Segal Rogerscasey Canada

INVESTMENT Insight

February 2015

In This Issue: HOT

Q&A about the Low Price of Crude Oil

The dramatic drop in the price of crude oil has dominated the headlines for the past several months. The commonly quoted U.S. crude oil benchmark West Texas Intermediate was trading at over $106[1] per barrel in June 2014, plummeted below $55 in mid-December 2014, and fell significantly below $50 in January 2015. Even if one does not watch the news regularly, the decline was noticeable at the gas pump, as the related price of gasoline has taken a nosedive in less than one year's time.

In this *Investment Insight*, we will explore the possible reasons behind the price decline, address any specific asset allocation or asset class implications for investors, and discuss possible supply-and-demand scenarios for oil and the potential impacts of those situations on crude prices and the global economy.

Why the Recent Decline in the Price of Crude Oil?

A considerable amount of commentary has circulated recently seeking to explain the price swing, but little explains the sell-off satisfactorily. Some of the arguments put forward are listed below, followed by Segal Rogerscasey Canada's observations:

- There is the claim that the global economy is slowing down in various parts of the world, including China and the eurozone, resulting in reduced energy demand. This argument holds merit, even though a question remains about the size of the impact such developments would have on crude oil prices, especially given that we are not talking about an abrupt economic collapse in the energy-dependent parts of the world.
- The Organization of the Petroleum Exporting Countries (OPEC) has been associated with the current price drop, coupled with the claim that Saudi Arabia in particular is trying to foil the U.S. shale revolution ("fracking") while also seeking to inflict pain on the Russian and Iranian oil industries by increasing production. However, at its meeting on November 27, 2014, in Vienna, OPEC resolved to maintain business as usual, not to increase production (that would otherwise have been a tool to drive prices down further). Even though we do concur that countries such as Saudi Arabia are seeking to preserve market share, there is no new or implied increased OPEC production to explain the current slide.
- There is also the claim that we are now in a "supply glut." This is a rather peculiar explanation given that not much has changed in the past several months. The U.S. shale revolution has progressed for several years now, and no major new or unexpected supply has entered the global energy market recently to justify such a large downside move.
- Another argument is that geopolitical forces are at play. However, little has really changed to impact crude oil in either direction:
  - Even though the Islamic State of Iraq and Syria (ISIS or ISIL) has not been endangering new oil fields in recent months, the united international campaign against this terror group is still having only a limited impact.
  - The internal strife in countries such as Libya continues to drive some volatility, as oil shipments have been erratic due to the fighting by various factions.

[1] All prices listed in this report are denominated in U.S. dollars.

- The circumstances in Ukraine and the sanctions on Russia are no longer new developments and, consequently, should have a relatively neutral effect on the global price of oil.
- The nuclear negotiations with Iran had been progressing poorly, and the threat of some sort of pre-emptive military strike by Israel (and possibly assisted by its neighbors) may still be in the cards. This would add a risk premium to the price of oil.

What Are the Specific Asset Allocation and Asset Class Implications?

There are a number of factors currently in play that can affect multiple asset classes. First, the U.S. Federal Reserve's (the Fed) discontinuance of quantitative easing (QE) extinguishes that source of liquidity for financial markets going forward. In addition, the prospect of higher U.S. interest rates in 2015 implies that the cost of capital should increase. This will put pressure on the less-financially-sound corporations that have tapped into bank credit facilities or into the high-yield bond market for sources of funds. Previously, the Fed's dovish policy had a tendency to "lift all boats," or at least steady them, regardless of quality.

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With the drop in crude oil prices, we might expect that energy production companies would earn less revenue to support operations. Those companies with the highest leverage (debt) may find themselves in some distress and at greater risk of bond default. Meanwhile, those corporations with healthy balance sheets may find themselves in a position of opportunity while seeking to streamline operations and cut costs. One of the results of the Fed's recent policy shift could be greater market volatility, building a stronger case for active investment management strategies since security selection will be more vital.

Several of the large oil companies have come under criticism in recent years, not concerning profitability or earnings, but regarding their growth in revenue. These companies were experiencing weak revenue growth due to their inability to replace old terminating projects with new ones, as attractive new prospects were not readily available or were simply too expensive. Given the recent decline in the energy sector, these factors may result in greater merger-and-acquisition activity. The major energy players and producers are expected to benefit the most from making acquisitions given their financial strength, while the smaller energy companies will have a greater struggle to survive and remain independent. Private equity firms may also further venture into the energy space as they entertain the possibility of owning energy companies or acquiring oil properties.

In terms of fixed income, the high-yield asset class has been considered very attractive due to the higher yield potential coupled with low expected default rates. Many investors who engaged in this asset class did so passively, particularly through exchange-traded funds (ETFs). Now with a lower liquidity environment going forward, the expectation is for higher interest rates, and the possibility of higher rates of default, so this asset class may come under greater scrutiny. It is possible that passive investing in high-yield over the next several years may no longer be beneficial, especially after evaluating returns on a risk-adjusted basis.

How Might the Decline in Oil Prices Play Out?

