



THE DRIVE YOU DEMAND

SPOTLIGHT

Energy sector underperformance has ended, outperformance lies ahead

Having ended 2017 as one of the worst performing global sectors, sustained outperformance lies ahead for energy stocks in 2018. The underlying crude oil market is now undersupplied while inventory levels have fallen sharply. These supply-demand and inventory dynamics have historically translated into improving corporate profitability over the coming 12-24 months. The rebound in corporate profitability should help reverse the persistent underperformance of the sector versus the broader market since 2011.



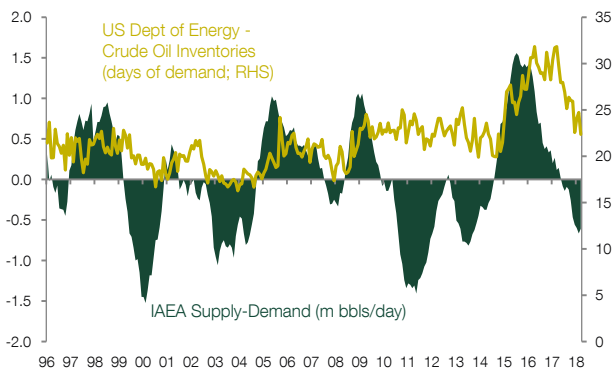
Key points

- ◆ *The current supply-demand and inventory dynamics look like 1996-1997 and 2010-2014 periods where crude oil rose 53-99%*
- ◆ *The 60% rise in crude from the summer, 2017 lows should see corporate returns rise by 400-600 bps*
- ◆ *The normalisation of corporate returns in the energy sector is the key to reversing the all-time low valuations of the energy sector versus global equities*

Having ended 2017 as one of the worst performing global sectors, energy stocks have stopped underperforming and have begun to accelerate, rising 11% since end-September 2017 and nearly 4% in 2018 alone, outpacing the performance of global equity indices.

A key support for this positive energy story has been the dramatic reversal in the supply-demand balance that had weighed so heavily on the underlying price of crude oil since 2014. Moreover, crude oil inventories, which had been at multi-decade highs in 2015-2016 and weighed on market prices began to reverse sharply in 2017 leaving absolute inventory levels nearer to historical averages of approximately 22 days of demand in April 2018 according to the US Department of Energy.

Energy market is now undersupplied and drawing down inventories



Source(s): UBP, Bloomberg Finance L.P., IAEA, US Dept. of Energy

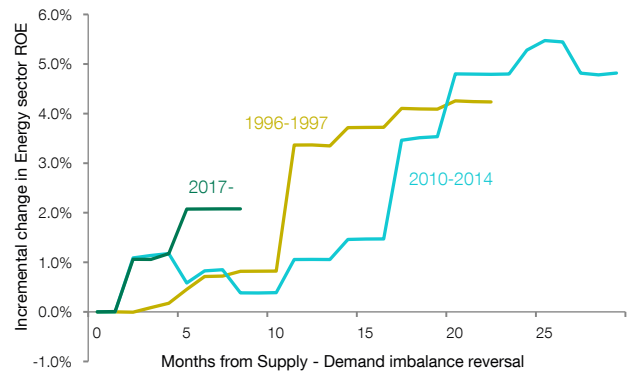
With crude oil markets now undersupplied and inventories largely normalised, the market dynamic looks much like the 1996-1997 and 2010-2014 periods in the global economy. During those years of undersupply and normalised inventories, crude oil rose between 53-99% leaving the 60% rise from the summer lows consistent with those periods.

High frequency data continues to highlight inventory tightness and supply restraint. These create the potential for an even more favourable supply/inventory backdrop akin to the 1999-2000 and 2003-2004 periods when the crude market was not only meaningfully undersupplied, but inventories were well below the historical average. In these periods, crude oil prices soared by 100-200% and corporate returns rose

1,200-1,300 bps. It is worth noting, however, that with our expectation of global growth and therefore global demand momentum peaking in the first half of 2018, this case remains an overly optimistic scenario for energy investors.

In addition, with energy markets now undersupplied and inventories tight, crude prices are now more susceptible to both periodic conflicts as well as intermittent production outages that have arisen in producing regions in recent years.

