

## Focal Point

# Oil: Demand and output cuts to support prices in 2018

December 22, 2017



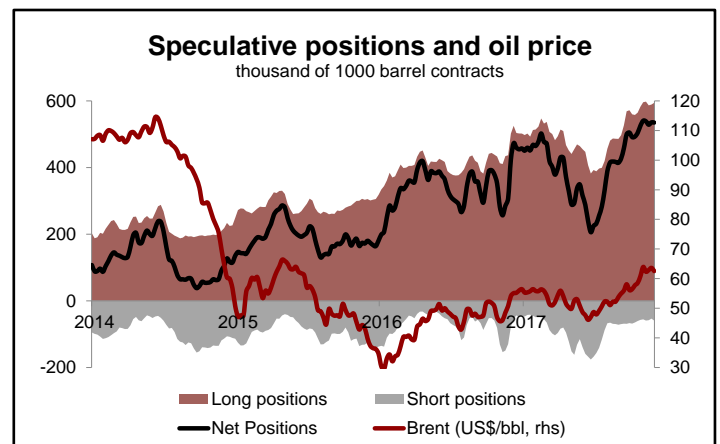
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- Tight compliance by OPEC and Russia to the supply cuts plan and strong demand led Brent price up by 40% in H2 2017, to 64 US\$/bbl. The extension of the agreement to end-2018 will support prices at just below the current level.
- Short term risks are on the upside, as a breakup of the agreement looks unlikely and demand could be stronger than expected. However, discipline among the producers will be hard to be maintained in 2019, due to diverging economic and political priorities: this will exert a limited downward pressure on prices.
- The effect of continuing cost rationalization and stable oil prices will favor energy stocks. Despite the recent improvement, they remain undervalued in the medium term, with also safe and high dividend yields. We suggest an overweight position in this defensive sector, consistent with our current more balanced and less risky sector allocation.
- Should the market experience a setback, the sector's defensive characteristics would not represent the best choice to play a rebound.

In the second half of 2017 oil prices staged a quick recovery. The agreement between OPEC and some other key producers to reduce supply by around 2% of global output was instrumental to this rebound. Its recent renewal will be a key driver of the projected stabilization in oil prices for the next year. However, such an agreement will be harder to maintain in 2019. In what follows we sketch our forecast for oil prices and some key implications for equity markets.

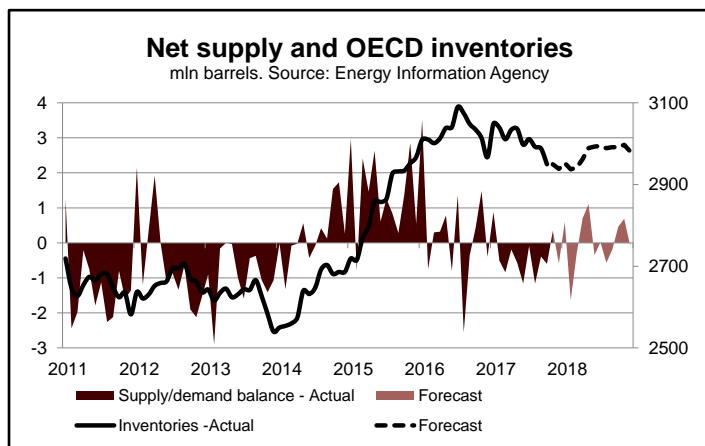
### Supply remains the key driver for prices

The agreement reached last winter by the OPEC and a few key non-US players (most importantly Russia), aimed at restricting supply, proved surprising stable. According to recent estimates, compliance during the autumn exceeded 100% (i.e. member countries cut output by more than what was agreed), nearly the double of what achieved in past attempts at coordinating supply. The output from US shale producers picked up slowly, and was matched by higher demand, as the business cycle in both emerging and developed economies strengthened. As a result, the drop in prices occurred in June (with the Brent down to 46 US\$/bbl.) was quickly reversed, with prices ending the year at around 64 US\$. At the same time, the proven strength of the commitment, the positive macroeconomic surprises and the temporary reduction in supply due to political instability in the Middle East and Northern Africa led markets to revise upwards their expectations on oil prices. Therefore, long speculative positions reached a record high, further supporting spot prices.



