

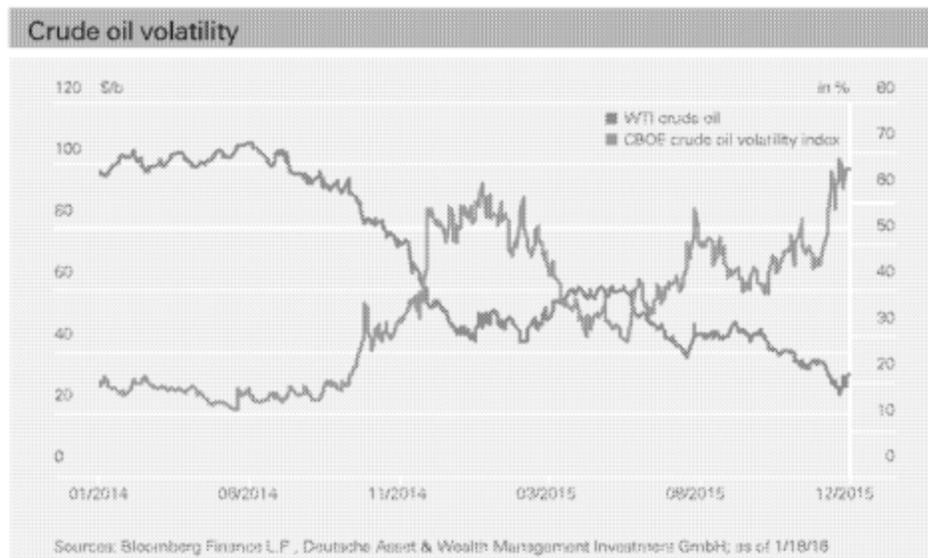
More volatility ahead?

Of course, much of the world's oil production is still under the sway of companies closely affiliated with governments and located in the Middle East and other volatile places. That share looks set to grow again in coming years.

In December 2015, the Organization of Petroleum Exporting Countries (OPEC) decided to abandon its usual production target. For Saudi Arabia in particular, the main goal appears to be to maintain market share by driving higher cost producers out of the market. Among Gulf producers, fears are also growing that some of the oil demand might eventually be replaced by alternatives due to changes such as the growth in hybrid or electric cars in coming decades. This could make it even harder to maintain cartel discipline if and when prices recover.

Tensions within OPEC are nothing new. Nor are wild swings in the oil price – as you might expect given high capital expenditure but low operating expenses in both shale and traditional oil exploration. Average short-run cash costs for all production methods are probably at about \$10/b, maybe even below. And cash costs might not even represent the lower limit of how far prices could fall in the short term. Some of the costliest sources of oil, such as Canada's oil sands, are also costly to shut down once production gets going. Add concerns about dollar strengthening, possible bottlenecks in storage capacity, the vagaries and delays in physically moving crude oil and its derivatives, not to mention significant speculative inflows, and large movements – in both directions – are all too plausible.

Worse still, oil-price volatility might well be here to stay. Shale has added a new set of swing producers at price points along much of the supply curve. Many of their costs, including funding costs, will fluctuate across the economic cycle, and probably much more so than for traditional producers. And Saudi Arabia appears to be less ready than in previous cycles to step in and stabilize prices. For the rest of the world, this could create significant challenges, not least in monetary policy.



Decline in price, rise in volatility

While market participants are still vigilantly discussing the positive and negative effects of lower oil prices on economies and companies, this chart shows two factors that have undoubtedly contributed to the anxiety that oil has created: the speed of the price decline and the increase in volatility, which makes dealing with oil more tricky for both industry and capital markets.

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