Insights from Guinness

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OPEC announces first production cut in 8 years

OPEC concluded their formal meeting on Wednesday 30th November 2016 with an agreement to cut production levels. This ratifies the 'Algiers Accord' which took place on 28th September, when planned cuts were first announced. The announced cut is a clear positive for near term oil prices and will tighten the oil market in 2017.

What has been announced?

OPEC have opted for a new production limit of 32.5m b/day, representing the first action from the group since November 2014 and the first quota cut since 2008/09. The 'referenced' OPEC production, for October 2016, and used as a starting point for the cuts, was around 33.7m b/day, so the announcement represents a cut of 1.2m b/day (all numbers for OPEC-14 including Gabon). This ratifies the 'Algiers Accord' which took place on 28th September, when planned cuts were first announced. There is also an understanding that non-OPEC, including Russia, will cut production by 0.6m b/day, which would bring the total reduction to 1.8m b/day – well in excess of most expectations in the lead up to the meeting.

The OPEC production cuts agreed by each member country can be seen in the table below:

(m b/day)	Oct 2016*	Adjustment	Jan 2017	% adjustment
Saudi	10.54	-0.49	**10.05**	-5%
Iran	3.70	0.09	**3.79**	2%
Iraq	4.56	-0.21	**4.35**	-5%
UAE	3.01	-0.14	**2.87**	-5%
Kuwait	2.84	-0.13	**2.71**	-5%
Nigeria	1.60	*exempt*	**1.60**	*n/a*
Venezuela	2.07	-0.10	**1.97**	-5%
Angola	1.75	-0.09	**1.66**	-5%
Libya	0.42	*exempt*	**0.42**	*n/a*
Algeria	1.09	-0.05	**1.04**	-5%
Qatar	0.65	-0.03	**0.62**	-5%
Indonesia	0.74	*suspended*	**0.74**	*n/a*
Gabon	0.20	-0.01	**0.19**	-5%
Ecuador	0.55	-0.03	**0.52**	-5%
OPEC-14	**33.72**	**-1.19**	**32.53**	**-4%**

**For most member countries, the 'reference' point for the cut is October 2016 production, except Angola where Sept 2016 production is used. Source: OPEC; Guinness Asset Management*

The announcement amounts then to a 5% cut for all members except for 1) Libya and Nigeria, recognising their unusually depressed levels of production due to unrest, and 2) Iran, recognising its journey back to normalised production post the lifting of sanctions in January 2016. Indonesia has been suspended from the group since, as a net importer of oil, it chose not to participate.

The agreed cuts are effective from 1st January 2017, and will be kept in place initially for six months, extendable for another six months depending on how the oil market evolves.

Unexpectedly, the OPEC agreement contains official reference to non-OPEC production: "This agreement has been reached following extensive consultations and understanding reached with key non-OPEC countries, including the Russian Federation that they contribute by a reduction of 600k b/day production". It is understood that Russia has agreed to shoulder 300k b/day of cuts, whilst other unnamed non-OPEC countries (suspects include Oman, Kazakhstan and Mexico) will share the other 300,000 b/day.

OPEC have also taken the unusual step of establishing a 'Ministerial Monitoring Committee", including OPEC and non-OPEC members, to monitor implementation and compliance with the agreement. We think this gives an indication of strong intent to see the cuts through.

Reasons for the announcement

OPEC's 30th November statement, which accompanies the announcement of cuts, builds on the comments they made when announcing provisional cuts at the end of September.

OPEC's 28th September statement said *"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."*

The 30th November statement said *"market rebalancing is underway, but the Conference stressed that OECD and non-OECD inventories still stand well above the five-year average. The Conference said it was vital that stock levels were drawn down to normal levels. The Conference also noted the drop off in investment levels in both 2015 and 2016, as well as the huge layoffs the industry has witnessed in recent years. It emphasized the importance of continued investments for an industry that needs regular and predictable investments to provide the necessary supply in the medium- and longer-terms."*

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.

