# TIME FOR SOME PERSPECTIVE IN THE ENERGY MARKET

8 September 2022

RASAMEEL

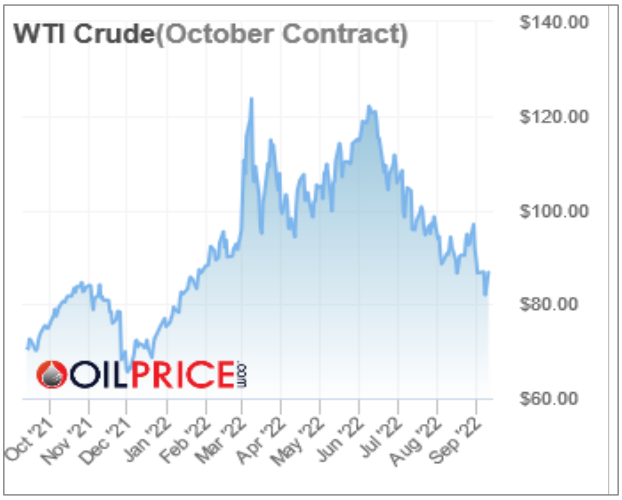
## TIME FOR SOME PERSPECTIVE IN THE ENERGY MARKET

Oil is down a whopping 33% from its highs made in June. Is this another recession omen to be heeded or a rare buying opportunity? We will examine how supply and demand reacted to previous economic cycles and compare the environment to the dynamics of today.

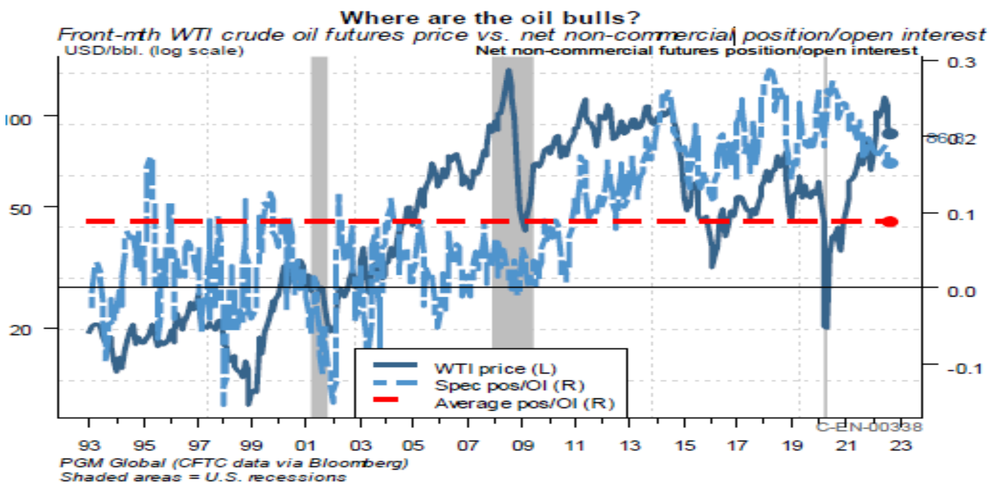
## WHY HAS OIL SOLD OFF?

Oil prices are now trading close to the levels last seen since late January before Russia's invasion of Ukraine. Many investors sought to speculate in the energy and grain markets, as they rightfully expected disruptions in both markets since Ukraine and Russia are both important players in the supply chain of food and energy. Thus, when the price of oil went to $120 in a hurry, we expected weaker price action based on the tendency for oil prices to overshoot.

However, we maintain our long-term view that oil prices will remain higher for longer. The physical market remains tight as evidenced by extremely low inventory levels, and as indicated by WTI contract time spreads. Furthermore, oil producers in the West are the least hedged in years, indicating their own bullish stance on the path of oil prices.

