The Market Observer

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Positive medium term outlook for Oil

At Ausbil Investment Management, we have high conviction that the outlook for the oil market will continue to improve markedly over the medium term. The oil price remains on track for an ongoing recovery, with the market balancing in 2H16 then entering deficit in 2017 through a combination of healthy demand growth, accelerating US shale output decline, underinvestment in the wider conventional oil industry and advancing natural field decline.

Demand growth remains healthy

We believe 2015 was the strongest year for demand growth since 2010 at 1.6mmb/d year on year (yoy), which was a dramatic resurgence in oil demand after a sluggish 2014. Low prices are likely to be the key driver of the uptick in demand, although Chinese oil demand also proved resilient despite growing fears of an industrial slowdown. The healthy demand environment is forecast to continue in 2016, with both the International Energy Agency (IEA) and the US Energy Information Administration (EIA) forecasting demand growth for the period at around 1.4mmb/d and a similar level continuing in 2017. Our own view is for another year of above-trend demand growth in 2016 of +1.3mmb/d, somewhat impacted by rising prices and potential macroeconomic fallout from the UK referendum.

While we are positive on the potential take up of electric and hybrid vehicles, in the medium term (before 2020) we are not of the view that there is likely to be a material impact on the oil market. Longer term, this impact will likely accelerate. Wood Mackenzie, a consultancy group, forecasts electric/hybrid vehicles will account for 2-3% of the car fleet in the US, Europe and China by 2025. If correct, this level of take up is expected to reduce global oil demand by a mere 0.35mmb/d in 2025.

OPEC to continue to target market share

While no agreement was reached earlier in the year for OPEC members and Russia to freeze production, it clearly highlighted a willingness to undertake a coordinated constructive policy. It was also a potential indication of the financial stress that low prices were inflicting upon producers. We assume that there will be no intervention from OPEC to support the oil market, instead OPEC members will continue to target market share recovery. OPEC production has increased recently following the recovery in output in Nigeria and increased output from Saudi Arabia to meet the higher seasonal domestic demand profile. While Libya and Nigeria represent a risk of increased production from OPEC, most producers lack the capacity to expand production further, with total OPEC spare capacity of 2mmb/d.

US onshore production decline to accelerate

Earnings results earlier in the year from the listed US shale companies saw announcements of 40-60% capex cuts proposed on average for 2016, which followed on from circa 40% cuts in 2015. These cuts to investment are materialising in a dramatic pullback in US drilling activity. The total number of onshore drill rigs deployed in oil plays in the US declined to a low of 316 earlier in the year, down approximately 80% since reaching a peak of 1609 rigs in early October 2014. Despite this pull back in activity over the last two years, production impacts were modest in 2015 given productivity improvements and the likely high grading of resources. 2016 will see the full impact of the collapse in the US rig count with production currently declining 100kb/d per month. Total US oil production is now down 1 mmb/d or 11.2% yoy due to this reduced Lower 48 (Contiguous US, not including Alaska and Hawaii) production.
We expect US shale production will continue to decline near term despite oil prices recovering from earlier in the year and the rig count turning up modestly. We believe that oil prices will need to strengthen further and sustain higher prices before we see a significant acceleration in drilling activity. Oil prices at these levels are not high enough in our view to stop the decline in US onshore production output.

Capex cuts industry wide to play major part in recovery

The wider global oil industry continues to slash investment. It is estimated that the major global oil companies have cut capex by 44% over 2014-16, which is equivalent to some US$500 billion in gross upstream investment. Just a handful of major upstream projects reached Final Investment Decision (FID) in 2015, totalling 1.3mmboe/d plateau production and we anticipate a similar figure this year. Next year (2017) will be the last reasonable year for conventional longer-cycle start-ups, namely those projects which were sanctioned before the oil correction in 2014. While the market continues to focus on short-cycle investment implications of US Shale, this significant underinvestment in the wider oil industry, when combined with natural field decline of 5-7% pa, compounds supply issues and will result in a significant shortfall in required supply in coming years. We believe that supply issues will be compounded by the requirement for significantly higher and stable oil prices before we start to see any material approval of major projects and even then the supply response from these long-cycle projects is unlikely to occur for many years post the investment decision.