There had been intense negotiations in the lead up to the meeting, sparked by the imbalance in current production levels of key OPEC members versus recent history. In particular, pressure had been mounting on Saudi, Kuwait and UAE to shoulder the lion's share of the cut, since they have increased their market share significantly versus other OPEC members over the past three years (currently standing at nearly 60% of OPEC production versus the 25 year average of around 50%).

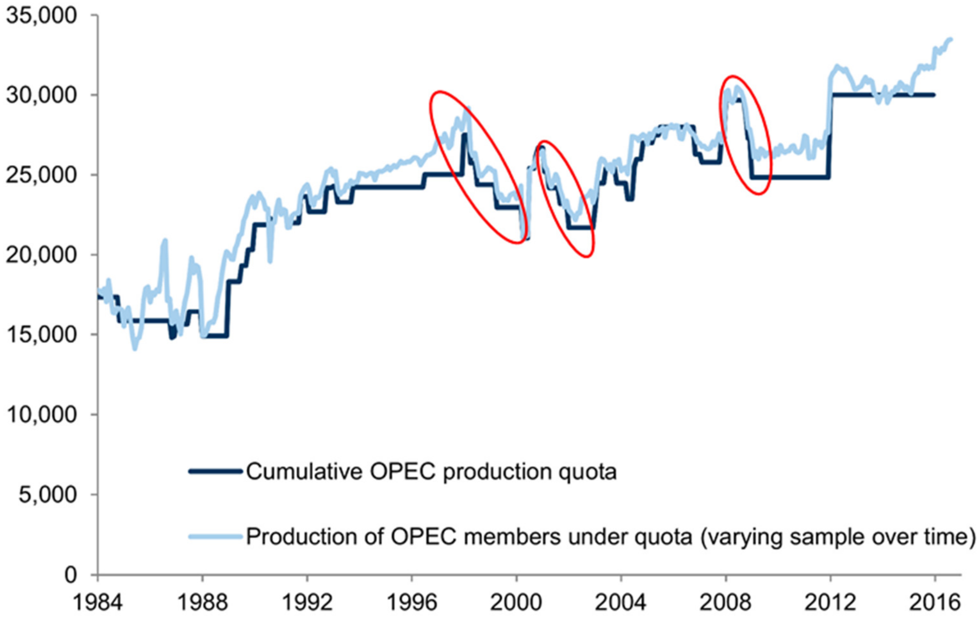
It is something of a coup, therefore, for Saudi to have negotiated the same 5% production cut as most other OPEC members (Iran exempted), which is a testament to the strength of their bargaining position versus other poorer member countries.

Notwithstanding Saudi's successful negotiation, we believe that Deputy Crown Prince bin Salman (the architect of Saudi's oil policy) has come under sustained pressure to put a firmer floor under the oil price, for the sake of Saudi's fiscal budget. In September, 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/bbl is needed to close the gap fully), whilst not spiking the oil price too high and over-stimulating non-OPEC supply. We must also acknowledge that with the planned IPO of Saudi Aramco, Saudi has a tactical desire to see prices higher through that process.

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 another key step on that journey.

Will OPEC comply with the agreement?