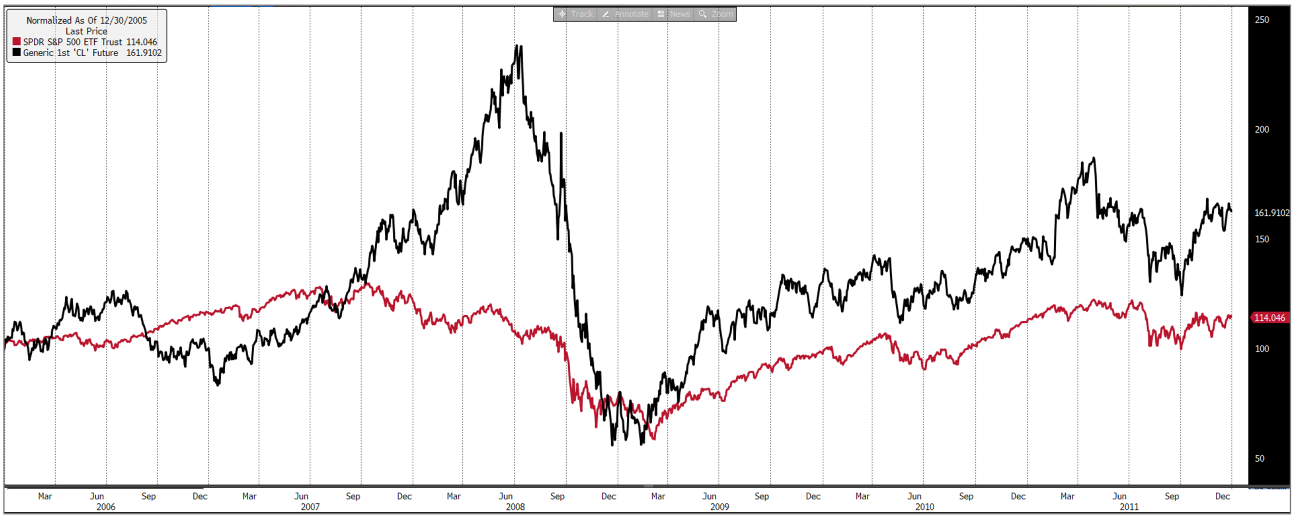


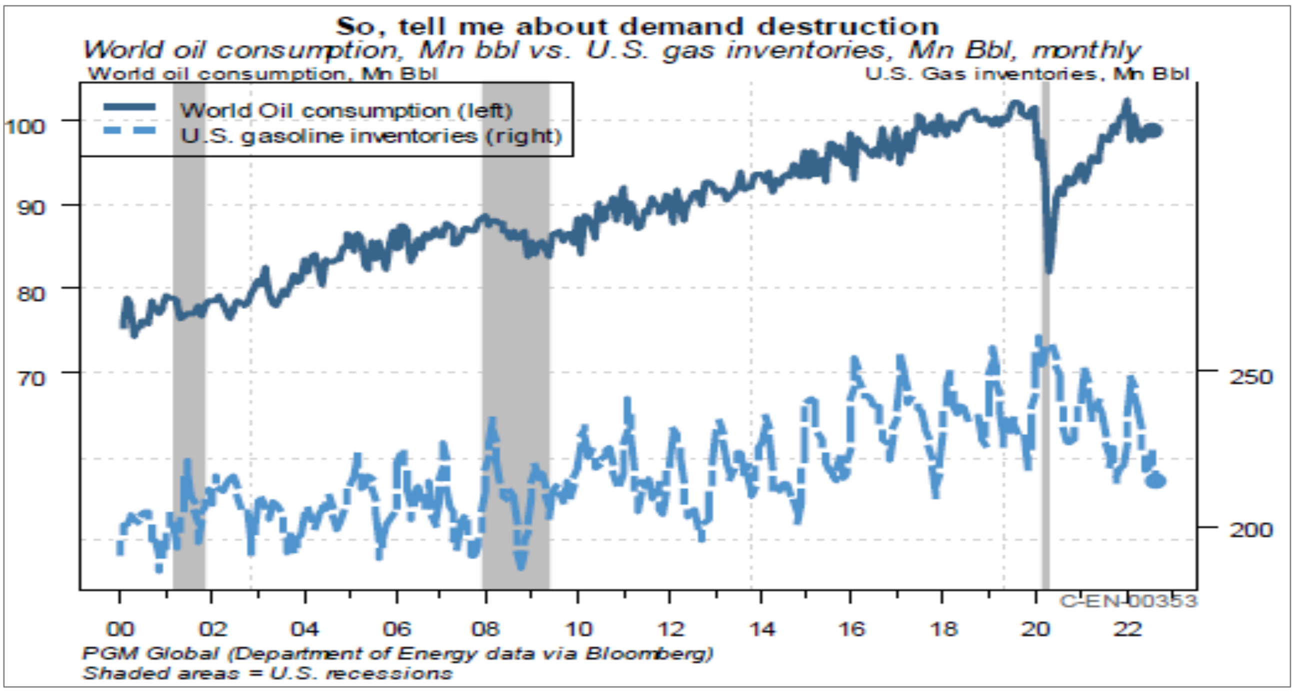

Yet, today's oil price is little changed since the start of the year. This can be explained by the Commitment of Traders report, as speculators in the market sold their long oil positions in fear of an oncoming global recession. We also suspect the recent OPEC announcement to roll back the production increase of 100K barrels per day may have signaled a fear of oversupply to the market, which exacerbated the recent price declines. That announcement may have spooked the markets, but in the physical world it really affects nothing in terms of supply. OPEC is not able to reach their quotas anyway, as only Saudi Arabia and the UAE have the spare capacity to grow production within the cartel and are reluctant to max out their own production capacity. Yet speculators' response to the news has been the main driver of short-term price movements. As speculators exit the market, the fundamentals may start to play a more decisive role in dictating the path of oil prices. However, there is still a large open interest position amongst oil traders, which may indicate a further leg down in oil prices as investors grapple with more recessionary headlines. Nevertheless, the trade in oil is now less crowded than at the onset of the Ukraine invasion, which further limits the downside on oil prices especially since the physical market continues to buy oil products at premiums to the contract price.



