

Finding Bottom in the Oil Patch

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Oil prices peaked in the summer of 2014 at \$109 per barrel before beginning a multi-year decline as market attention shifted from concerns over “peak oil”—the hypothetical point at which maximum global production has been reached—to the impact on crude prices represented by the U.S. shale oil revolution.

The summer of 2014 saw domestic shale experience an explosion in production growth at the same time as new traditional deepwater extraction projects came on stream after a substantial investment period. With crude hovering around \$100 per barrel, high oil prices killed demand and drove inventories to record highs. The Organization of the Petroleum Exporting Countries (OPEC)¹, traditionally the dominant producers, rapidly lost market share to shale.

Slumping Crude



Source: Federal Reserve Bank of St. Louis; Crude Oil Prices: West Texas Intermediate, Dollars per Barrel, Weekly, Not Seasonally Adjusted

¹ OPEC member countries include Algeria, Angola, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

While OPEC generally acts as a relief valve, cutting production to manage supply and demand dynamics with the intent of stabilizing prices, this time was different. The energy industry had been investing in projects with long lead times and high costs for years. This required high crude oil prices for initial break even and ongoing profitability with revenue growth as operations came on stream. This proved to be too much for OPEC to manipulate and the result was a global inventory glut that peaked in July 2016.

OPEC countries, battered by competition from U.S. shale, did not cut production until January 2017, and only after oil prices had been cut in half from prior highs reached in June of 2014.

There is nothing like a crisis to evoke action. The questions in 2016 were who would go bankrupt, which of the oil majors would have to cut dividends, and when would OPEC step in? The industry was oversupplied with capital, labor and equipment and to survive, companies needed to dramatically lower their cost structures. The competition from U.S. shale, where breakeven economics fell from potentially \$200+ per barrel a decade ago to a low of nearly \$30 for some operators, required both onshore and offshore producers to re-think their approach to the business.

OPEC to the rescue?

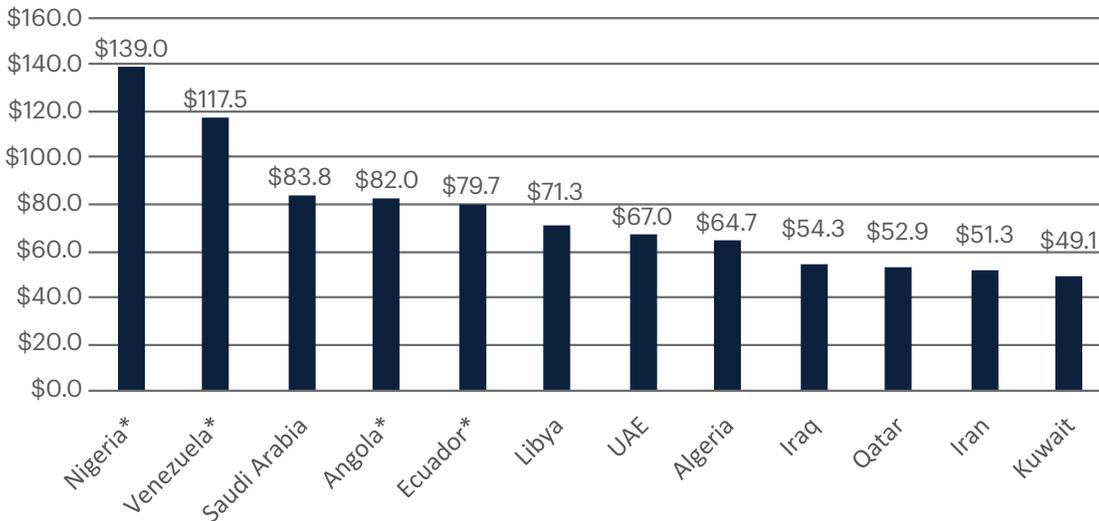
OPEC's mindset has changed from that of the previous several decades. Peak oil supply was the main concern just five years ago, but now the main concern is peak oil demand. Moving from supply to demand shifts OPEC's mindset and pushes them to be more focused on their share of the market—particularly as U.S. shale has the potential to meet nearly all of the global demand.