On November 30 the agreement was extended until the end of 2018, with the stated aim to stabilize the level of inventories rather than to lift prices. Our outlook for 2018 is based on the assumption that the pact will hold. As a consequence the Brent should ease slightly from the current level, as the effect of the temporary cutbacks subside, but will likely fluctuate at just below 60 US\$ for the rest of the year.

We think that risks are tilted to the upside in the short term, as geopolitical tensions in the Middle East may persist for longer longer and demand may be even stronger than expected. The offset provided by US shale producers has so far fallen short of expectations, both in terms of numbers of rigs in operations and sluggish productivity increase. Should this continue, global supply would be capped in the coming months.



### Downside risk to prices in 2019...

However, the situation is likely to change from the second half of the year onwards. The Chinese economy may face a steeper slowdown than we expect, depressing oil demand. For example, looking at the estimates from a series of global macromodels, a 1 percentage point reduction in Chinese GDP growth pushes oil prices down by around 7%.

Concerning supply, it has to be recalled that the agreement struck in November tries to balance several possibly conflicting objectives. It targets at a price level high enough to be admissible for high cost producers and compatible with the forthcoming IPO of Saudi Aramco, but without triggering an overflow by low cost suppliers (i.e. US shale) and a reduction in demand.

Within a few months the incentive not to deviate from the agreement may weaken, especially for Russia. Its below average production costs and the possibility to tap into new oilfields, expected to start operating later next year, would make it trickier to forego additional revenues (extremely important for fiscal policy) in order to comply with the agreed cuts. In this sense the meeting scheduled for June 30 to monitor the implementation of the agreement could become a turning point, as Russia could use it as a way out. Moreover, the additional investment undertaken by US producers in 2017 will add to supply.

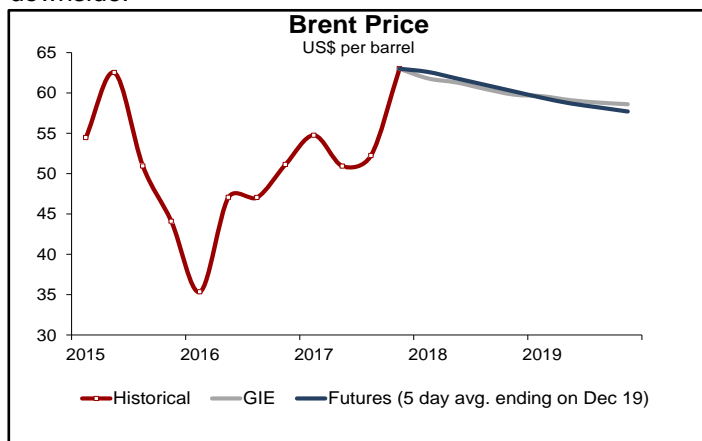
All in all, we expect Brent price to ease from the final months of 2018 onward, and start to converge gradually to the long term marginal cost, estimated at around 55\$/bbl, which is also consistent with the fiscal targets of the largest producers.

The possibility of a higher supply from Russia and US producers introduces a large downside risk to the forecast. Needless to say, the ongoing tension between Saudi Arabia and Iran, potentially heightened by the new assertive US policy on Palestine, constitutes a looming risk of supply disruption.

### ...but with a limited impact on inflation

The stabilization of oil prices at just below the current level plays only a minor role in our forecast of globally higher inflation next year. In order to provide a range of the possible impacts of possible shocks to oil prices on US inflation (possibly the most closely watched macroeconomic variable next year), we ran some simulations using the Federal Reserve's FRB/US model.

In order to calibrate the upside and downside shock to oil prices, we consider the one year-ahead volatility implied by futures. Taking an admittedly very large 95% confidence interval we get a potential upside of 47% and a 20% downside.



In the simulations we assume that the oil price reaches those levels within four quarters starting at the beginning of 2018 and remains there thereafter.

We find that in case of a nearly 50% increase in oil prices, US headline inflation would climb to around 3% by the end of 2018. Should prices fall by 20%, inflation would reach a though of 1.8%. In neither case the impact on inflation and unemployment would not be enough to force the Fed to deviate from its path of interest rate hikes in 2018 and 2019.

