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Energy Sector update – Brent Oil price focus

What's happened with Brent?: Brent prices slumped ~40% from a June peak of ~$115/bbl. Fundamentally, the downward pressure on oil prices relates to the current demand/supply imbalance caused by a lack of synchronised global growth, higher inventory levels and increased shale production in the US, which is reducing fixed input costs for energy. On the supply side, US producers continue to increase production, which has resulted in an oversupply of light sweet crude in the Atlantic Basin, leaving a structural overhang of ~2mbd.

At a technical level, oil prices first fell when the Saudi Arabian Oil Company released prices for October, with steep cuts in Asian markets interpreted by many around two key factors: (1) a push to increase market share and (2) to put pressure on inefficient US shale producers. Prices again fell to $90bbl when producer and investor selling started to occur at the back end of the (price) curve, while speculative shorts pulled down the front end. In addition, only last week (27th November, Thursday) we saw crude prices fall again after OPEC confirmed it would not cut production levels to stem the collapse of the oil price and provide a 'floor'.

Our view on Brent - $70 or above but risk skewed to the downside in the short term: Over the medium term, we remain neutral on the outlook for the oil price. In terms of the overall market consensus analyst forecasts, the Brent (oil) curve and implied prices from the equity market all suggest prices of ~$70 or above represents current fair value. That being said, markets do not always behave in equilibrium and we believe there is additional risk to the downside of the oil price over the next 6 months from a number of competing factors.

Firstly, we expect the imbalance in the supply/demand dynamic to further persist into 2015, as non-OPEC supply growth outstrip oil demand growth. The swing factor to this in the coming year will be dependent on when/if OPEC decide to cut production to balance the market supply. In the short term, contrasting political objectives and differentials in break-even prices may lead to inaction and additional supply in excess to seasonal normal demand. Additionally, increased stockpiling by countries at these lower prices may also result in inventory overhang for longer, even if production cuts occur.

Non-OPEC producers will also need to cut production but this may take several quarters to achieve this outcome. Some market estimates with hedged production and $30-$40 bbl costs suggest that 2015 projected US growth will be impacted by the recent price action. However, moderating our cautious view is the expectation that a sub $70bbl price may be a catalyst for OPEC to cut production as protracted low oil prices will impact the growth outlook for a number of member countries, especially Nigeria, Venezuela and Iran, while Qatar, Kuwait and UAE will be impacted to a lesser extent. Technical factors such as relative strength indicators (RSI) and the steepness of the (price) curve also suggest that Brent may be oversold in the short term (refer Figure 1 and Figure 2).

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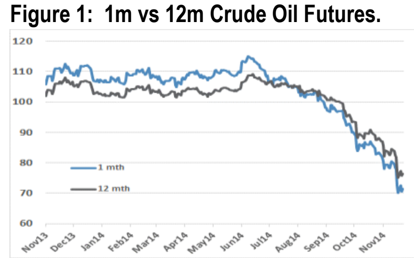
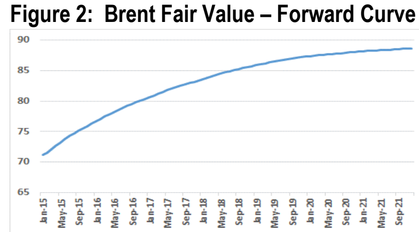
Figure 1: 1m vs 12m Crude Oil Futures.



Source: Bloomberg, Short term futures trading lower than the long term futures.

Figure 2: Brent Fair Value – Forward Curve



Source: Bloomberg. A relatively strong contango.

Table1: Scenario Analysis

	P&L Impact	Existing 4.3% OW	Scen-1 1.1% OW	Scen-2 EW
ORG	-3.23	3.16	3.16	1.72
STO	-4.44	3.25	0.00	1.77
WPL	-3.72	3.10	3.10	1.69
Energy	**-3.80**	**9.51**	**6.26**	**5.18**
CSL	-0.84	4.85	6.48	7.01
RMD	-0.23	3.98	5.61	6.14
Healthcare	-0.34	8.83	12.08	13.14
Core P'folio P&L		**-1.71**	**-1.58**	**-1.56**

Scenario Analysis when Brent drops further 20%.

Retain our OW in Energy…: Based on this analysis, we continue to favour the Energy sector over the medium to long term and post the recent sell off, it continues to look relatively attractive both at the sector level and in terms of individual companies.

Based on our scenario analysis, and assuming a further price drop of 20% and a rotation of our active weight into Healthcare (the least sensitive sector to crude oil price movement), we estimate that moving from OW to Neutral will only see a ~15bps uplift in the Core portfolio P&L (Refer Table 1). As such, we are comfortable with maintaining our current position at this point in time.

…but we are keeping an eye out for the black swan event: However, part of our scenario analysis is to consider what other geopolitical and other risks may result in further 'irrational' behaviour by either OPEC and Non OPEC countries, as well as investors themselves. This could lead to a key downside risk to our view, and represent elements that cannot be modelled easily.

To this extent, our view around a bear case scenario is premised on the following key issues: (i) excess production continues for longer than expected and / or (ii) bearish market sentiments continue to drag Brent prices lower, and (iii) the current cartel arrangement that supports OPEC breaks down leading to an irrational supply response caused by both economic and geopolitical uncertainty for individual countries. As such, we have identified the outcome of the next OPEC meeting and the outlook for demand (via global growth outlook and inventory levels) as key determinants in the medium term outlook. This will be something we will be continuing to monitor closely as we head into the New Year.

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