Alternatives

OPEC likely to support the oil price

Short-term volatility should not distract from improving oil fundamentals. Despite the resilience in U.S. shale oil, we expect oil prices to recover.

Ever since its stark decline in 2014, the oil price has become a much more important factor to consider for economists and strategists alike. With the recovery of the oil price stoking and an important OPEC meeting lying ahead of us, we have asked Eugene Bidchenco, Co-Head of Commodities in the Alternative & Real Assets group in Deutsche Asset Management, to provide an in-depth view on the current state of the energy markets.

Can you count the times when listed companies from various sectors have complained about tough and increasing competition in recent years? Call us old-fashioned, but isn't this how normal markets are supposed to work? Enjoying the comforts of an oligopoly or regulatory protection is pretty nice for producers, of course. According to economics 101, lack of competition is not a good thing, however. It is rarely supposed to last. And it is by no means a credible reason to cry foul when the going finally gets tough. Of course, crying foul is just what global oil companies did in 2014, notably U.S. shale-oil producers, following OPEC's decision to temporarily stop distorting the oil market. One side-effect of the squeezed cash flows of oil companies and their resulting suffering was the broader financial-market turmoil in early 2016.

Ever since then, it has actually come to be seen as good news for the world economy and broader markets when OPEC and its allies decide to keep a tight lid on production. While this is contrary to what economists once thought (and many still think, given the resulting costs to consumers) it is the way investors have been playing it for the past two years. Last week's rumors of a Saudi-Russian agreement to cut production significantly helped several equity indices to reach record highs.

In ironic contrast to the 1970s, many market participants seem more concerned about OPEC having too little, rather than too much power. While there is a legitimate fundamental debate about this question, there is little reason to hope you will have to pay less for filling up your car any time soon.

Still not willing to deal with open markets

So, how powerful is OPEC? Questions regarding its ability to influence the oil market began to surface soon after the emergence of U.S. shale oil. In the short to medium term, however, it is hard to downplay OPEC's market impact, as it still supplies over 30% of global production. A simple refusal to cut production to accommodate the rise of the U.S. shale output resulted in oil prices plummeting to their decade lows in late 2014. In similar fashion, news of the cartel's decision to limit production in 2016

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Expectations in a nutshell

- On May 25th, OPEC will announce how it intends to continue to influence the oil market.
- We expect the cartel to keep its production caps in place for another six months – at least.
- We expect rising oil prices with WTI to reach $58 per barrel by March 2018, albeit with plenty of volatility along the way.

reinvigorated the commodity, sending the Brent price from 35 U.S. dollar per barrel ($/b) to above $50. Most recently, when the price slipped below 50$/b for the first time since November 29th of last year, the market didn't seem too panicked, as news of the potential production-cut agreement began to circulate in the media buoying the commodity. While we acknowledge the OPEC's ability to influence the oil market, the short-cycle U.S. shale-oil industry has certainly proven to be the great disrupter.

Our strategic view of the price for West Texas Intermediate (WTI) reaching 58$/b by the end of the first quarter of 2018 relies quite heavily on the assumptions with regards to shale oil's role as an extremely flexible marginal-cost producer. The ability of shale to increase or decrease production in relatively short periods of time is one of the reasons why we believe that oil is to continue to trade in a relatively tight corridor of approximately $20 in the coming quarters, albeit with quite a bit of volatility. The most recent 14% slide in the price of the commodity was not that uncommon. In fact, it was just one of a handful of double-digit price declines since February of last year, when the price of WTI oil reached its decade-low of 27$/b. Exceptionally high levels of speculative positioning in futures markets might have contributed to the decline.[1] Due to the relatively small size of the physical oil (trading) market, asset-allocation decisions of much larger macro-driven funds, together with ETF-based speculative buying, can make the price of oil deviate from its intrinsic value in the shorter term. In our view, focusing too much attention on hundreds of short-term data points trying to predict weekly oil-price moves seems rather futile when it comes to achieving long-term investment success.

Instead, we should focus our attention on the bigger picture by identifying and analyzing several crucial underlying trends of this complex market. In particular, we have identified the following four drivers which we believe to be not quite as well-understood as they should be. Taken together, they could provide us with some insight into future oil-market dynamics.