## OIL DEMAND THROUGH RECESSIONS

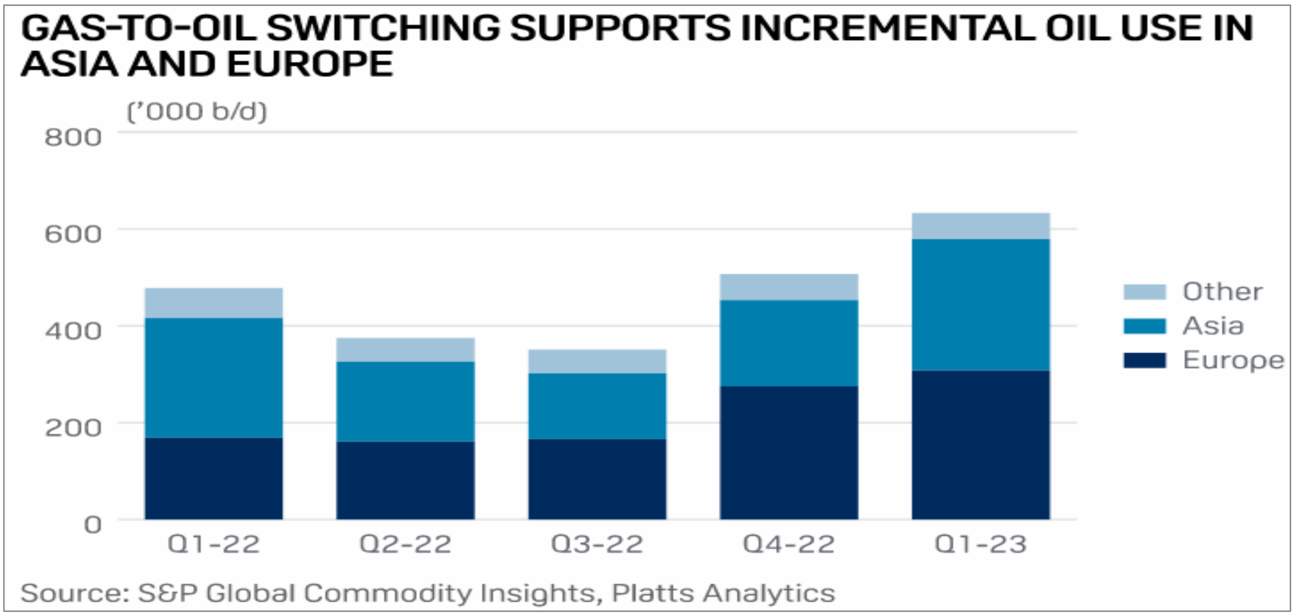
If we examine prior recessions, we can observe that oil consumption didn't always recede. The National Bureau of Economic Research reports seven recessions since 1970, including the pandemic. In only two of those seven recessions did oil consumption fall 10% from peak to trough of the economic cycle. The first detraction was in the early 1980's after the fruits of President Jimmy Carter's National Energy Act introduced fuel efficiency standards and provided much needed relief from fuel shortages; the second detraction occurred more swiftly in the 2020 COVID pandemic. It is important to note that the Global Financial Crisis in 2008 caused oil demand to fall around 2%, and oil prices performed very well compared to other risk assets from the onset of recession reaching all-time highs of $140. Oil was by far the best performing asset coming out of the recession. Oil consumption held steady as demand from Emerging markets, and high rates of urbanization from poverty into the middle class, meant that there was a systemic bid for energy. These dynamics are still at play in developing nations, as people's income rise, they will demand cars instead of bikes, larger homes, and more food.



