Focal Point

Oil: strong, but not permanent price increase

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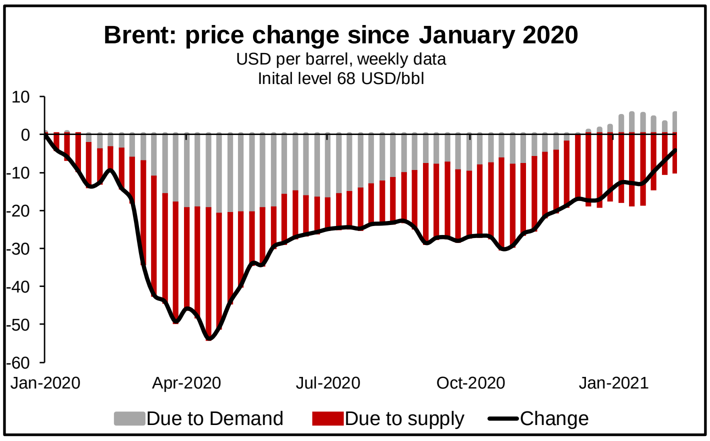
- Year to date, Brent prices have been up by nearly 30% to US$ 67/bbl, one of the fastest increases in decades. The climb is set to continue well into summer, and we project prices to peak at just below US$ 75/bbl by the end of Q3.
- A quick global recovery will push up demand strongly, against a tightly disciplined supply of OPEC+ and a slower than in the past pick up in US shale production. Stronger supply and growth normalization is then set to gradually drive prices back within the range of US$ 60 to 65/bbl, which suits both US and most of OPEC producers.
- Energy equities' recent outperformance still has legs. Higher oil prices will push earnings further up keeping valuations attractive. The ESG score is a negative but the cyclical upturn and low positioning bode well at least in the short term.
- Oil sector credit looks cheap to fundamentals but will remain hindered by its poor ESG profile especially as the ECB might decide to underweight Oil bonds in its purchase programs.

The sharp increase in oil prices (+29% year to date) has been one of the key factors behind rising fears of global inflation overheating and has led to speculations about the start of a new commodity super-cycle. We do believe that oil prices still have legs, but longer-term a balance between the largest producers (OPEC, Russia and US shale companies) will prevail, bringing the Brent prices back within the 60-65 range by the end of 2022. Higher oil prices will support a further increase of energy equities and tighter credit spreads at least in the short term, but headwinds from ESG concerns will strengthen in the medium term.

The pandemic effect on prices is almost erased

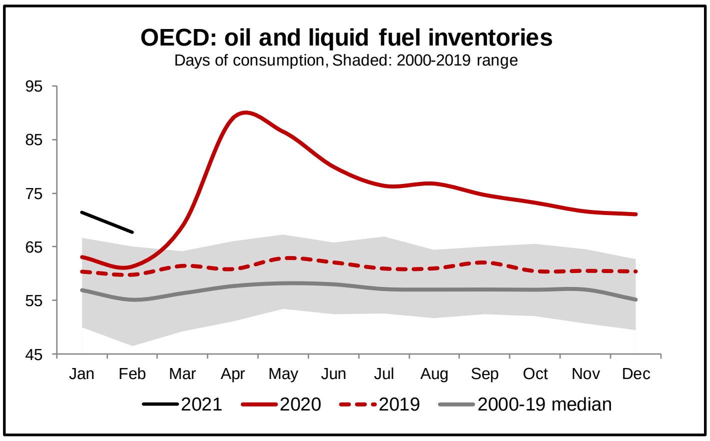
In the first weeks of 2021 the continued pick-up in prices has gathered speed, in line with increased mobility in Asia and the higher global optimism as vaccination in the US and the UK proceeds quickly, likely ensuring a reopening of the economy in the spring and summer. The winter months, moreover, have been colder than normal, leading to strong demand despite the mobility restrictions. On the supply side, the agreement between OPEC, Russia and other non-US players (OPEC+), responsible for more than 45% of global oil output, has proven effective in limiting supply growth. Their output is some 15% below the January 2020 level, contributing to mop up the large stock of inventories. On top of that, harsh weather conditions in Texas led to severe disruptions in oil extraction, which is taking off the market around 5% of global output. Production and refinement will be restored, but this will take a few weeks. Rising physical demand for oil is compounded by speculative inflows, as investors are turning to commodities as hedges against inflation.