The four major drivers of the oil market

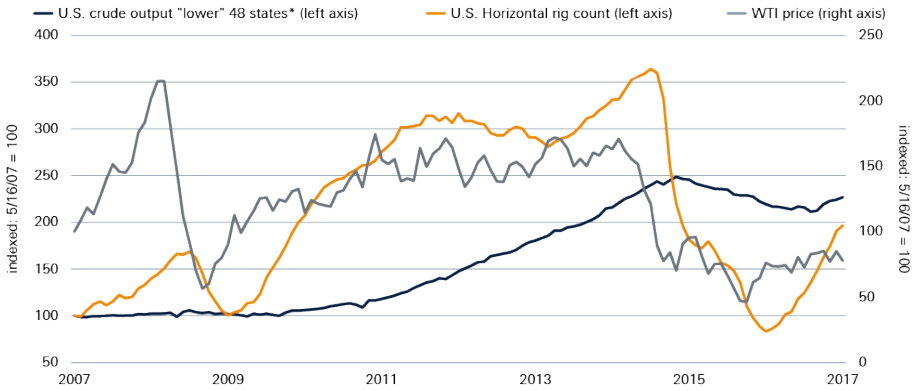
For the last several years, investors continued to question **global demand**'s ability to grow. Yet physical demand has continuously beaten expectations. This year again, after a sub-par first quarter, many investors began to doubt growth. We refrain from putting too much emphasis on a single data point or data series. Given the amount of influencing factors involved, oil-demand statistical data is notoriously volatile and should never be looked at in isolation. Global demand growth has averaged 1.4% over the past 5 years and we expect for it to continue to grow at around 1 to 2 million barrels per day each year in 2017 and 2018. Considering the fact that China was responsible for the bulk of underlying demand growth of the last 30 years, we pay increased attention to Chinese customs oil-import data which is not currently indicating any major slowdowns. In fact, oil imports continue to move higher, partially because of the local Chinese production experiencing relatively large declines

[1] Bloomberg CFTC NYME Crude Oil Net Non-Commercial Futures Positions reached a historic high on 2/21/17, having fallen by more than 40% in the following two months.

in 2016. Eventually, Chinese production might recover, but we are not expecting this to happen immediately, based on the data.

The **U.S. production** has seen a surprisingly strong resurgence this year. After declining by approximately 15% since reaching its peak in March 2015, it has gained more than 7% since the beginning of this year. U.S. shale production has proven to be much more resilient than it was expected, mostly due to increased well productivity and reduced input costs. According to some reports, every rig starting production now is likely to produce 2.5 to 3 times more than back in 2014.[2] As the chart below shows, the number of rigs has been a poor indicator of output in 2015 and 2016. With new rigs only becoming fully productive after around 8 months, U.S. production is set to grow further, as rigs recently added come on stream. While the sector is still infamous for its high cash needs, some shale producers are now able to pay for maintaining and increasing production at WTI prices as low as 50$/b. Horizontal rigs, mainly used for shale oil, have doubled in number since their low in May 2016. We believe, however, that new rig-count growth will slow at prices of less than 50$/b. By contrast, WTI reaches 60$/b, we could see very robust levels of incremental supply of U.S. shale oil hitting the market, stifling any prolonged rally in the commodity.

U.S. oil rigs and onshore oil production on the rise again

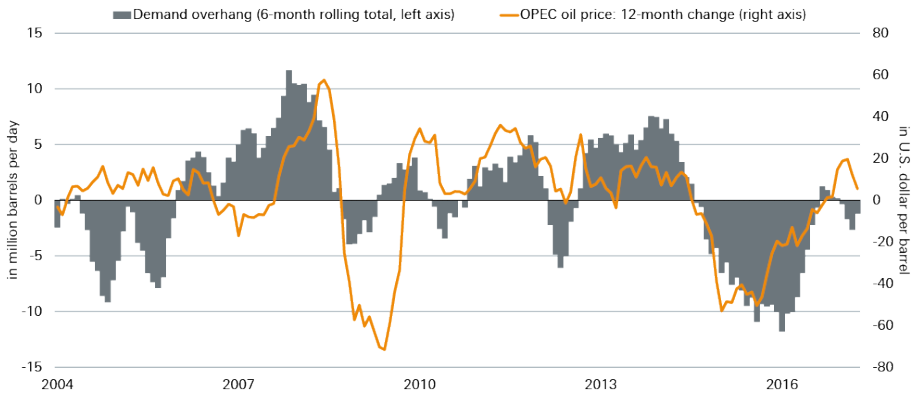


Source: Thomson Reuters Datastream; as of 5/17/17
* "lower" 48 states refers to all states except for Alaska and Hawaii