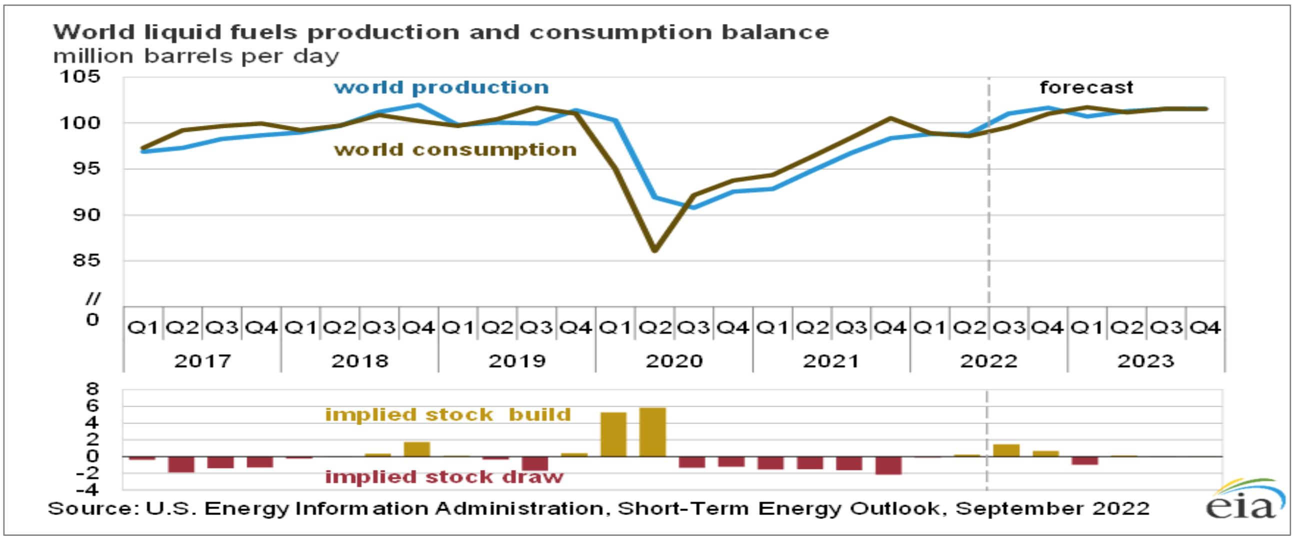
Oil prices can still move sharply lower as volatility in the market remains high amidst the uncertainty of war and an energy crisis in Europe. Yet, there is good reason to believe that oil prices may be well supported long term due to:

- the exceptionally low inventories of oil products held in inventories in the US and Europe
- the lack of investment to grow production by Western producers
- the impending switch of natural gas to oil due to the exorbitant prices of global natural gas prices



