Insights from Guinness

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Has OPEC just blinked?

OPEC concluded an extraordinary meeting on Wednesday 28th September 2016 with an agreement to cut production levels. The details of the cut remain to be agreed but this is clearly a positive step for near term oil prices and it removes the perceived downside risk.

What has been announced?

OPEC have opted for a new production limit of 32.5-33.0m b/day, representing the first action from the group since November 2014. Most recent OPEC production is around 33.5m b/day, so that appears to represent a cut of 0.5-1.0m b/day (all numbers for OPEC-14 including Gabon).

It is not fully clear who will be cutting and when and we would expect these details to be ironed out at the next OPEC meeting on November 30th 2016. According to the FT, the Saudi Oil Minister has announced that "...*three countries that had special conditions — namely Libya, Nigeria and Iran — that have been constrained for their own respective reasons will be permitted according to the terms of reference to produce at maximum levels that make sense and generally it would be the levels they have achieved recently."*

The announcement refers to co-operation from 'non-member countries' although there are no details. We could potentially see a number of non-OPEC countries join in with OPEC. On previous occasions, Russia, Norway and Mexico have joined OPEC action.

Within OPEC, we expect the lion's share of the production cut to be shouldered by Saudi (say 0.4-0.5m b/day), with support mainly from UAE and Kuwait. This seems only fair, since it is these three countries who have been overproducing relative to other members during the past four or five years.

Reasons for the announcement

OPEC's statement says "*In the last two years… Oil-exporting countries' and oil companies' revenues have dramatically declined, putting strains on their fiscal position and hindering their economic growth. The oil industry faced deep cuts in investment and massive layoffs, leading to a potential risk that oil supply may not meet demand in the future, with a detrimental effect on security of supply."*

Clearly, OPEC economies are under significant stress, which is the near-term driver for the decision to cut. There is also the growing concern that the oil industry will be unable to supply enough in the future, leading to the next oil price spike, though that is probably a secondary concern to OPEC at present.

Considering Saudi's position, we believe that Deputy Crown Prince bin Salman (the architect of Saudi's oil policy) has come under renewed pressure to put a firmer floor under the oil price, for the sake of Saudi's fiscal budget. Earlier this week, Saudi announced 20% cuts to ministers' salaries, and curbs to state allowances, as part of their response to running the highest budget deficit among the world's 20 biggest economies. With this in mind, Saudi's actions at the head of OPEC appear designed to achieve an oil price that to some extent closes their fiscal deficit (though $80/bl is needed to close the gap fully), whilst not spiking the oil price too high and over-stimulating non-OPEC supply.

Overall, we believe that Saudi's long-term objective remains to maintain a 'good' oil price, significantly higher than current levels, and yesterday's action was an important step on that journey.

Immediate implications

A line has been drawn in the sand: OPEC is not willing to tolerate oil prices at these low levels for a sustained period. We expect higher oil prices as a result.

Whilst this announcement is a very important one and we view it in a positive light, we of course await OPEC's actual actions so that we can assess the impact on global oil supply/demand dynamics.

Excluding the Canadian wildfires and other transitory production outages, we estimate that the world oil market has been around 0.5m b/day oversupplied this year. If OPEC removes 0.5-1.0m b/day, it would bring the market into short term deficit and commence a period of oil inventory drawdowns.

The supply reaction is unlikely to happen immediately as it still needs to be fully sanctioned (we believe) at the November 30th OPEC meeting. Expected increases in production from Libya and Nigeria could keep the market oversupplied for a short period yet, and to some extent will offset cuts from other OPEC members.

Longer term, we expect oil prices to find a happy medium where OPEC economics are better satisfied, the world economy is stable and US oil production grows in a controlled manner. We think that the oil price which achieves this is around $70 per barrel.

Is there a conspiracy theory to all of this?

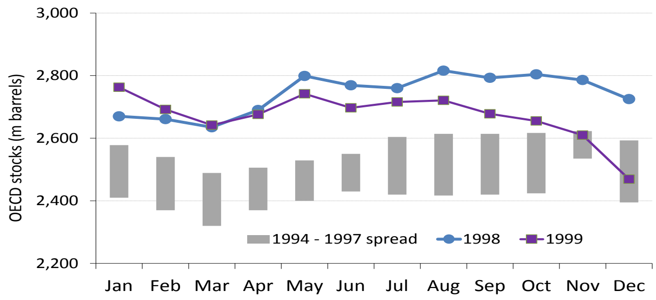
Saudi production (and Middle East production in general) peaks in the summer as electricity demand for air conditioning is met by burning crude oil. Over the last three years, Saudi's production has fallen by between 200k b/day and 400k b/day in the second half of the year. There is also some evidence to suggest that Saudi's peak production rates have been supported by drawdowns from domestic inventories, rather than solely from current supply. We have been expecting a seasonal fall in Saudi's production again in the second half of this year, so this announcement may only be sanctioning a production fall that was going to come anyway. Either way, Saudi's actions are very likely to have the desired effect of putting a floor under the price.

