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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.

April 2018 | Global Investment Committee

UBP

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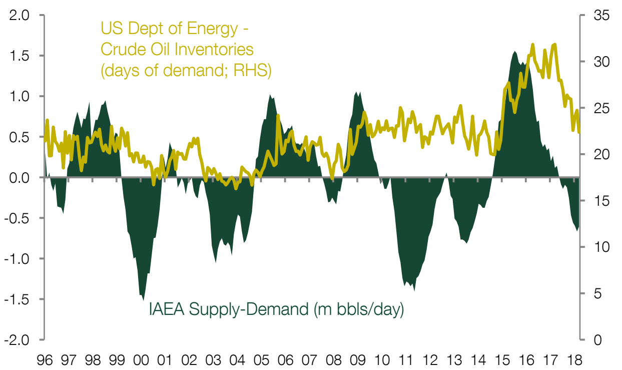
Key points

- *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



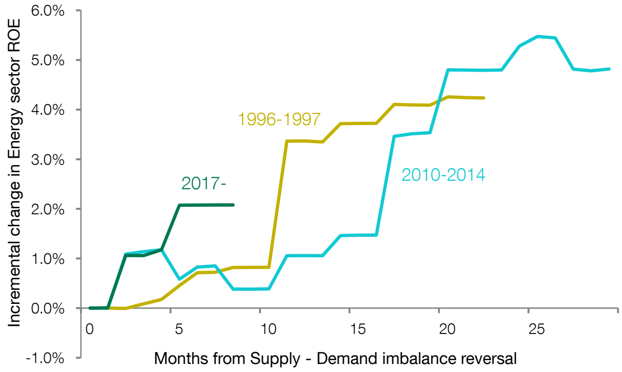
Source(s): UBP, Bloomberg Finance L.P., IAEA, US Dept. of Energy

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

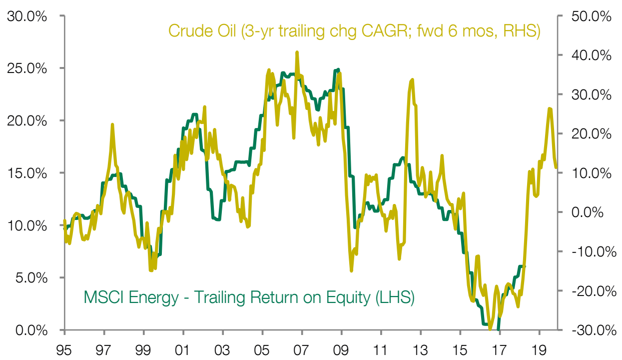


Source(s): UBP, Bloomberg Finance L.P., MSCI

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.

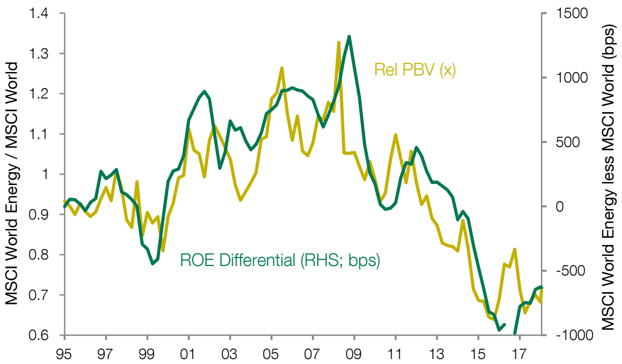
Strong crude prices = Improving corporate profitability



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.

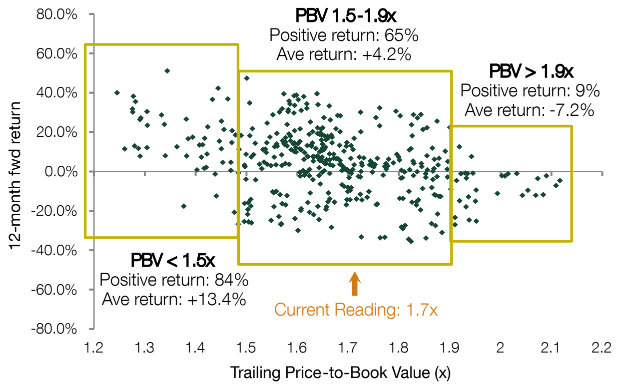
Energy Sector: Historically cheap vs the broader market due to consistency of poor returns



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

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



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

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.

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