Tighter short-term supply as shale reacts slowly

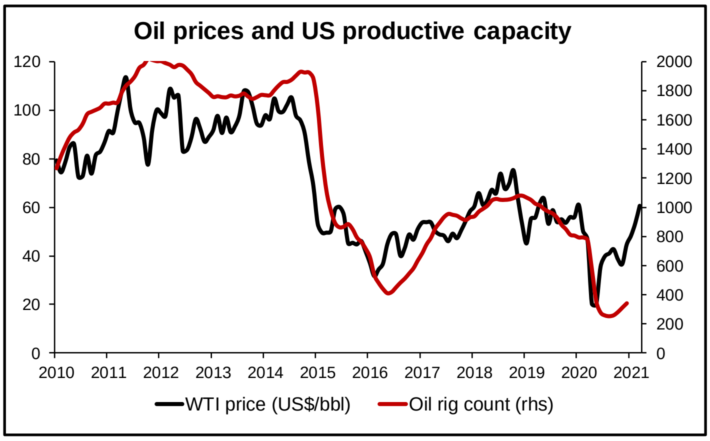
With inventories drifting back within the historical range, the interplay between supply and demand will be transmitted more rapidly to prices. The sharp increase in consumption (expected especially in the US) will prop up gasoline demand and, in the euro area, the push towards infrastructure envisaged by the Next Generation Plan will likely raise energy consumption later in the year. Moreover, widespread immunisation in the US will lead by the summer to a rebound in all the activities that have been curtailed during the lockdowns. With transportation (especially airlines) soaring from the current depressed level, oil demand may temporarily outpace overall activity growth.

We expect the spike in demand to meet, at least until the end of the year, by a tightly controlled supply. OPEC+ members seem to have learnt the lesson from badly timed increase in supply in April 2020, exactly when the pandemic killed off demand.



Since the economic recovery started off, production has been nudged up only very gradually and by far less than the projected increase in demand. This position has been confirmed at the March 4 meeting, where countries ruled out any increase in production allowing only a small rise in Russian and Kazakh supply. A genuine ramp-up in OPEC+ production, back to the end 2019 level will have to wait for more certainty on the strength of the global recovery. A meaningful increase in supply will likely be postponed to the second half of the year. A possible wildcard could be the end of sanctions against Iran, as the US administration is keen to re-join the talks on nuclear capacity. However, a quick restoration of the pre-Trump status quo is not given the still large divergence in positions between the two countries. Moreover, OPEC+ output is roughly 12 times higher than Iran's, so it can accommodate an increase in Iranian supply. The hit to public finances in Gulf states has been strong but not severe enough to force them to increase supply to replenish the state coffers. As signalled recently by rating agencies, debt remains relatively low when measures as share of GDP and governments have in the past set aside significant fiscal reserves. Finally, the urge to maintain and increase market shares, which in the past led to substantial rises in supply, looks weak, as the prospects of a quick increase in supply by US shale producers (OPEC+'s main rival) appear low.

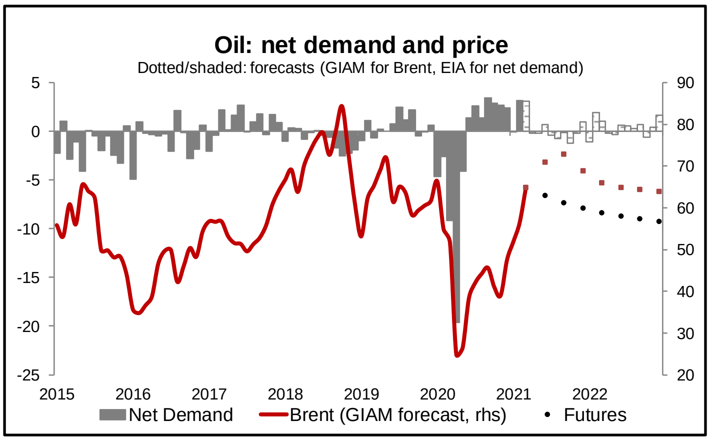
Indeed, a key factor behind our forecast of a near US$ 75 bbl peak in oil Brent is our expectations that, while WTI prices returned to 2019 levels, US productive capacity will struggle go back fast to the levels prevailing at that time.