What is the historical precedent?

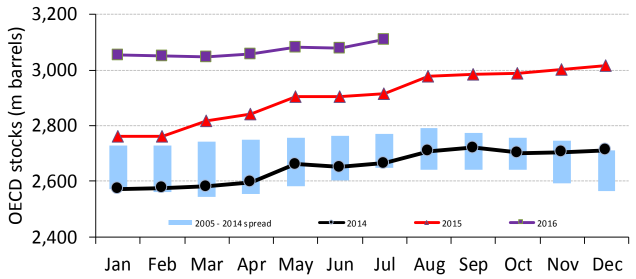
The historical precedent is a positive one and that is why this announcement by OPEC is particularly relevant.

In early 1998, OPEC announced its intention to cut its production quota by 1.25m b/day to reduce oversupply which had caused global oil inventories to swell by around 300m barrels (as shown in the chart below). Oil prices troughed in late 1998 at around $10/bl (some time lag after the initial announcement) and then recovered as the market tightened with global oil inventories returning to their normal operating levels by the end of 1999. The oil price subsequently averaged just under $30/bl in 2000.

OECD oil inventories 1998-1999 (million bbls)



OECD oil inventories – current (million bbls)



Source: IEA Oil Market Reports; Guinness Funds

Moreover, energy equities outperformed world equities in the subsequent periods after the oil price low (despite broader equities enjoying the tail-end of the dotcom boom in 1999/2000):

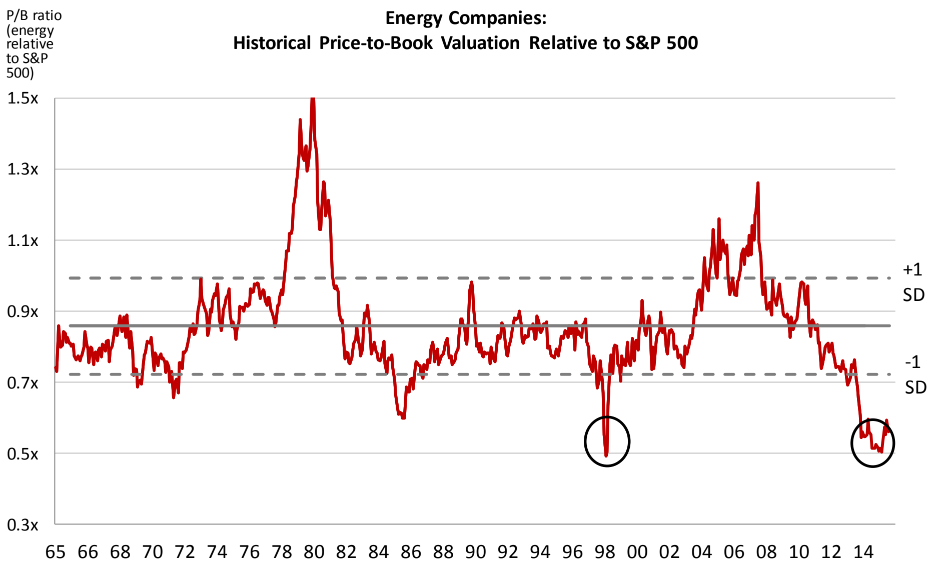
Source: Bloomberg; Guinness Funds

Total return from 15 Dec 1998	1 yr	2yrs	3yrs	5yrs
MSCI World Energy Index	26.6%	25.8%	16.8%	39.5%
S&P 500	23.1%	15.6%	0.2%	-0.8%
Outperformance (%)	3.5%	10.2%	16.6%	40.3%

How will energy equities be affected?

This announcement effectively removes the downside risk in crude oil prices and therefore forms a significant positive for sentiment towards energy equities. The weight of energy equities within the S&P 500 still close to multi-decade lows and relative price/book valuation versus the S&P 500 is still close to 65 year lows, shown below, is bouncing off a similar level to 1998/99.

<u>Energy companies: historic price to book valuation relative to S&P 500</u>



Source: Bernstein; Guinness Funds

If you believe, as we do, that yesterday's news helps on the path to a recovery in the oil price to $70+/bbl, the case for accumulating energy equities at this level looks good, with upside across the energy complex of around 50%.

The Guinness Global Energy Team

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