Still in the early stage of ROE improvement

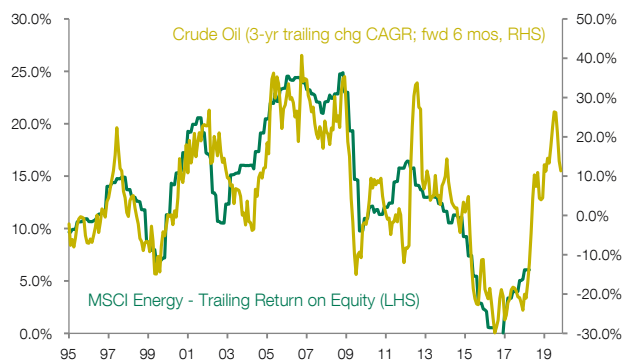


Source(s): UBP, Bloomberg Finance L.P., MSCI

Even without a repeat of 1999-2000 or 2003-2004s, the more moderate scenarios of 1996-1997 and 2010-2014 suggest an attractive earnings outlook for energy sector corporates. Remember that, during these periods, energy companies saw a rise of 400-600 bps in corporate returns over the subsequent two to three years (see chart). With corporate ROEs having already rebounded by 200 bps as the crude market became undersupplied in 2017, any repeat of what happened from 1996-1997 and 2010-2014 suggests that a further 200-300 bps in ROE improvements to 9-10% may lie ahead.

In the past, however, the long-term trajectory of crude oil has been an excellent guide to earnings prospects for the global energy sector in the subsequent six months. The strength in crude in late-2017 therefore suggests that a 9-10% return on equity for the coming year may end up being overly conservative for the sector looking ahead.

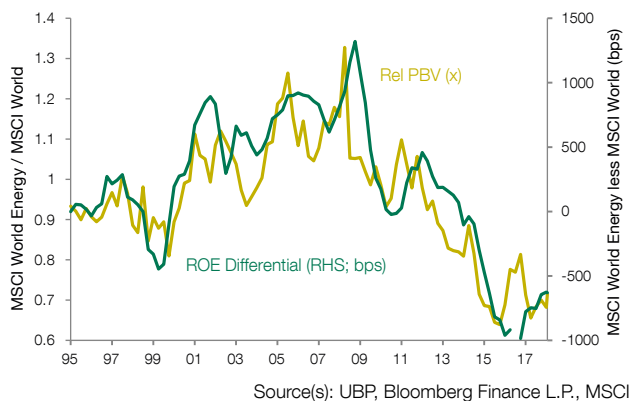
Strong crude prices = Improving corporate profitability



Source(s): UBP, Bloomberg Finance L.P., MSCI

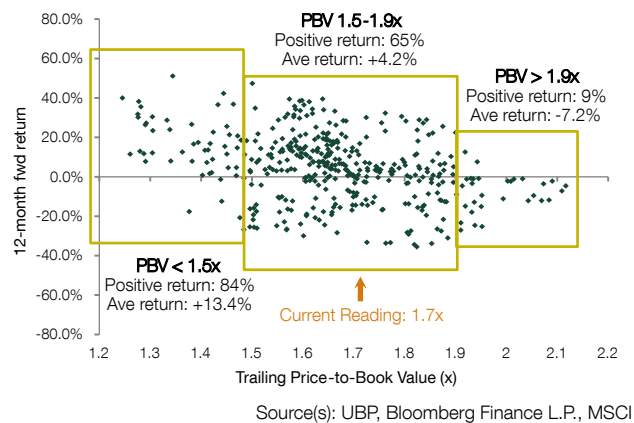
Compared to the broader market, valuations for the energy sector remain near historical lows. However, the gap between returns generated by energy companies and the broader universe of listed companies is similarly historically wide. This supports the idea that a reassessment of energy sector earnings as suggested by recent trends in crude oil prices as well as the supply-demand and inventory balance in the sector are key to any acceleration in the re-rating of the sector and its outperformance compared to the broader market.

Energy Sector: Historically cheap vs the broader market due to consistency of poor returns



In absolute terms, current valuations still leave risk-reward in the energy sector skewed in favour of investors. However, as seen in January 2018, when valuations reached 1.8-1.9x book value, if there are no further indicators that corporate returns are continuing the multi-year improvements begun in 2017, then valuations may yet become a constraint on absolute return prospects in the sector.