The shutdown of active US rigs in response to the 2020 price collapse has been stronger than in past downturns: activity was curtailed by 70% in just three months. Reactivating existing wells or digging new ones takes time and entails significant costs. Meanwhile, the capital position of the industry has deteriorated sharply. Several large companies have filed for bankruptcy and the sector underwent a wave of consolidation in the second half of 2020. Therefore, the needed focus on returns tightens capex to meet lower cash flows. Capital constraints may become even more binding as ESG pressures reduce the ability to find external financing. Moreover, adding capacity may be hampered by post-merger reorganisation.

Structurally weaker demand caps price upside

Mid-term, US shale production will eventually rise, and the industry will become again the marginal producer, playing a disciplining role on prices. Therefore, and in line with the normalisation of economic activity, we see prices to converge to the 60-65 US$/bbl range by the end of 2022.



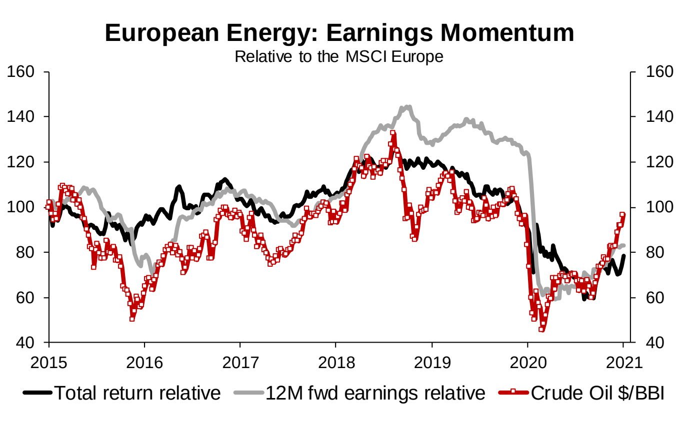
While upside risks for oil prices exist, related mostly to more severe capacity constraints in the US shale industry, the possibility of an escalation in prices, back to the US$100/bbl last seen in 2014, remains very low. The last sharp increase that occurred between the late 1990s crisis and the GFC was driven by the emergence of China as an industrial powerhouse. The likely pick-up in investment in advanced economies will lift substantially demand but cannot be compared in size and duration to the push originated by China. Moreover, technological progress has made growth much less energy intensive during the last two decades and this trend should, if anything, accelerate as pressure on environmental protection increases. Secondly, the composition of demand is likely to become less intensive. While air travel will increase sharply once Covid-19 is fully under control, the diffusion of smart or home working may lastingly reduce commuting while the switch from business travel to videoconferences is likely to become permanent.

The European energy equity sector still has legs

European Majors' FY20 results were overall in line with expectations, except for BP that reported a miss due to significantly lower demand for fuels and weaker than expected refining margins. The outlook is anyhow constructive with a rebound expected in production, realized prices, refining margins and marketing results, following the expected increase in crude prices. Furthermore, the unexpected upward movement of Brent in the >60$/bbl area would lead to additional cash flows vs company's guidance that are based on a Brent at 45-50$/bbl.

At the same time, ESG compliance is getting a higher scrutiny. All European companies have officially communicated strategies in line with the Paris agreements, aiming at carbon neutrality by 2050. The ESG friendly rhetoric addresses some long-term issues of the business but the market will seek further proof of returns (and returns at scale) in the renewable businesses, as this is an area of investor scepticism at present. Furthermore, it is not easy to find sizeable investment opportunities in the renewable business. To finance this massive, multidecade transition, avoiding an excessive deterioration of the leverage, the EU Majors, apart from Total cut the dividends (Shell -66%, BP-50%) and/or issued some hybrid bonds (Total, BP and ENI). This didn't stop S&P (the most conservative rating agency) to downgrade Total and Shell by one notch. Credit quality remains anyhow very good (in general in the single-A bucket).

