Energy Outlook: Oil Recovers, Opportunities Arise

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research,* reviews 2016 and highlights the upside potential for energy in 2017.

> Looking to 2017, our view remains that there will be further price recovery

A LOOK BACK

This past year has not been an easy one for the global oil market. While oil prices have bounced from the 13-year lows reached during the first quarter of 2016, both West Texas Intermediate (WTI) and Brent crude prices averaged in the mid $40s for the full year, about 10% lower than 2015.

The recovery has been slow for several fundamental reasons, including a strong dollar (especially with the recent jump in U.S. bond yields) and concern about high levels of refined product inventories worldwide. However, there are also reasons for optimism. Supply response in various non-OPEC geographies (U.S., China, Mexico, Colombia) is visible, and there are supply outages in some of the OPEC countries (Libya, Nigeria, Venezuela). Most recently, on November 30, OPEC announced its first coordinated production cut since 2008, alongside a similar commitment from Russia. History teaches us not to expect 100% compliance, but even partial implementation will still be a bullish driver for oil supply.

Looking to 2017, we remain of the view that there will be further recovery, to an average of $70/Bbl WTI and $73/Bbl Brent. This represents a cyclical peak, since we expect long-term prices to average in the $60s, but the higher 2017 level will provide a stimulus for the industry to get out of its two-year period of austerity and back to a more sustainable level of investment. Oil and gas capital spending was down globally by more than 20% in 2015 and 2016, the steepest two-year decline since at least the 1980s. The result was a non-OPEC supply decline of nearly 1 million barrels per day (1.5%) in 2016, as well as a large number of long-lead-time project cancellations (in countries such as Brazil and Canada) whose effects on supply will be felt in the latter years of this decade.

While there are a few companies (for example, in the Permian Basin) that are able to grow production even in the current commodity landscape, the vast majority worldwide cannot. For the industry as a whole to be able to afford a durable recovery in drilling activity, and thus supply growth, there must be recovery in cash flow, which in turn requires higher oil prices. This certainly does not mean that oil is heading back to its all-time highs above $100/Bbl, but we think it will be very difficult to achieve medium-term non-OPEC supply growth below the $60s.

NATURAL GAS

In contrast to our upbeat view on the global oil market, we are much less enthused about North American natural gas. The exceptionally hot summer helped in 2016, adding to the fact that domestic supply was rolling over more or less continually during the year. However, some of the structural trends are still bearish: development of industrial gas demand has been frustratingly slow, the ramp-up in wind and solar has been eating into the market share gains of gas in the power sector, and liquefied natural gas (LNG) exports will not be needle-moving until 2018.

Following a 2016 average of around $2.40/Mcf for Henry Hub gas, we project a 2017 average of $3.25/Mcf, which is better but still not too bullish. Meanwhile, the European gas market is in even rougher shape, with demand languishing near 20-year lows. Asian gas demand has been growing, but not as much as the industry would have hoped, which helps explain the current oversupply in the global LNG market as supply ramps up from projects in Australia and elsewhere.

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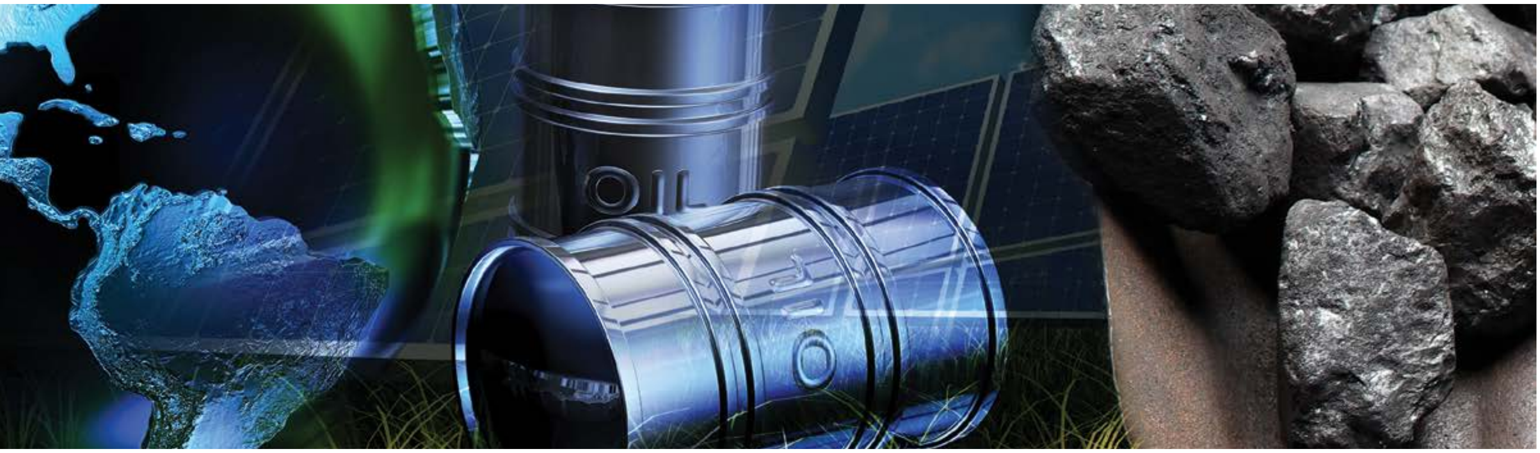
U.S. ENERGY POLICY OUTLOOK