Energy Sector: Absolute valuations suggest risk-reward remains favorable



From a bottom-up perspective, the UBP equity analysis team believes that the outlook for European energy majors appears promising as long-cycle projects begun in 2011-2013 are now coming on stream. This should allow production growth to accelerate meaningfully in the year ahead. Moreover, with free cash flow among continental companies now higher even with crude at nearly US\$70/barrel, compared with 2014 when it hit US\$100/barrel, free cash flow generation and corporate discipline means the prospects for payouts to shareholders appears attractive. In contrast, however, large US players may feel more constrained as their recent investment in shale oil means that the production benefits will come later while requiring more upfront capex, so restricting the free cash flow available for shareholders.

The UBP technical analysis team suggests that holding the 200-day moving average in the February sell-off has offered good long-term support while the positive long-term momentum bodes well for investors seeking exposure to the energy sector.

Authors



Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management
michael.lok@ubp.ch



Norman Villamin
Chief Investment Officer (CIO)
Private Banking
norman.villamin@ubp.ch



Patrice Gautry
Chief Economist
patrice.gautry@ubp.ch

Disclaimer

This document is a marketing communication containing GENERAL INFORMATION on the financial services and/or financial instruments, and reflecting the sole opinion of Union Bancaire Privée, UBP SA and/or any entity of the UBP Group (hereinafter "UBP") as of the date of issue. It may contain generic recommendations but should not be deemed an offer nor a solicitation to buy, subscribe to, or sell any currency, product, or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. This document is meant only to provide a broad overview for discussion purposes, in order to determine clients' interest. It does not replace a prospectus or any other legal document relating to any specific financial instrument, which may be obtained upon request free of charge from UBP or from the registered office of the fund concerned, where applicable. The opinions herein do not take into account individual clients' circumstances, objectives, or needs. In this document UBP makes no representation as to the suitability or appropriateness, for any particular client, of the financial instruments or services described, nor as to their future performances. Clients who wish to obtain more information about any specific financial instruments can request it from UBP and/or their Relationship Manager. Where an investment is considered, the information on the risks linked to each financial instrument shall be provided in good time by separate means before the investment decision is taken. In any case, each client must make his/her own independent decisions regarding any securities or financial instruments mentioned herein and regarding the merits or suitability of any investment. Before entering into any transaction, clients are invited to carefully read the risk warnings and the regulations set out in the prospectus or other legal documents and are urged to seek professional advice from their financial, legal, accounting and tax advisors with regard to their investment objectives, financial situation and specific needs. This generic information is therefore not independent from the proprietary interests of UBP or connected parties, which may conflict with the client's interests. UBP has policies governing cases of conflicts of interest. The investments mentioned herein may be subject to risks that are difficult to quantify and to integrate into the valuation of investments. Generally speaking, products with a high degree of risk, such as derivatives, structured products or alternative/non-traditional investments (such as hedge funds, private equity, real estate funds, etc.) are suitable only for clients who are capable of understanding and assuming the risks involved. The value of any capital investment may be at risk and some or all of the original capital may be lost. The investments are exposed to currency fluctuations and may increase or decrease in value. Fluctuations in exchange rates may cause increases or decreases in the client's returns and/or in the value of the portfolio. The client may be exposed to currency risks if a financial instrument or the underlying investment of a financial instrument is denominated in a currency different from the reference currency of the client's portfolio or from the currency of his/her country of residence. For more information on risks, the brochure called "Characteristics and risks of certain financial operations" should be consulted. The information contained in this document is the result neither of financial analysis within the meaning of the Swiss Banking Association's "Directives on the Independence of Financial Research" nor of independent investment research as per the EU's regulation on MiFID provisions. In principle, EU regulation does not govern relationships entered into with UBP entities located outside the EU, including but not limited to Union Bancaire Privée, UBP SA in Switzerland, which is subject to Swiss law and Swiss regulation, in Hong Kong, and in Singapore, and the subsidiary in Dubai. Reasonable efforts have been made to ensure that the content of this document is based on objective information and data obtained from reliable sources. However, UBP cannot guarantee that the information the Bank has gathered in good faith is accurate and complete. Circumstances may change and affect the data collected and the opinions expressed at the time of publication. Therefore information contained herein is subject to change at any time without prior notice. UBP makes no representations, provides no warranty and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein nor does it accept any liability whatsoever for any errors, omissions or misstatements in the document. UBP does not undertake to update this document or to correct any inaccuracies which may have become apparent after its publication. This document may refer to the past performance of financial instruments. Past performance is not a guide to current or future results. The value of financial instruments can fall as well as rise. All statements in this document, other than statements of past performance and historical fact, are "forward-looking statements". Forward-looking statements do not guarantee future performances. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not happen as forecast. The actual performance, results, market value and prospects of a financial instrument may differ materially from those expressed or implied by the forward-looking statements in this document. The projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP also disclaims any obligation to update forward-looking statements, as a result of new information, future events or otherwise. Any performance data included in this document does not take into account fees, commissions, expenses charged on issuance and redemption of securities, or any other costs, nor any taxes that may be levied. The tax treatment of any investment depends on the client's individual circumstances and may be subject to change in the future. This document does not contain any tax advice issued by UBP and does not necessarily reflect the client's individual circumstances. This document is confidential and is intended to be used only by the person to whom it was delivered. This document may not be reproduced, either in whole or in part. UBP specifically prohibits the redistribution of this document, in whole or in part, without its written permission and accepts no liability whatsoever for the actions of third parties in this respect. This document is not intended for distribution in the US and/or to US Persons or in jurisdictions where its distribution by UBP would be restricted. UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority ("FINMA").

