What's behind the turnaround in energy?

Jonathan Waghorn – Guinness Global Energy Fund

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Jonathan Waghorn, co-manager of the Guinness Global Energy fund, says oil prices have fluctuated over the past 18 months, but now could be an interesting entry point for investors.

After three years of underperformance, energy equities performed strongly in the first half of this year, up 14.3% versus 6.5% by the MSCI World. This is partly due to the strength in spot oil prices.

What is behind the turnaround in energy?

More importantly, however, are long-term oil price expectations, which have improved significantly: the four-year Brent forward price has risen this year by 9% to $99 at the end of June 2014 (see graph below).

The rise and rapid expansion of ISIS in the Middle East has also brought the sector into focus in recent months. Although it is unlikely to affect the near-term oil supply; the strength of energy equities has coincided with a general tightening of oil market fundamentals. Why? In essence, demand has proved stronger than expected, particularly in the US, while supply has been hampered by a slew of OPEC problems (Libya, Iraq, and Nigeria included).

Supply growth from US shale oil continues unabated, up half a million barrels a day since the start of the year, but the market is starting to recognise the world needs this oil to keep the global oil market in balance. So the turnaround in energy equities reflects a growing realisation the oil market may remain in tighter supply and demand balance over the next few years than many were anticipating.

Momentum swing

The greatest momentum swing has been the European integrated oil and gas sector. The promise of improved returns now seems a more likely prospect, thanks to a shift in focus from volume growth to profitability.

The trend began with Total's announcement its capex cycle peaked in 2013, followed by positive statements of intent from Shell, BP, and Statoil, among others. By contrast, the US super-majors (ExxonMobil and Chevron) were more muted, reflecting a softening of US refining margins and a 'pause' after a stronger run-up than their European peers in 2013.

Among the better performers in the services sector, were Halliburton (+40.6%), Patterson-UTI Energy (+38.9%), and Unit Corporation (+33.3%) which benefited from rising onshore US oil and gas activity. The US oil and gas-levered names, in particular Penn Virginia (+79.7%), Newfield Exploration (+18.9%), and Carrizo Oil & Gas (+54.7%), enjoyed a combination of strong production and the rising WTI price.

Volume to value shift

Meanwhile, European integrated oil and gas companies, including Statoil (+31.9%) and Total (+20.6%), enjoyed the shift from 'volume to value' in their operations described above. Other notable positive performers were ShawCor (+40.0%), which has enjoyed an expansion of its international project backlog, and Canadian Natural Resources (+37.4%), a beneficiary of improving Canadian heavy oil pricing.

As a group, emerging market and US super-major oil and gas companies performed the weakest. Sentiment towards Gazprom (+1.9%) was coloured by the Russia/Ukraine crisis, whilst Exxon (+0.9%) and Chevron (+6.4%) were held back by a slight deterioration in the outlook for US refining. This also impacted our one pureplay US refining position, Valero (+0.4%).

Price ceiling

The most likely scenario for the rest of the year is an average price of Brent and WTI in the trading range of $90 to $110/barrel. Once the floor of this range looks threatened, OPEC will reduce supply, and any price weakness below $100/barrel (Brent) will be prevented by OPEC cuts. Should the oil price rise much over $125/barrel, demand will weaken, putting a ceiling on the price for the time being.

This year, non-OPEC supply is expected to grow better than at any point over the last three years, but is being countered by supply disruption across North and West Africa (Libya, Nigeria, and Algeria) and the Middle East (Syria, Yemen, and foremost, Iran). Factor in respectable demand growth and the market looks balanced, we should recognise we are only one ill-judged military move away from another oil spike.

At the heart of it all, we believe Saudi Arabia is working hard to try and maintain a 'good' oil price (Brent at $100 to $110/ barrel). So far, they are succeeding. Energy equity valuations at the start of the year reflected an expectation that international oil prices return in the longer term to around $80/barrel.

Their turnaround in performance means today they reflect a long-term oil price of $85 to $90/barrel: an increase of 5% to 10%, but still well below the spot oil price at over $100.

Dislocation

The dislocation between energy equities and the broad market is expected to continue to correct, in particular as the current oil price and long-run market expectations continue to come together. $100 oil is around where that could happen. Tactical investors should start to take note of this turnaround in energy equity performance.

Turnaround in energy equities: Spot oil prices vs 48-month futures ($)