Since we are on the topic of commodity markets, let's address the outlook for U.S. energy policy as the Trump administration and the new Congress take charge. When it comes to oil market fundamentals, the recent U.S. election – like almost all elections anywhere in the world – has very limited effect. One obvious beneficiary will be the Keystone XL pipeline, as well as some other delayed midstream projects, which the incoming administration will likely approve. Opening up Arctic and East Coast offshore acreage to drilling is also an open question, but under foreseeable oil price conditions, it is largely a moot point.

Where the new political landscape matters more is with regard to the electric power sector. The Obama administration's proposed Clean Power Plan will not take effect nationwide, although 16 states are already moving forward with their own de-carbonisation targets. Coal, whose market share in the electricity mix had

U.S. ENERGY MARKET SHARE BY SECTOR

	COAL	WIND & SOLAR	NATURAL GAS
			
	DOWN 17%	UP 6%	UP 14%
	NOT DECLINING AT A FASTER RATE	GAINING BUT AT SLOWER RATE	TREND OF FURTHER EXPANSION
2005	50%	2%	19%
2015	33%	8%	33%



plummeted from 50% in 2005 to 33% in 2015, will benefit by not declining at an even faster pace. However, it is hard to imagine coal's share rebounding, since its underlying decline was driven largely by technological changes (fracking and cheap gas, plus cheaper renewable power) and, to some extent, state-level regulations. Non-hydro renewables (mainly wind and solar, though including geothermal and biopower), which had soared from 2% in 2005 to 8% in 2015, should keep gaining share, but at a slower rate than what they could have exhibited under the Clean Power Plan. Natural gas (up from 19% in 2005 to 33% in 2015) is likely to be a mixed bag from state to state, but our bias would be for further expansion on the whole.

UPSIDE PARTICIPATION

For energy investors, we believe the most important theme in 2017 is to have exposure to the potentially continuing oil price recovery. This can be accomplished most directly with equities of oil producers (E&P and integrated companies), and indirectly via service contractors and midstream MLPs.

Since nearly all of these companies are involved in a combination of oil and gas, it is important for investors to consider the individual commodity weighting of any given company. Other business-specific factors, such as geographic exposure and balance sheet metrics, are also relevant. Selectively, there are opportunities in some of the gas-centric companies. Similarly, companies involved in refining and renewable energy, which are less tied to commodity price trends, should also be considered on a selective basis.

KEY TAKEAWAYS:

- Looking to 2017, we remain of the view that there will be further recovery, to an average of $70/Bbl WTI and $73/Bbl Brent.
- While the U.S. presidential election should have little effect on oil market fundamentals, one obvious beneficiary will be the Keystone XL pipeline, as well as some other delayed midstream projects, which the incoming administration will likely approve.
- For energy investors, we believe the most important theme in 2017 is to have exposure to the potentially continuing oil price recovery. This can be accomplished most directly with equities of oil producers (E&P and integrated companies), and indirectly via service contractors and midstream MLPs.

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Head Office Broadwalk House 5 Appold Street London EC2A 2AG
www.RJIS.co.uk

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