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OIL PRICE SLIDE: SUPPLY SHOCK OR SLIPPING DEMAND?

IN BRIEF

- Global oil prices have declined 45% since June, driven by excess supply and weaker global demand
- While price weakness could be a boon for economies that import a lot of oil, it could impair the economic growth of countries heavily dependent on oil revenues
- After a broad selloff in the energy sector of the high-yield market, investors may find some good opportunities in the future

Strong supply gains in the United States and the Middle East, concurrent with sluggish demand growth, have driven the price of Brent crude oil to a five-year low of less than $60 a barrel — off nearly 50% since June. As the growth of non-OPEC oil production continues to accelerate and with OPEC's recent decision not to curtail output, oversupply could continue, with further pressure on prices likely.

How much further and longer oil prices will fall remains to be seen, along with the final impact on different economies and oil producers. While in broad terms the plunge in oil prices can be stimulative, the downside is also evident — spending and production cuts by oil producers as well as a broad energy sector selloff in the US high-yield bond market. Whether we ultimately see a net positive or negative impact from oil price weakness depends on how much is supply versus demand driven and if this is a short-term cycle or longer-term trend.

Overwhelming supply or underwhelming demand?

New technologies providing more diversified oil sources, such as shale oil, coupled with the surprising resilience of Middle East production — Libya's production recovery in particular — has pushed supply to new heights. In addition, increased exports by non-OPEC countries and major growth in US shale oil over the past five years have made oversupply inevitable.

If weakened global demand for oil was not a factor, the oversupply could be viewed more favorably. Lower oil prices reduce gasoline prices, which acts like a tax cut for consumers. With more disposable income to spend, consumers can direct these savings elsewhere, driving up the prices of non-energy goods on greater demand.

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In the short term, the likely impact would be a disinflationary impulse, while in the medium term, we see the potential for growth-induced inflationary pressure.

For oil-dependent net importers, a supply-driven price decline that results in abundant, inexpensive oil has significant benefits. Economies with the greatest macroeconomic imbalances — Turkey and South Africa, for example — could use lower-cost oil to help narrow their current account deficits.

For many countries, lower oil prices could provide the opportunity to produce the same output with a lower cost of input — a positive net effect for their economies. Further, if the price declines were supply-driven alone, eventually the market might absorb the excess oil supply, allowing prices to climb and ultimately restore balance. In our view, however, excess supply isn't the only force weighing on oil prices.

Low inflation concerns

With declining oil prices putting more pressure on already low global inflation, the view toward inexpensive oil could be more negative — particularly for the Bank of Japan (BOJ) and the European Central Bank (ECB), who are struggling to stimulate domestic growth and inflation. On the other hand, the US Federal Reserve, which recently ended its third round of quantitative easing even with inflation below target, might sit on the sidelines and let others offset its relative monetary tightening.

If this is a one-time decrease in oil prices rather than a long-term trend, we expect to see a one-time relative price adjustment rather than a long-lasting effect on global inflation. Current price declines could reverse fairly easily if global growth were to pick up a bit in 2015 along with a cut in supply.

The impact of demand weakness

The International Energy Agency (IEA) recently cut its outlook for 2015 global oil demand by 230,000 barrels per day to 900,000 barrels a day.[1] Such demand weakness turns the impact of low oil prices considerably more negative, particularly if it is viewed as long term. For those oil export economies with small cushions of international reserves, long-term demand weakness is more onerous. Middle East oil exporters such as Saudi Arabia could seemingly hold up longer, given their high current account surpluses and substantial reserves. Still, while Middle Eastern countries show no signs of cutting production and OPEC has more than a million barrels in oversupply, allowing oil prices to go into free fall could be damaging — even in stronger economies.

There are still plausible explanations for short-term demand weakness, such as the seasonal refinery maintenance, that decreased demand in August and September. While the refineries used less crude during the maintenance season, production continued to grow, which could have pressured crude oil prices into some of the declines we saw later in the summer and early fall.

Emerging markets most at risk

Russia, where oil accounts for a considerable portion of export revenues, has suffered significant setbacks, particularly in December, due to the precipitous fall in the oil price as well as continued geopolitical tensions, international sanctions and falling foreign investment. Russia's still substantial foreign exchange (FX) reserves and flexible exchange rate regime, however, have helped mitigate some of the damage. Nevertheless, we expect the Russian economy to experience a sharp downturn in the coming quarters.

Venezuela, whose oil exports account for roughly 95% of the country's export revenues, lacks those supports. Beset by very poor macroeconomic policy and dwindling reserves, Venezuela is facing difficult and costly policy choices over improving its current account deficit. Although the government has indicated a commitment to service its external debt, Venezuela may be less able to meet its payments if oil prices continue to fall. While Venezuela and the state-owned PDVSA oil and gas company made around $5 billion in amortization payments in October, the lower oil prices mean that US dollar availability could become very tight when sizable amortization payments are due in March and October/November of next year.

The downside for oil dependent economies

As one of the few developed countries with a significant portion of its economy dependent on oil, Canada stands to lose if oil price weakness continued, and the Canadian dollar would likely underperform the US dollar. Norway, similarly dependent on oil revenues, is also losing a significant boost to its economy.

[1] IEA Oil Market Report, December 2014. IEA.org

The potential hit to exports and new capital spending may outweigh the benefit Canadian consumers receive from lower prices at the pump, and most estimates point to about a quarter percent decline in economic growth next year resulting from lower oil prices. Although that is a seemingly small drop, it is actually quite meaningful given that current growth rates are somewhat anemic.

With respect to Canadian oil sands, we think existing production could remain profitable, even with further declines, but would expect to see cuts in higher-cost new production. On a positive note, many oil sands production companies have built balance sheets strong enough to withstand the current cycle, with ample reserves and the ability to protect their dividends.

US high yield and shale oil

Following oil prices on their steep descent, energy — which had been the fastest growing sector of the high yield market over the past three years — has taken a severe beating in recent months, with the market punishing both solid and weak companies in the sector. Will oil's production growth follow suit?

In our view, the high yield market financed the rapid growth and production in the shale oil industry, given minimal involvement from major oil producers. When the bond market was supportive, energy companies outspent cash flow to accelerate production growth. Now, as oil price weakness has resulted in higher cost of capital and significantly lower access to it, shale oil producers cannot continue reinvesting in drilling programs. Given the decay rates of shale oil fields, overall production levels are highly sensitive to spending on new well development.

We're already seeing many of these companies shift focus from growing production to preserving liquidity. Many are maintaining only the core production necessary to help keep oil field leases, and allowing less productive leases to expire. They have also made material reductions in their planned capital spending for 2015.

From an investment perspective, we expect to see an increase in credit stress and possibly defaults among energy companies, and, therefore, a high probability of capital loss. But many shale oil companies are still in a good position to sustain their businesses. So, while the market has punished the entire energy sector, we see emerging value plays available to investors. We might also see additional investment opportunities based on the potential for a pickup in mergers and acquisitions. Right now, given rapid declines in equity valuations, energy companies may be unwilling to sell at these low levels. As their operating profiles and balance sheets get increasingly pressured, however, they may be forced to sell, and we expect to see some better capitalized acquirers come into this space over time.

The magnitude, duration and outcome of oil price declines are tough to call given that supply, demand and weak global growth are all intertwined contributing factors. After dropping by more than half from a high price of nearly $150 a barrel on the eve of the global financial crisis in 2008, the price of oil at its new low should be viewed as highly beneficial. Weakening global growth — particularly in Japan and Europe — with very real concerns over deflation, however, may be casting a cloud over what would otherwise be a positive trend.

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