In late 2016, OPEC countries, along with Russia, agreed to reduce their output by nearly 1.8 million barrels per day. The reduction seems modest given that 2016's average global oil production was around 90 million barrels per day. Nonetheless, the move was expected to reduce inventories and drive up prices. The gambit worked initially and prices did rise. Unfortunately, for OPEC at least, U.S. shale producers and non-OPEC members boosted production to reflect rising prices. In late May of 2017, OPEC and Russia extended the reduction and asked other countries to follow suit.

OPEC, however, has few weapons to force compliance with requested production cuts and, in fact, only Saudi Arabia and Venezuela adhered to the requested drawdown. This led many to rely on Saudi Arabia to carry the heavy lifting, with backsliding the most egregious in OPEC member Iraq, according to OPEC. Why is this?

The chart on the next page shows fiscal breakeven oil prices for OPEC countries; the price level required to ensure that governmental fiscal accounts are balanced. Countries heavily reliant on revenue from their oil fields to keep the lights on are particularly impacted by OPEC calls for production cuts—leading many to simply ignore the wishes of OPEC.

Estimated 2017 Fiscal Breakeven Oil Prices for OPEC Countries



Source: International Monetary Fund, April 2017. *2017 data unavailable from IMF: Nigeria (Fitch), Venezuela (2015), Angola (Fitch), Ecuador (2015).

Differing fiscal breakeven costs across OPEC members highlights the weakened strength of the organization in an era of low oil prices. OPEC, led by Saudi Arabia, is tasked with a charter that seeks agreement across many countries with widely-varying levels of economic strength.

OPEC's brief is somewhat similar to that of the European Central Bank (ECB) of the European Union (EU)—both have a common benchmark for all members, the U.S. dollar price of crude oil for OPEC and the Euro for the EU. OPEC requesting that member countries reduce output is reminiscent of EU members Germany and France imposing austerity on economic laggards such as Greece and Italy via the ECB. But unlike the ECB's power to dictate fiscal terms and assistance to member states, OPEC cannot "compel" members to follow its guidelines. In this scenario, while the ECB has leverage to accomplish its goals, OPEC is not in the same position to do so.

Meanwhile, U.S. shale—with economic breakeven costs of around \$50 a barrel—will continue to complicate OPEC's attempts to "stabilize the market" and return oil to its traditional role of providing a significant boost to OPEC country finances. OPEC has shifted attention from "peak oil" to balancing price and market share as U.S. shale has the potential to produce 100% of normalized global demand over the next couple of years.

Looking forward

Given the diminishing ability of OPEC to engineer price levels, and the growing dominance of U.S. shale, what are the prospects for U.S. companies active in the oil patch? There are several considerations to keep in mind when analyzing the energy companies:

- Investment in offshore drilling remains in the middle stages of driving down cost structures. U.S. shale has shifted from a marginal player to a top quartile player on the global stage—absorbing much of the slack created by OPEC's actions. OPEC has been successful in curbing long lead-time mega projects, such as deepwater drilling, that lacked sufficient profitability in a new world of lower oil prices.
- U.S. shale breakeven costs continue to fall as efficiency gains drive costs lower. While we expect continued improvement in efficiency, costs for shale producers will likely increase as service providers increase prices. We are near the point where current economics are not sufficient to drive further investment in shale production.
- Inventories today are at all-time highs and may well be at peak levels as U.S. production has declined, non-OPEC production is flat, and OPEC has recently extended the 2016 production cut. Normalizing of inventories is critical to stabilizing oil prices and OPEC is one key to that occurring. The potential for U.S. shale to meet global demand has created volatility in commodity markets and energy stock prices, leading to pain for many companies but upward gains for selected high quality names.

We expect that global production costs for services, labor and materials will likely put upward pressure on oil prices as inventories begin to normalize throughout the second half of 2017, and that rising costs will continue to create value for quality, low cost operators. We prefer to own these types of firms versus higher cost producers and believe that stock markets will begin to reward efficiently-run service providers.

We also believe that in the long run, and despite its reduced firepower, OPEC will be instrumental in normalizing inventories amidst a background of strong but moderating global demand. These factors should be supportive of our investments, and we will continue to invest as opportunities arise in both producer and service provider stocks.

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