should further increase pressure on US inventories, which are already 20% below recent years' levels (see Figure 4), supporting gas prices in the coming months.

Figure 3: Oil prices (WTI, orange line, LHS) vs. natural gas prices (yellow line, RHS)

Source Bloomberg, 15 November 2018

Figure 4: US natural gas working inventories, billion cubic feet (5-year range)



Source Natixis, Bloomberg; October 2018

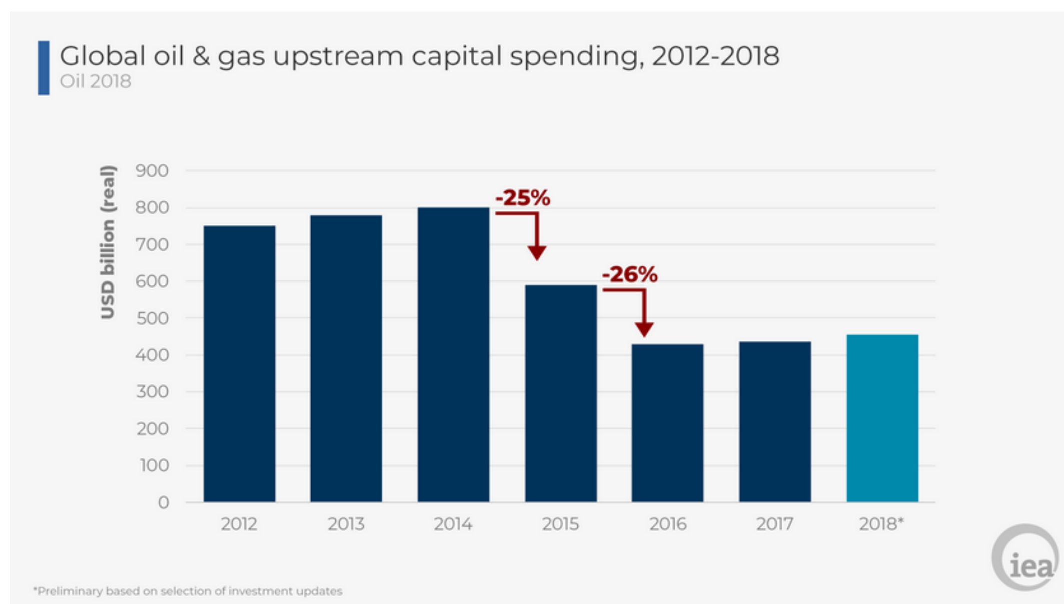
What does the oil sentiment shift mean for our energy holdings?

As mentioned, spot price volatility will most likely remain in the short- to medium-term, with price movements depending on political actions, OPEC+ decisions at their forthcoming meetings, geopolitical risks or supply disruptions. Besides political considerations, US shale production is becoming an ever more important marginal oil supplier, which can relatively quickly adjust production up or down. Shale oil is expected to become increasingly important in the coming years. Our base case remains that oil prices stay range-bound, with WTI trading between USD 50-70 per barrel and Brent trading USD 5-10 higher, as OPEC+ actions and US shale production should counterbalance each other at the boundaries of the aforementioned range.

However, in our view, a more important factor for enterprise valuations is the long end of the oil futures curve, which has been remarkably stable in the past month and is actually higher than six months ago. Many exploration and production (E&P) companies are not that sensitive to spot prices as they hedge themselves against short-term fluctuations, while their investment decisions and terminal value depend on the long-term oil price outlook.

When looking at long-term oil price expectations, it is important to assess supply and demand expectations. About four years ago, we observed a cyclical oil price downturn triggered by technical innovation particularly in the shale oil and gas production, leading to a significant reduction in global oil and gas capex spending, especially outside of the US (see Figure 5). While global oil and gas capex has slightly picked up since 2017, we are still in the early stages of the recovery where many investment decisions can be delayed or cancelled, potentially leading to undersupplied oil and gas markets in the coming years. We believe these supply concerns have pushed long end of the oil price curve up in the recent months, and have resulted in a less pronounced price move in energy stocks.

Figure 5: Global oil and gas capex



Source International Energy Agency

How are we positioned?

In our convertible bond strategies, we keep our holdings in the large integrated oil companies such as Total, BP or Eni unchanged. Their share prices should retain their long-term positive momentum as the companies benefit from high refining margins, LNG demand growth, and significantly lower capex and production costs than a few years ago, resulting in healthy profit margins and the strongest cash flow generation in their history. In order to potentially benefit from the seasonal natural gas price spikes, we also selectively maintain our holdings in energy producers with a higher exposure to natural gas. Outside of the energy sector, we recently added industrial and shipping companies benefiting from the rising demand and export capacities for LNG, and we selectively added chemical companies, which should benefit from the lower oil input costs.

On the other hand, we have been reducing CCC-rated energy producers and oil service companies due to the increased uncertainty concerning the energy capex outlook.

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