Recovery in price to continue into 2H16

We expect the market to balance in 2H16 and enter deficit in 2017. While 2016 prices may actually average lower than those in 2015 (Brent US$52/bbl) as the market adjusts, prices should exit the year strengthening as the market begins to balance, with further upside risk moving into 2017 and beyond, given the significant underinvestment on the supply side.

We believe the market is significantly underestimating the impact of the longer-cycle industry-wide chronic underinvestment. Ultimately this supports our high conviction that oil markets will enter a material deficit over the medium term and prices will continue to strengthen significantly. We believe a scenario can be presented where oil prices break through US$100/bbl again in periods of heightened volatility. Our base case scenario is for oil prices to increase to an average of US$60/bbl in 2017 and US$70/bbl in 2018. Both years are above consensus and likely to result in ongoing earnings upgrades and ultimately share price outperformance for listed energy companies. Given the Ausbil Investment Process primarily focusses on earnings and earnings revisions, we have built up a significant overweight position in the Energy sector in a bid to capture any potential outperformance.

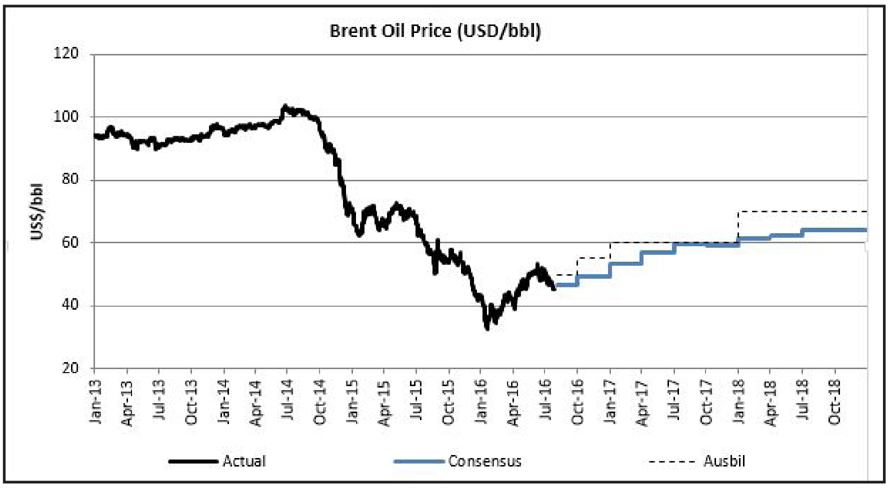

Chart 1: Brent Oil Prices (US$/t) – Actual vs Consensus

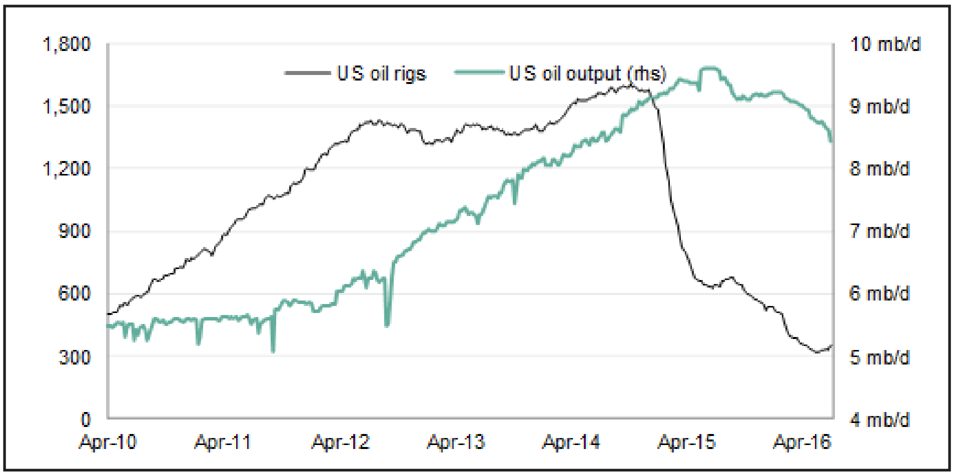

Chart 2: US Onshore Oil rig Count vs US Oil Output