Energy Sector In The Spotlight As Oil Prices Advance On Healthy Demand, Output Curbs

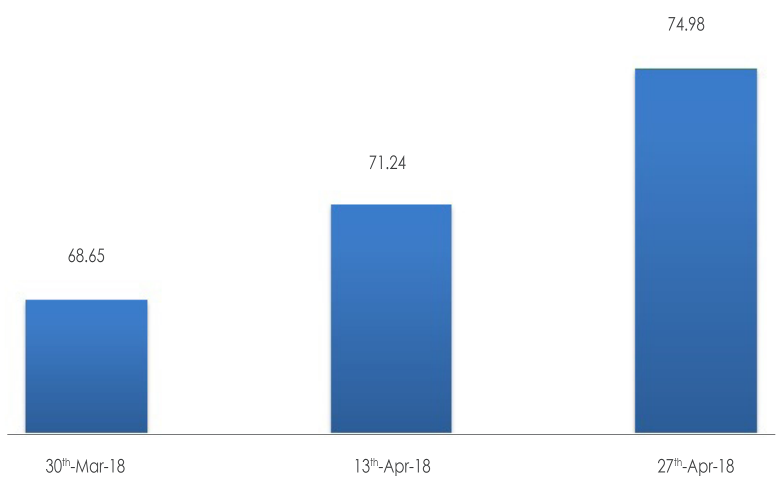
After being ignored during the first quarter market volatility, the energy sector has seen a reversal of fortunes in recent weeks. The sector's earnings and cash flow outlook has brightened with the international Brent crude oil benchmark moving closer to $75 per barrel. In addition to healthy demand growth as well as output limits set by some of the largest producing countries, nascent geopolitical risks are also supporting higher crude prices. Cost cuts implemented when oil prices were far lower are now giving margins an additional boost. Explorers and producers are still hesitant to increase capital spending, choosing to increase shareholder payouts instead. Though structural shifts such as the popularity of electric automobiles continue to cloud the long-term demand outlook, the energy sector is likely to receive more investor attention in the near term.

KEY TAKEAWAYS

Cost cuts implemented when oil prices were far lower are now giving margins an additional boost. Explorers and producers are still hesitant to increase capital spending, choosing to increase shareholder payouts instead.

Most investors have been cautious about the energy sector as crude oil prices have swung wildly in recent years. From over $110/barrel in mid-2014, the international Brent crude oil benchmark dropped sharply to below $30/barrel by early 2016. Except for the few with very low costs, most producers saw their cash flows turn negative. To preserve cash and survive the downturn, the industry curtailed

Brent crude oil prices have surged recently



In dollars per barrel

Data source: U.S. Energy Information Administration capital investments in exploration and new production facilities. Attention shifted to lowering costs through efficiency gains and higher cost projects were postponed or even abandoned.

The sharp reduction in production costs allowed U.S. shale oil producers to maintain high output levels, even at lower prices. This forced the group of large oil producing countries, OPEC, to impose production quotas on members in 2016. Unlike in the past, OPEC members largely honored the production limits set for them and pushed oil prices higher. This production discipline continued in 2017 and together with modest improvement in demand, especially in Asia, helped crude oil prices to sustain the recovery.

By the second half of 2017, major automakers made dramatic shifts in their product strategy by committing to vastly increase the number of electric cars produced. While earlier forecasts set the global market share of electric cars below 10% by 2025, governments in some of the major markets such as China and India announced plans to fully switch to non-polluting vehicles by 2030. This encouraged some of the largest automakers to increase their production targets for electrical vehicles several times. This unexpected change significantly weakened the long-term demand outlook for crude oil.

Despite higher oil prices, most producers remain remarkably hesitant to increase their capital outlays in new exploration and production. The extreme price volatility over the last few years has made integrated global energy companies more cautious in their capital allocation.

Nevertheless, improving demand, renewed geopolitical tensions and continuing OPEC production limits have lifted crude oil prices to the highest levels in more than three years. The Trump administration's decision to withdraw from the nuclear agreement with Iran diminishes the possibility of more exports from that country. The ongoing political crisis in Venezuela could also meaningfully limit supplies into the international market in the near term.

The large oil producers that had succeeded in significantly reducing operating costs to survive in the low-price environment are now reaping sharp gains in profit margins. Most of them are using the higher cash flows to increase shareholder payouts in the form of dividends and share buybacks. This should help sustain near-term investor interest in the sector.

Despite higher oil prices, most producers remain remarkably hesitant to increase their capital outlays in new exploration and production. The extreme price volatility over the last few years has made integrated global energy companies more cautious in their capital allocation. Much of the new investments are from smaller producers who operate in select regions and have much shorter project timeframes. New investments are unlikely to spike until oil prices remain at elevated levels for a longer period.

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