### Energy stocks appear still undervalued

The projected stabilization of oil prices at a much higher value than that of the past two years will increase the attractiveness of oil stocks, which have also staged a marked improvement in fundamentals.

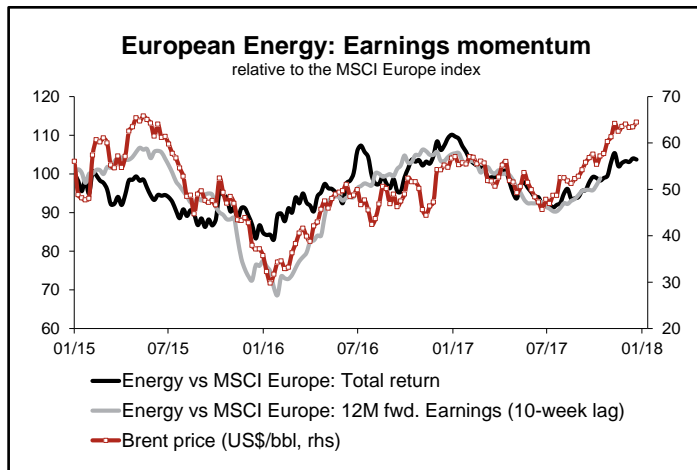
This year, the European energy sector has delivered a total return of 5%, underperforming the European index by 6pp. This is in line with stabilizing 12-month earnings estimates (+0.5% vs. +6.5% of the European index) after the noticeable increase in 2016. Such estimates are also lagging, as usual, the recent increase in oil prices.

After the H2 2015 price slump, oil companies have been supported by three factors: a cyclical rebound in commodity demand (which limited oversupply), deep cost and capex reduction and de-leveraging. This ultimately triggered a substantial recovery in free cash flow from the trough of April 2016. Since then, energy sector's earnings have improved by an astonishing 74%. The last reporting season, which refers to Q3, showed a noticeable earnings growth, above the average European sector (+77% vs. 11%). Sales' growth was higher too at +21% vs. index average of 4%. The sector's earnings revisions' trend remains strong, approaching a cyclical high. Such recovery has in turn reduced substantially tail risks for the sector. The improvement clearly shows up in much healthier balance sheets too.

Given our forecast for oil prices, companies should improve cash flows in 2018, leading to an over 5% dividend yield. The free cash generated should indeed cover the dividend by a factor of nearly 1.5, helping maintain a lower indebtedness (debt/ebitda) compared with the Stoxx600 average. Moreover, our credit analysts believe there are

high chances to see increasing cash dividends in 2018 and possibly some share buy-backs.

Such policies would benefit equity investors over bond holders at the margin. Additionally, efforts to increase efficiency could push the breakeven oil price down to 45\$, boosting profitability.



On top of this, while showing some exuberance on the 12-month PE and a still lower ROE if compared to the European average, the sector fares particularly well on other long-term valuation metrics, ranking third of the 24 European sectors that we follow. All the main indicators show a higher discount than the average European sector. Furthermore, our “value” indicator (12-month forecast earnings divided by the 10-year rate, adjusted for the risk premium), while around the fair value, is indeed increasing.

Based on the EV/EBITDA ratio (EV is “enterprise value” which takes into account also the debt position), the oil sector looks substantially cheaper than the MSCI Europe (by 34%). Such discount is by 5-10% higher than the historical average.

In sum, we see several reasons to overweight an undervalued sector like energy at this stage, given also our short term cautious approach to equities and prudent bias for sector allocation. In order to compensate for the possible risks originating from the recent higher positioning on both the oil sector and the oil futures markets, we put on underweight the more expensive material sector, which is linked to the commodity space anyway and shows a similar high global positioning. Having said this, investors’ sentiment on the oil sector is indeed high, but only slightly above the average occurred in the years from 2008 to 2012.

Furthermore, the oil sector would not score badly among other European sectors (slightly positive in relative terms), should, as we forecast, inflation and real rates increase in the next year and the German yield curve steepen.