Active management in the oil sector is very important, as certain companies continue to have attractive prospects and can benefit from acquisitions, particularly the larger companies, while others will experience difficulty in maintaining profitability.

The oil price decline has put pressure on the high-yield bond market, as oil companies with weak financial prospects also floated bond issues. It may be difficult for these companies to obtain additional sources of financing from banks and other financial institutions.

In the absence of significant economic weakness and given the high costs of oil production in North America, if prices remain depressed for very long (say below $70 to $80 a barrel), many new projects are likely to be cancelled or postponed with a potential global supply shortfall down the road. The U.S. has become a swing energy producer, but its current high costs of production make many projects unviable when oil prices are below a certain threshold. We consider the following scenarios:

Scenario 1 (Bearish)

Supply declines modestly but demand declines significantly as global economic performance dwindles. Oil prices remain low.

Defaults in the marginal energy producers, which make up one-third of the high-yield fixed income market, occur and cause a contagion in credit. Lending banks increase loan-loss provisions that hurt subsequent earnings and financial risk measures, resulting in a bank sell-off. The global economy weakens further and equity markets decline, putting further downward pressure on oil markets. Several oil-producing economies face a severe financial crisis, putting emerging market debt in general under stress.

Central banks globally, including the Fed, consider extending easy monetary policy and defer increasing interest rates. If economic performance declines significantly, QE will be reconsidered.

Crude oil could trade in the $35 to $55 range.

Scenario 2 (Neutral)

Supply declines modestly and demand increases modestly. Oil rebounds, but not significantly. Industry consolidation takes hold. Some defaults in the high-yield market occur. The global economy continues to grow, but at anemic levels outside of the U.S. sphere. Several oil-producing economies face budgetary pressure, raising concerns about emerging market debt, but in many cases, debt payments are rescheduled.

Crude oil could trade in the $55 to $70 range.

Scenario 3 (Bullish)

Supply declines significantly and demand responds strongly, alleviating oversupply concerns and even suggesting future deficits. The global economy continues to improve and is poised to accelerate. OPEC also looks to decrease supply. Oil prices rise, but not to $100 levels, especially as U.S. oil production continues to expand, which puts a cap on maximum oil prices. Defaults in the high-yield fixed income space are minimal and large-cap energy companies experience good financial results, especially those that were able to make acquisitions during the weak price period.

Crude oil could trade in the $70 to $90 range.

Which Scenarios Are Most Likely?

Currently, our prognosis would be that the future environment should fall under either Scenario 2 or 3, or some blend thereof, especially given that lower energy prices in aggregate should be beneficial to global economic activity, and because central banks should provide a floor to weakening economic performance.

"Crude oil production costs will remain high globally but are expected to decline gradually in the U.S."

Crude oil prices this century have faced upward pressure not only from rising Asian demand and rising production costs, but also from a weak U.S. dollar (USD) and inflation. China and India, in particular, will continue to increase demand, as their developing middle class is expected to use more energy. On the other hand, demographics in the developed world where populations are aging, and an emphasis on energy conservation/efficiency and developing alternative fuel sources, would suggest a declining trend in energy consumption as time progresses. Crude oil production costs will remain high globally but are expected to decline gradually in the U.S. as the applied technologies improve and labour/equipment costs are pressed downwards due to the industry's current weakness. (It is not anticipated that shale production technology will be adopted on a widespread basis throughout other parts of the world at the present time given the cost, but this could become another bearish issue in the years ahead.) The USD appears to be in a strengthening trend, so as long as crude oil is quoted in this currency, it could give the perception that crude oil prices are weaker on a global basis than is actually the case. Even though current oil prices may be at depressed levels (currently in the range of $40 per barrel to $60 per barrel) and could be expected to move higher, there are pressures anticipated in the next several years that could keep oil from reaching its prior peak.

"Segal Rogerscasey Canada sees an investment opportunity in the energy sector, but we are also aware of new risks that must be considered and strongly suggest active management going forward."

The impact of a protracted period of lower oil prices has multiple and far-reaching implications both geopolitically and in terms of investments. The repercussions can affect many asset classes from master limited partnerships to private equity to emerging market debt. Similarly, the implications of oil prices over $100 per barrel were equally significant with a shift to the "haves" (countries exporting oil) from the "have nots" (those importing it). Unfortunately, given that the oil price is not based upon any calculable intrinsic value and supply and demand are impacted by variables that are virtually impossible to predict (who projected $50 pricing last June?), price estimation over the near term is simply speculation. Over the long-term, the price level will determine supply from new technology and/or sources and affect demand, through conservation measures, yet we would expect general upward pressure due to global growth and increasing standards of living. In the near term, as with many substantial unexpected events, Segal Rogerscasey Canada sees an investment opportunity in the energy sector, but we are also aware of new risks that must be considered and strongly suggest active management going forward. ■

Segal Rogerscasey Canada will provide a more detailed analysis of recent oil-sector behaviour in a forthcoming issue of *Investment Focus*, "Crude Oil's Low Price — Q&A on the Causes, Consequences and Implications for Investors."

Questions? Contact Us.

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