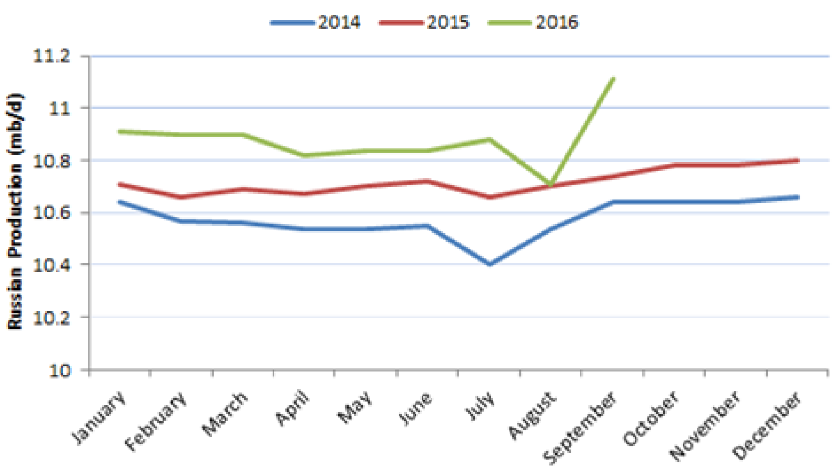
Our observation is that when OPEC agree to reduce production to tighten the oil market, adherence to that agreement is good. The following chart shows the three episodes of OPEC quota cuts over the last 20 years, in 1998, 2002 and 2008:



Source: Goldman Sachs; Guinness Asset Management

In each case, the production of OPEC members under quota was cut close to new quota levels, albeit the cut in 2008 was around 75% of what had been announcement, though still 3m b/day in absolute terms. In this instance, we would expect that OPEC will adhere to the targets set, since failure to do so would ultimately show up in elevated inventories and a lower price, which is what OPEC cannot afford.

There is less precedent to assess whether non-OPEC cuts will be adhered to, and we note that historic promises by Russia (e.g. in 1998) to cut production were not followed through. On this occasion, we observe that Russia's production spiked by around 400k b/day going into recent negotiations, therefore a 300k b/day cut is palatable in that it merely pushes Russia back to July 2016 production levels.



Source: Russian Energy Ministry

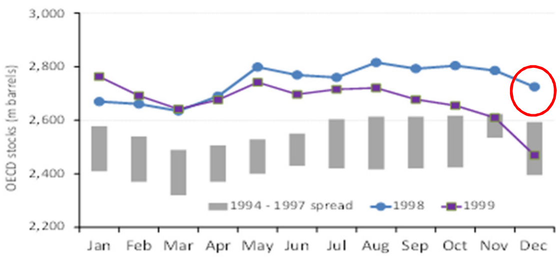
Implications of the OPEC cut

We estimate that the world oil market started 2016 around 1m b/day oversupplied. This had moved close to balance, as nearly a year of global oil demand growth and non-OPEC supply declines more than compensated for higher OPEC production from Iran. However, over the past 2-3 months, the market has loosened, led by partial recoveries in Libyan and Nigerian supply, plus tactical increases in Russian and Iranian production as key market participants positioned themselves into the latest round of OPEC negotiations.

A reduction in OPEC and non-OPEC production of up to 1.8m b/day now provides a clear path to a tightening oil market in 2017. OECD oil inventories currently sit at 3.07bn barrels, around 300m higher than normal for this time of year. A cut of 1.8m b/day for 6 months equates to around 320m barrels, so there is logic in the numbers that have been agreed from the perspective of returning inventories to within the normal range.

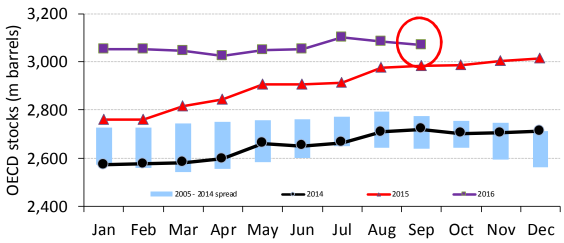
There is precedent for this, looking back to 1998/99. In early 1998, OPEC announced its intention to cut its production quota by 1.25m b/day to reduce oversupply which had caused global oil inventories to swell by around 300m barrels (as shown in the chart below). Oil prices troughed in late 1998 at around $10/bbl (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/bbl in 2000.

OECD oil inventories 1998-1999 (million bbls)



Source: IEA Oil Market Reports; Guinness Funds

OECD oil inventories – current (million bbls)



Source: IEA Oil Market Reports; Guinness Funds

In this cycle, we also expect oil prices to respond positively to declining OECD inventories.

