Causeway Capital Management LLC

Market Commentary: Why Own Energy Stocks?

January 26, 2016

Are energy stocks worth the risk? Yes, but like most cyclical stocks, the time to buy is typically when investors only see the darkness, not the dawn. As a systematic risk factor, volatility has exhibited one of the longest period of drawdowns and worst cumulative returns over the past 15 years. Unfortunately, energy stocks are loaded with volatility. In order to compensate clients for the performance turbulence associated with energy stocks, Causeway requires well above average portfolio expected returns. What returns should we expect? The answer depends on the commodity price assumed in the stream of cash flows (positive or negative) from each company. In a free market, supply and demand dictate price. Causeway expects steady oil supply this year—production from the Organization of the Petroleum Exporting Countries (OPEC) offsetting declines in non-OPEC countries. We have examined the data, consulted with industry experts, and determined that oil demand growth will likely exceed supply growth by over one million barrels per day (mmbpd) this year. That should lead to oil inventories declining by the end of this year. We believe that once this inventory decline becomes evident, buying interest will rise in the energy sector globally.

The International Energy Agency (IEA) expects 2016 oil demand to increase by 1.2 mmbpd. Our prior demand estimate from mid-2015 was 1 mmbpd, but the lower oil price along with continued US real gross domestic product (GDP) growth above 2% could drive the upside to 1.2 mmbpd.

Causeway expects 2016 oil supply to remain about flat year-over-year. 2016 non-OPEC supply should decrease by 600 thousand barrels per day (kbpd). This is largely consistent with our expectation back in July 2015, when we projected 2016 non-OPEC supply shrinkage of 500 kbpd. Given the current oil price of about $30 per barrel, we believe there could be further downside to this estimate. Note that the 600 kbpd implies a decline of only 1% off the roughly 60 mmbpd of non-OPEC production.

At oil prices below $50 per barrel, increasing numbers of even highly efficient exploration and production projects become uneconomic. Managements have little choice but to balance capital expenditures and cash flow. No incremental cash flow equals no drilling and no new wells. Almost by definition, this should hamper production growth, due to the natural decline characteristics of oil reservoirs. Then consider the rapid decline rates of North American unconventional shale wells (the source of much of the world's incremental growth in supply over the past five years). If that wasn't enough, oil & gas exploration requires financing. Without the support of the capital markets and banks, the capital starvation program will shrink funding for new projects and thus restrict supply.

Iran's return to the market and estimated incremental export of 600 kbpd will likely offset the entire decrease in non-OPEC supply. We have no visibility on OPEC supply growth outside of Iran, but we currently assume OPEC growth, other than Iran, to be flat in 2016. We would note that Saudi Arabia's December production was 400 kbpd below the peak level reached at mid-year, which refutes the notion that the Saudis are continuing to grow production unabated.

We believe that the inflection in inventories will correspond to the inflection in the crude oil price. Just as oil prices slid as rising inventories were reported throughout 2015, we believe oil prices should rebound to at least $45/bbl as inventory draws are reported in the second half of this year.[1]

More pain may loom in the next few months, however. Inventories will continue to build through June as supply continues to outpace demand. During this period of time, the oil price could remain weak. We will likely use that opportunity to add further to portfolio holdings with the highest crude oil beta. Once inventories begin to contract, the market may price in undersupply faster than expected as much of the current inventory in regions like China and the United States will remain hoarded for risk reasons.

---

[1] *Note that even in this scenario, the overall inventory number in 2016 could end up higher than 2015, such that 2016 is still considered to be a "build" year based on IEA data. (Note that data such as demand numbers get revised up, more often than not, throughout the year.) We think the directionality drives the oil price – once inventory draws are reported in data, the oil price should begin to recover.*

This market commentary expresses the author's views as of January 26, 2016 and should not be relied on as research or investment advice regarding any investment. These views are subject to change, and there is no guarantee that any forecasts made will come to pass. Forecasts are subject to numerous assumptions, risks and uncertainties, which change over time, and Causeway undertakes no duty to update any such forecasts. Information and data presented has been developed internally and/or obtained from sources believed to be reliable; however, Causeway does not guarantee the accuracy, adequacy or completeness of such information.