UK: UBP is authorised in the United Kingdom by the Prudential Regulation Authority, and is subject to regulation by the Financial Conduct Authority (FCA) and limited regulation by the Prudential Regulation Authority.

Dubai: This marketing material has been issued by Union Bancaire Privée (Middle East) Limited, a company regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for professional clients and/or market counterparties only and no other person should act upon it. The financial products or services to which this material relates will only be made available to a client who meets the professional client and/or market counterparty requirements. This information is provided for information purposes only. It is not to be construed as an offer to buy or sell, or a solicitation for an offer to buy or sell any financial instruments, or to participate in any particular trading strategy in any jurisdiction.

Hong Kong: UBP is a licensed bank regulated by the Hong Kong Monetary Authority (HKMA) and a registered institution regulated by the Securities and Futures Commission (SFC) for Type 1, 4 & 9 activities only in Hong Kong. The securities may only be offered or sold in Hong Kong by means of documents that (i) are addressed to "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO"); or (ii) are defined as "prospectuses" within the meaning of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the "CO") or constitute offers to the public within the meaning of the CO. Unless permitted to do so under the laws of Hong Kong, no person may issue or have in his/her possession for the purpose of issuing, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the securities, directed at, or likely to be accessed or read by, the public in Hong Kong, except where the securities are intended to be disposed of only to persons outside Hong Kong, or only to "professional investors" within the meaning of the SFO.

Singapore: UBP is a merchant bank regulated by the Monetary Authority of Singapore (MAS), is an exempt financial adviser under the Financial Advisers Act (Cap. 110 of Singapore) to provide certain financial advisory services, and is exempt under section 99(1)(b) of the Securities and Futures Act (Cap. 289 of Singapore) to conduct certain regulated activities. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with generic recommendations may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) to institutional investors under Section 274 of the Securities and Futures Act (Cap. 289) of Singapore ("SFA"), (ii) to relevant persons pursuant to Section 275(1), or any person pursuant to Section 275(1A) of the SFA, and in accordance with the conditions specified in Section 275 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Luxembourg: UBP is registered by the Luxembourg supervisory authority the *Commission de Surveillance du Secteur Financier* (CSSF).

Italy: Union Bancaire Privée (Europe) S.A., Succursale di Milano, operates in Italy in accordance with the European passport – held by its parent company, Union Bancaire Privée (Europe) S.A. – which is valid across the entire European Union. The branch is therefore authorised to provide services and conduct business for which its parent company, Union Bancaire Privée (Europe) S.A., has been authorised in Luxembourg, where it is regulated by the Luxembourg financial supervisory authority, the *Commission de Surveillance du Secteur Financier* (CSSF).

Monaco: This document is not intended to constitute a public offering or a comparable solicitation under the Principality of Monaco's laws, but might be made available for information purposes to clients of Union Bancaire Privée, UBP SA, Monaco Branch, a regulated bank under the supervision of the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR) for banking activities and under the supervision of the *Commission de Contrôle des Activités Financières* for financial activities.