Assuming the oil price moves above $50/bbl in 2017, there will be a supply response from the US, with onshore shale oil production likely to return to modest growth. But more than offsetting this will be a further year of global oil demand growth, currently forecast by the IEA at 1.2m b/day.

Through 2017 and beyond, 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.

How will energy equities be affected?

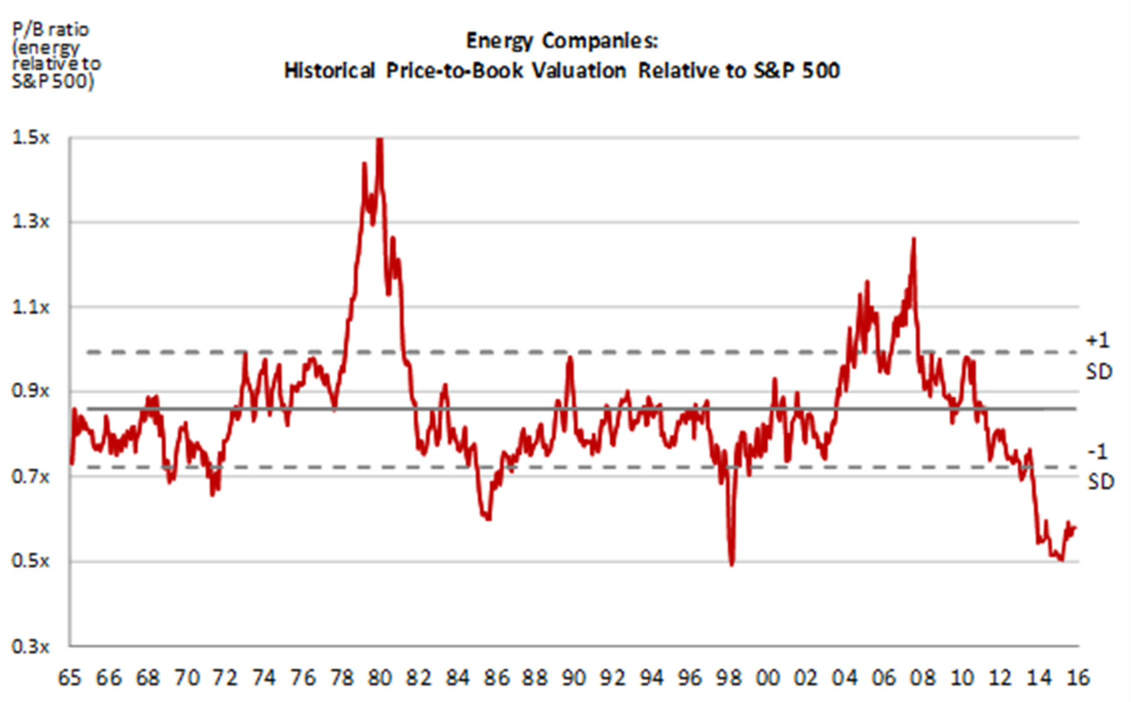
This announcement effectively removes the downside risk in crude oil prices and therefore forms a significant positive for sentiment towards energy equities.

In the 1998/99 period discussed above, 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):

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%

Source: Bloomberg; Guinness Funds, in USD

Today, 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.



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 strong, with upside across the energy complex of around 40-50%.

The Guinness Global Energy Fund has a bias in its current positioning towards oil-levered producers and service companies and we believe it is well placed to capture the upside described here.

The Guinness Global Energy Team

Guinness Global Energy Fund is an equity fund. Investors should be willing and able to assume the risks of equity investing. The Fund invests only in companies involved in the energy sector; it is therefore susceptible to the performance of that one sector, and can be volatile. Details on the risk factors are included in the Fund's documentation, available on our website.

The value of an investment and the income from it can fall as well as rise as a result of market and currency movement; you may not get back the amount originally invested. Past performance is not a guide to future performance.

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