Are There Opportunities in Oil?

Executive summary

U.S. oil prices have now spent the early months of 2015 at below $55 per barrel, after spending the past four years near an average price of $100 per barrel. Investors have been bargain hunting in the oil patch but have yet to be rewarded, and the expected boost has yet to materialize. Direct investment and employment in oil production has fallen, although production has not yet slowed. Consumers are reaping a savings windfall from low gasoline and energy prices but seem to be saving rather than spending their extra cash. In our view, time will resolve both issues.

Later this year, the decline in oil industry investment may result in slower production, but for now the industry is producing more oil based on the prior spike in investment spending and some technical factors that incentivize them to produce now instead of later. The decline in production growth should eventually lead to oil prices recovering, but perhaps not as dramatically as some might expect. After months of saving a bit of money when they fill their gas tank or heat their home, consumers will realize they have some extra money in their pocket and may begin to expand spending in other areas of the economy.

We believe investors should be watching both the energy industry and consumer stocks for opportunities to potentially benefit from the slide in oil prices. Lower energy prices are likely creating stress for some energy companies and investors may benefit from providing capital to a struggling industry. Consumer stocks could see better sales growth later this year as a result of the shift in consumption patterns. Oil prices should see some recovery later in the year, but they will likely struggle to rise to $65 per barrel because of strong supplies globally and relatively weak demand growth.

Update on oil price trends

After the collapse in oil prices during the last half of 2014, oil prices have spent early 2015 in a volatile range of low prices. West Texas Intermediate Crude Oil prices have ranged between $55 and $42 over the first quarter of the year. Speculators expanded long oil futures positions and positions in oil and energy equity exchange-traded products, but prices have remained stubbornly low. Oil rig counts, a measure of investment in oil production, have dropped by nearly half in the past six months, but oil production has continued to grow, adding 280,000 barrels per day of production, and oil inventories have risen to the highest level in at least 80 years.

Despite strong demand from speculators, the growth in oil inventories and oil production has suppressed oil prices. We anticipate oil prices are likely to finish 2015 above the recent price range—perhaps reaching $70 per barrel should oil production slow, closing the current gap between global supply and demand. However, the path is likely to be quite volatile, with some chance oil prices could reach new lows for the year should speculators become impatient with the lack of price gains or should oil production fail to slow sufficiently.
Impact of low prices on the oil patch

Low prices are creating some pressure on domestic oil explorers and producers, particularly those with relatively high costs of production or those who have relied on excessive leverage to fund investments for production.

We witnessed some signs of distress at the end of 2014 when bond yields for junk-rated energy companies spiked relative to yields for the broad high yield indexes. Yields on the energy sector of high yield climbed above 10 percent in December 2014, an increase in yields of more than 4 percentage points in just over five months. Meanwhile, the high yield index climbed to just 1 percentage point over the same time period, reaching a yield of 7.3 percent.

Stress appears to have since eased in the oil patches, with yields falling almost 2 percentage points, but yields remain more than 2 percentage points higher than the index. We have witnessed some companies raising capital in equity and convertible debt markets, such as Whiting Petroleum raising $2.75 billion in late March through the sale of common stock, convertible senior notes and senior notes.

We anticipate the industry will likely see additional transactions, such as mergers, stock or note sales and perhaps even some bankruptcies. The impact will likely be across a small subset of the total industry with capital in the form of larger companies and private capital acquiring the distressed assets.

This transition in the industry from companies with relatively weak balance sheets and poor productivity, given the longer-term outlook for lower oil prices, may create opportunities for investors and companies with stronger balance sheets and operating efficiencies. Ultimately the industry should be in a stronger position a year from now, with a lower cost of capital and better productivity.

Where are the possible consumer benefits?

Since November 2014, retail sales have been slowing despite an improving employment market, solid consumer confidence and falling energy prices. Market observers have been concerned that this time may be different and consumers may not spend. Between October and March 2014, the skeptics have seen their fears borne out.

Despite a 3 percent annualized decline in the headline consumer price index and a seven point increase in The Conference Board Consumer Confidence Index, retail sales have declined by more than 2 percent annualized and the savings rate has increased by 1.3 points to 5.8 percent. Much of the decline in retail sales may be explained by the fall in gasoline prices themselves. Over the same time period, gasoline station sales fell by nearly 20 percent, which is reflective of the decline in the price of gasoline.

Historically, when faced with windfalls from tax cuts or falling energy prices, we have not seen a response in consumer spending for six to 12 months. Typically, consumers save the initial windfall and eventually treat their increased wealth as permanent and increase their spending. With 70 percent of U.S. gross domestic product (GDP) comprised of consumer spending, and less than 3 percent investment spending in the oil industry, the eventual lift in consumer spending could provide a modest lift to U.S. GDP, perhaps exceeding 3 percent this year.
**Longer-term energy prices and opportunities**

Over the last five years, U.S. crude oil prices have been above $100 per barrel nearly one-quarter of the trading days, and above $85 per barrel more than three-quarters of the time. During this period, prices reflected a relatively tight relationship between supply and demand, a ramp up of demand from emerging market countries, particularly China, and little supply growth. In the past three years, U.S. oil production has doubled while world oil production has grown by just 6 percent, and growth in China has slowed from double digits to around 7 percent. With the Organization of Petroleum Exporting Countries (OPEC) choosing to maintain current oil output levels, the status of “marginal producer” in the oil market is now falling to the highest-cost producers, which in this case are the shale oil producers who have dominated the growth of oil production in the United States.

While in the near term these oil producers are likely to cut production in response to the lower prices, in the long term the stronger players in the industry are likely to continue their innovation. This innovation could lead to lower marginal production costs and ultimately keep oil prices relatively low. We also expect the industry to ultimately capitalize on their intellectual capital in exploiting shale formations to extract oil and natural gas by implementing their methods in similar formations outside the United States. This should keep the world well supplied with carbon-based energy over the next few years.

We expect both the energy industry itself and some of its key consumers to be beneficiaries of investment in energy production and of lower energy costs. The industry may benefit from the lessons learned by these companies in the development and extraction of energy from the shale formations. These companies will likely be sought to further develop new fields for oil and natural gas production, particularly as the technology and operational skills are further refined. The lower costs may enable some manufacturers who have moved offshore to return to the United States since the cost of production inputs may have narrowed relative to the costs of producing outside the country.

**Conclusions**

- Oil prices are likely to see pressure in the near term, but should rise modestly on a longer one- to two-year horizon.
- Low-cost energy producers will see advantages and may benefit from consolidation opportunities.
- High-cost and highly leveraged energy companies are likely to see pressure, perhaps even defaults.
- Consumers could see some benefit from lower oil prices later this year, which could lift consumer spending.
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