Inventories have been a focal point of concern for the investment community over the past years as they remained elevated. Although many investors are still focused on U.S. inventories, which remain stubbornly high, global inventories have been continuously declining since about August of 2016 (according to the International Energy Agency, IEA). With non-OPEC ex U.S. production in decline, we are expecting this trend to continue, with global inventories starting to head lower through the end of this year.

[2]Data from the U.S. Energy Information Administration; as of 05/2017

Demand overhang/shortage and oil price well aligned



Source: Bloomberg Finance L.P.; as of 5/17/17

With all indications of **OPEC** agreeing to extend the production cuts for at least another 6 months, the cartel should be less of a wild card than has lately been customary. Our base-case scenario calls for the quota to be extended by another 6 to 9 months. Overall, we continue to believe that OPEC and Saudi Arabia in particular will continue to accommodate oil markets for the time being. We base our view on several important criteria that we believe influence their behavior. Firstly, we believe that OPEC is well-aware of the global inventory rebalancing that is currently taking place. Secondly, OPEC members are also aware that not extending the production cuts would have a major impact on global exploration & production (E&P) capex, which, after several years of massive declines, was finally set to increase this year, assuring that some of the long-lead oil projects could come to completion. Thirdly, allowing for the oil price to collapse once more and subsequently crushing the capex cycle would eventually result in much higher oil prices. This scenario would inevitably spur another wave of alternative fuel development, which in the long run could prove to be detrimental to the prosperity of many OPEC nations as well as Russia, which seems to welcome the collaborative efforts of cuts.

To conclude: we believe that markets will be little impressed if OPEC on Thursday only announces that the production cut will be extended for another 6 months. Oil prices should recover in the next 12 months, however, as inventories are set to decline in the second half of the year. Our price target of 58$/b is based on upheld production discipline of OPEC & Russia, continuously strong demand and a modest production growth coming from U.S. shale. In the medium term, we believe that additions to the global supply from outside of the U.S. will not be very consistent, with Libya and Nigeria providing quite a bit of volatility. Several years of underinvestment in the oil industry should result in an accelerated decline rate for the majority of conventional fields, which should help oil prices just as much as the fact that U.S. shale-oil production volumes are expected to peak as early as 2020.

OPEC has to surprise for us to keep the overweight of energy stocks

We have a positive stance on the energy sector. We would feel inclined to downgrade the sector to Neutral, however, if OPEC fails to surprise markets on the 25th. While we see little surprise

potential in terms of the length of the production cut, OPEC might agree to expand the cut, which would be taken positively by investors. Otherwise, we fear the sector could lose further momentum in the short term - since our upgrade, the oil price failed to gain traction despite OPEC and some non-OPEC producers' production cuts. Energy equities have not been able to decouple from volatile oil-price movements. The market does not give credit to the fundamental improvements of the companies' cash flows.

Nonetheless, Marco Scherer, Deutsche Asset Management's sector head of energy equity research, sees bright spots in various bits of the oil sector: "One big reason for the appeal of the integrated multinational oil companies is their dividend yield. However, you need to look very carefully whether any given company can actually afford those pay outs. That is: can it cover its dividends from cash flow even at current oil prices? Many integrated oil companies are making progress on this front, but only a fraction has achieved satisfactory dividend coverage just yet. We are even more selective when it comes to U.S. E&P companies, as they are more prone to oil-price changes and changing financing conditions. We believe they need to have excellent oil fields in order to be investable. Finally, service companies are a breed of their own. Being amongst those hardest hit in the downturn, the bigger and financially stronger companies are taking the opportunity to consolidate the market. We believe this consolidation should result in a champion's league of well diversified, multinational oil-service majors."

Glossary

Exchange-traded fund (ETF)

An exchange-traded fund (ETF) is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Organization of the Petroleum Exporting Countries (OPEC)

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

West Texas Intermediate (WTI)

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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