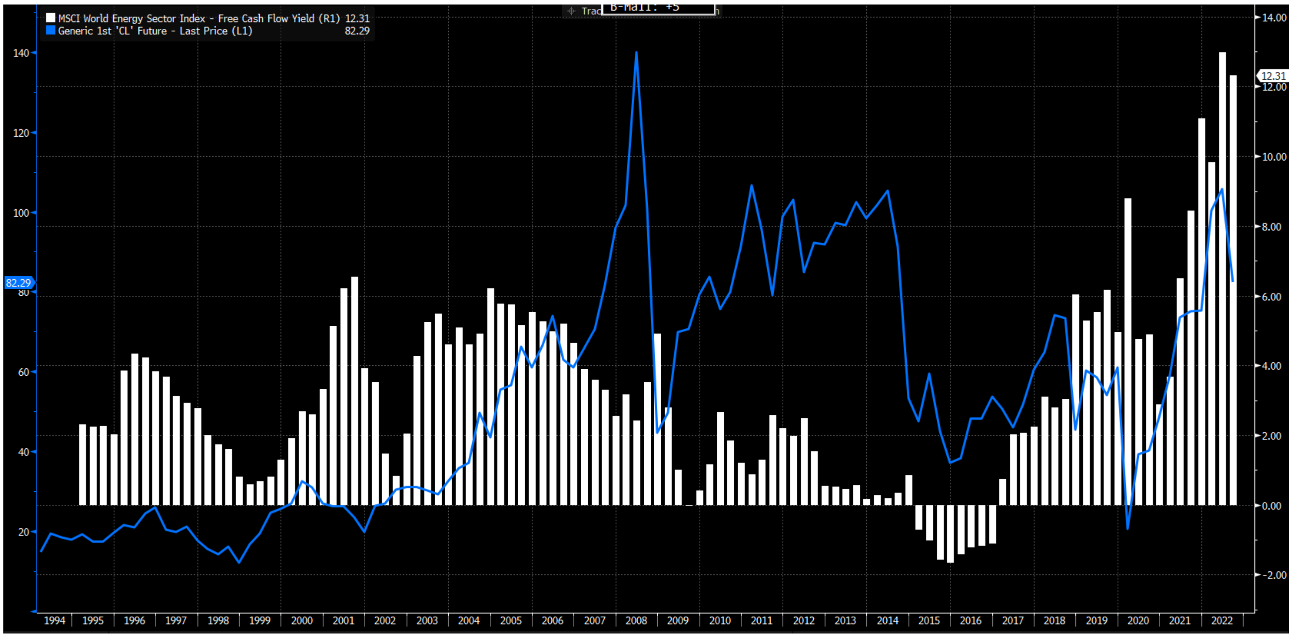

## PRODUCTION OUTLOOK, WHY ITS DIFFERENT THIS TIME

While in past cycles, energy producers have rushed to grow production to take advantage of higher prices, that resulted in an extended supply glut and hurt oil prices for longer as experienced in 2014. In this current cycle, the potential risk of an extended supply gut is minimized. Neither OPEC+ nor the Shale oil producers possess the appetite or the funding to substantially grow production, with most corporate producers preferring to distribute dividends to shareholders rather than grow production. As a result, production has not yet recovered to its highs in 2019. As demand grows out of recession, with a muted production response, we could see oil prices reaching all-time highs again.



## HOW TO PLAY HIGHER OIL PRICES FOR LONGER?

Energy equities are still valued with an oil price assumption of around $60 per barrel. Despite the staggering growth in free cash flow, and shareholder distributions, the energy sector remains one of the most attractive industries. As the oil price resilience approaches its most difficult test of recession fears, and oil producers start to hedge production around $80 per barrel, they will likely rerate upwards, as the market starts getting comfortable with the idea of higher oil prices for longer. Taking from the analogy in 2010, the chart below shows that equities in energy provide massive potential upside, even if oil prices remain at their current levels, as companies generate record free cash flow with an aim to grow shareholder distributions.




In conclusion, the recent sell off in oil prices and oil equities poses an attractive long-term buying opportunity for energy equities. Although the oil market looks to remain exceptionally volatile, and susceptible to headline risk, we believe in the long-term fundamentals for sustainably high oil prices driven by a newly discovered disciplined approach by oil producers, and sustained growth in demand as the economic cycle recovers from its current slowdown and possible recession.

## Disclaimer

This document is not directed at or intended for use by any person resident or located in any jurisdiction where the distribution of such information is contrary to the laws of such jurisdiction, or such distribution is prohibited without obtaining the necessary licenses or authorizations. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the content. The information contained in this document is for informational purposes only and should not be regarded by recipients as a substitute for the exercise of their own judgment. This document does not constitute a solicitation, an offer, or a recommendation to buy or sell any investment instruments, to affect any transactions, or to conclude any legal act of any kind whatsoever. When making a decision about your investments, you should seek the advice of a professional financial advisor. No representation or warranty of any kind, either express or implied, with respect to the content is made. This document is provided on a confidential basis to invited parties and may not be copied or distributed without prior written consent. Subject to contract. This document is prepared for promotional purposes, and it may not be presented or distributed in State of Kuwait except to the "Professional Clients" only according to the definitions contained in the first book of the Executive Bylaws of Kuwait Capital Markets Authority. Rasameel Investment Company hereby undertakes that it does not disguise, diminish, or obscure important items from the investment subject of promotion.

## Warning

The past performance of any investment or a product is not a reliable indicator of future results, and it cannot be relied upon for investment decision making.

RASAMEEL

**Rasameel Investment Company**
Kuwait City, Souq Al Safat, 3rd Floor, Office 6 & 5
P.O. Box 4915 Safat 13050

**T.** +965 2247 8800
**F.** +965 2247 6600
**E.** info@rasameel.com

www.rasameel.com

Rasameel