For the next few months, our quantitative model, based on our forecasts for the UK pound (many oil companies are listed in the UK), the MSCI Europe and the oil price, predicts a marginal overperformance for the oil sector (2%), should the market experience the broadly sideways movement we forecast. Should the broader MSCI EMU index correct appreciably in the next months (-5/10%) the sector would outperform more, by 4% or 7% in total return thanks to its more defensive nature. Should such market

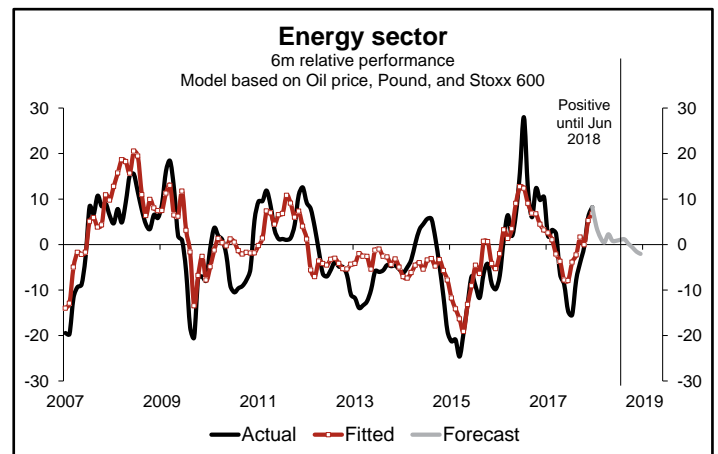
seback happen, we could think to go neutral the oil sector again, in order to play more cyclical sectors like financials or discretionary, for a subsequent rebound.

On a 12-month horizon, should the total return of the broader index improve and reach 6%, as we forecast by end-2018, the energy sector could underperform by 2pp. The latter results from a price underperformance of 4% and a higher dividend yield of nearly 200 bps.

Sectors	PE		PB		PCF		DY		Avg. Discount
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	
Europe	15.0	6.7	1.8	6.8	9.3	25.5	3.6	-6.9	11.5
Auto and Comp.	8.1	-39.1	1.1	2.9	4.7	11.3	3.5	9.5	-8.6
Banks	11.5	0.5	1.0	-13.6	6.8	30.7	4.7	-0.5	4.5
Capital Goods	17.3	19.0	2.8	28.9	11.6	27.0	2.7	-16.4	22.8
Consumer Durables	19.1	18.4	3.0	30.4	15.6	36.7	2.6	12.0	18.4
Diversified Financials	14.4	20.8	1.1	-4.9	9.5	13.3	3.2	-11.2	10.1
Energy	15.2	14.4	1.3	-16.7	6.3	12.3	5.3	12.2	-0.5
Food Retailing	14.7	-4.3	1.4	-22.7	6.3	-7.6	3.4	3.2	-9.5
Food, Beverages & T.	20.2	21.8	3.8	14.2	15.8	26.0	3.0	-6.0	17.0
Households	20.5	-15.8	5.4	45.7	16.9	12.1	2.6	13.1	7.2
Insurance	11.0	-18.0	1.2	3.4	14.5	-56.6	4.9	3.3	-18.6
Materials	14.6	14.3	1.8	13.7	8.4	19.0	3.2	4.2	10.7
Media	14.5	-29.9	2.1	-16.0	8.1	-6.5	4.0	3.4	-13.9
Pharma	15.3	-12.3	3.3	1.0	13.0	11.3	3.4	-1.0	0.2
Retailing	17.9	3.4	3.5	16.2	12.5	12.3	3.3	-8.9	10.2
Software	21.3	-20.2	3.8	17.1	17.7	24.1	1.5	-12.0	8.3
Technology Hardw.	18.3	-13.9	1.6	-29.7	14.5	19.7	3.2	7.6	-7.9
Telecoms	15.3	-63.7	1.6	1.3	4.6	-4.4	4.8	-13.8	-13.2
Utilities	14.3	3.0	1.5	-8.2	5.9	0.7	5.0	-4.1	-0.1

Note: Discount in % to long-run norm; 12m f = expected in 12 months. PEs are since 1995, the rest is since 2004 in case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple.  
Source: Thomson Reuters Datastream, IBES estimates.

Summing up, the sector looks attractive for a typical insurance portfolio, based on dividends which are definitely sustainable given our price scenario. Short term, it is still attractive for its defensive characteristics, but should the market experience a difficult phase in the next months, the sector could then underperform on a subsequent rebound phase.



# Imprint

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