Year-to-date, the energy sector is up by 15%, outperforming the MSCI Europe by nearly 11%. That said, since the end of 2019 the sector is still lagging the EU index by 23%. The good news is that analysts have revised up the sector earnings (12-month forward ones) by 14% vs 5% of the market index since January. This shows the energy's higher-than-average sensitivity to a recovering economy and the oil price. Energy's ROE is also increasing relative to the index and with oil prices remaining at current levels there is scope for further growth.



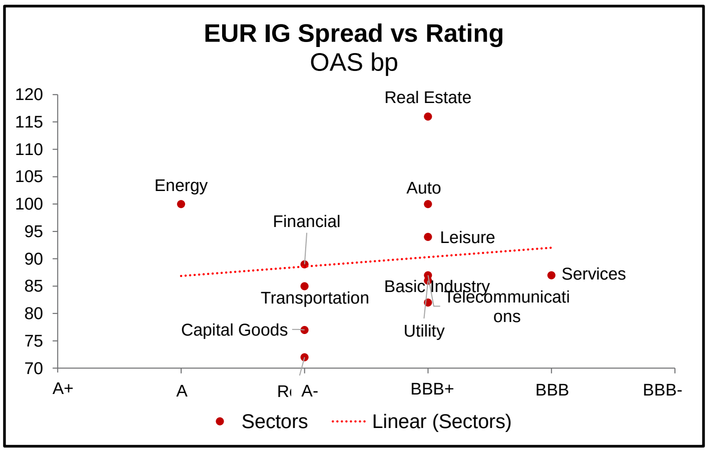
The fund positioning on energy remains near historical lows since 2007, albeit flows have recently increased. As we elaborated in more detail in a recent market commentary, the recovery in the global economy and a lingering accommodative policy support are triggering the continuation of the corporate earnings rebound. Yields bottomed out and, albeit remaining historically low, they should continue to increase this year. Such a "recovery" phase tends to favour cyclical and value assets, big Oils included. The latter have the highest correlation among EU sectors to CPI and PPI inflation and with commodity index momentum. Their beta to EU GDP is also one of the highest among sectors (after materials, auto and banks). Soaring yields are less unsettling for energy stocks than for the broader market as they are less affected than other Value-cyclical sectors as their correlation to yields is around zero (still much more convenient than the negative correlation which affects Growth and Defensive). Our quant models show the energy sector around neutral or slightly undervalued notwithstanding the performance achieved so far this year. Earnings revisions are increasing in relative terms and the valuation gap vs history re-mains very attractive (PE, CAPE etc.).

Low ESG scores will continue to represent a structural obstacle to the sector's performance because the big oils' "green" turnaround will take years to materialise. Nevertheless, as the economic cycle is turning, we think Oils can continue to outperform together with Value, Cyclicals and financials. Furthermore, clean energy-related stocks (production, equipment and tech companies) are relatively expensive, showing crowed positioning. In sum, we recommend an OW position on the sector.

Energy credit trades cheap to fundamentals but…

The recovery of oil prices is good news for the oil segment of the credit market, which is particularly large in the US, above 10% both in IG and HY. Brighter prospects for oil prices will also help alleviating the burden of shale gas producers. The latter have been the greatest providers of defaults in the US over the recent months, bringing 12-month trailing issuer weighted speculative defaults to 8.3% versus 4.6% in Europe according to Moody's.

Beyond defaults, a positive effect on the ratings could be observed, as rating agencies would probably think twice before downgrading the companies they have put under negative outlook over the recent month, given the better profitability prospects implied by higher oil prices. Hence both in the US and in Europe, we expect some short term out-performance as the sector is trading wide to its cyclical peers (see chart below) albeit lagging behind the recovering oil prices.



However, we think that, particularly in Europe, the sector will remain hindered by its ESG profile, as it is one of the most carbon-intensive segment of the market. The ESG technicals could even deteriorate further should the ECB underweight oil names within the CSPP or the PEPP. Indeed, we have growing signs that the ECB will try to reduce the carbon footprint of its corporate purchases. President Lagarde herself publicly claimed that she wants to "*explore every avenue available to combat climate change.*" Moreover, in an FT article, the Governor of the French Central Bank, Villeroy de Galhau, called for the ECB to decarbonize its €2.4 trn corporate credit holdings.

Imprint

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Sources for charts and tables:	Refinitiv/Datastream, Bloomberg, own calculations Version completed: see front page

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