CIO Flash
Oil price outlook – a slow-burn situation
January 12, 2015

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OPEC is playing the long game

— We expect[1] that the oil markets will remain under pressure in the first half of 2015 with OPEC happy to stand on the sidelines and not attempt to limit output.
— Our view is that OPEC may be playing a long game. Remaining on the sidelines to encourage the market view that oil prices will stay low for a considerable period thus discouraging capital inflows into non-OPEC production which has accounted for around 80% of the growth in global oil output in recent years.[2] The focus has been on the likely impact of the oil price on U.S. shale output, but OPEC may also want to discourage other potential players (e.g. Canadian oil sands and ultra deepwater projects).
— This OPEC's strategy will take some time to pay off. Although there are now some indications that the U.S.'s horizontal (i.e. shale) rig count is declining, a significant reduction in U.S. shale output could take time to achieve and it is possible that technological advances reduce the price break-even point for shale producers, further delaying the reduction in output.
— Little immediate relief is likely on the demand side of the equation as well. Lower prices are not likely to change demand substantially, with history suggesting that demand for oil is relatively price inelastic. So market adjustment has to come from reducing supply.

Our oil forecast for 2015

— We believe that OPEC's strategy is likely to have an impact and that a lot less capital will be deployed in the oil sector in 2015.
— On the assumption that capital investment into U.S. shale falls by ~40% in 2015, we expect that U.S shale oil output may start to fall in H2 2015. As a result we forecast oil prices (WTI) to move upwards from ~USD50/bbl now to USD65-70/bbl by end year.
— However, while we wait for lower investment to have an impact on U.S. shale output, high levels of production are likely to keep prices low over the next few months. Our forecast is for USD40/bbl in Q1, USD50/bbl in Q2, USD60/bbl in Q3 and USD65-70/bbl in Q4.[1]

Macro implications

— We expect lower oil prices to encourage growth in the developed markets and in Asian oil-importing countries, mainly through boosting consumer spending. For other emerging markets, the growth implications are more nuanced, particularly if lower oil prices make financial markets more generally risk averse.
— We also expect lower oil prices to result in lower inflation, bringing the Eurozone's HICP to an average of 0.3-0.4% in 2015 and will also reduce inflation expectations. Central banks' policy response will have to balance deflation fears against the likelihood of stronger GDP growth.

Investment implications

— In the short term, oil-related investing will carry substantial risk. Over the medium term, the key question is whether the overall positive impact from lower oil prices (most obviously on consumer spending) is more offset by the effect of price-related stresses on specific equity and fixed income segments.
— Equities: As oil is finding a bottom, the contango shape of the oil futures curve, combined with producer asset write-downs, will make oil investing a very precarious proposition over the near term. There will be longer-term implications too. In a sustained low energy commodity price environment, earnings and cash-flows for all oil market participants, i.e. oil majors, E&Ps and oil service companies will in our view suffer by more than the market is currently pricing in. For the major integrated oil companies, current dividend levels will be deemed unsustainable, increasing the investment risk. We would suggest a tactical underweight of the energy equity sector, but have an overweight to consumer discretionary, which should benefit from lower oil prices. Stresses in the High-Yield market could also increase equity volatility.
— Fixed income: Key concern is that sustained low oil prices (ie below USD 65/bbl) would result in increased pressure on the business model of oil related companies in the US and that particularly some shale companies will not survive the oil meltdown leading to an increase in default rates. In addition to the profit and loss impact and the adverse effect on financing, energy companies might suffer from downgrades (from low IG into HY but also within HY), putting significant selling pressure on the energy sector and consequently the entire High Yield market. The U.S. High-Yield is more directly exposed to oil prices than Europe, but an increase in general risk aversion and a decline in market liquidity could cause problems here too. High yield spreads rose noticeably in early December, as oil prices fell, but appear to have stabilized in early January.

[1]Deutsche AWM expectations 2015. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved; Deutsche AWM Investment GmbH, CIO Office; Deutsche Bank AG [2]Bloomberg LLP

Glossary

Explanation of terms

Contango – A term used to describe the shape of the futures market curve where future contracts are higher priced than the expected future spot price.

Eurozone – Comprised of the 19 member states of the EU, which have accepted the euro as their common currency and their sole legal tender. The states are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain.

[redacted] **– Exploration and production:** A term used to describe the upstream oil sector.

GDP – Gross domestic product: is the value of all goods and services produced by a country's economy.

HICP – Harmonized Index of Consumer Prices: An index measuring the purchasing costs for consumers buying a certain basket of common goods harmonized across EU countries. It serves as an indicator of inflation for the European Central Bank (ECB).

High Yield (HY) – Bonds which are sub-investment grade, see below.

Investment Grade (IG) – Bonds judged by rating agencies to be of at least medium quality (usually BBB or above.)

OPEC – Organization of Petroleum Exporting Countries, an organization consisting of the world's major oil-exporting nations, created for the purpose of coordinating the petroleum policies of its members and providing member states with technical and economic aid.

WTI – Abbreviation for West Texas Intermediate, a grade of crude oil which is used as a benchmark in oil pricing.

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