Global Energy Fund - February 2019

25 February 2019

Oil prices experienced a strong rebound, which led to the energy sector being top performer in the MSCI World Index and leading us to believe that an oil price recovery is on firmer footing.

Summary

- Believing that the Q4 sell-off was overdone, oil price sensitivity was raised to 1.2 by increasing the Fund's weighting in the exploration and production sub-sector
- Oil prices experienced a strong rebound, increasing 18%, which led to the energy sector being top performer in the MSCI World Index, rising 11.6%
- The Global Energy Fund benefited from its higher oil price sensitivity, and outperformed the benchmark
- The US implemented sanctions on Venezuelan oil, another one of the reasons why the Fund increased its oil price sensitivity during the month.

Market update

We saw a number of events affect oil supply over the last month.

Libya continued to declare a force-majeur on its largest oil field, El Sharara, removing 340kbblsd since December. When coupled with the recent imposition of US sanctions on Iran and, most recently, Venezuelan oil imports from the US, global oil markets have potentially now lost more supply from OPEC countries not included in cuts versus those that are participating in the cuts.

Iranian crude production declined by more than 1Mbblsd, already falling below levels witnessed previously under the Obama administration. Only two of the eight Iran export waivers issued by Trump have been utilised, albeit by the largest importers of Iranian crude, China and India.

At the end of 2018 we were estimating 2019 Venezuelan crude production declining by c.300kbbld – however, with the escalation in political and civil turmoil, together with the announcement of US sanctions, the rate of decline in production is likely to accelerate.

With regards to US production growth, we believe that it is unlikely to hit the level required to balance the market in 2019. The combination of a higher cost of capital, reduced access to borrowing capacity and investors' insistence on improvement in capital discipline and increased returns on capital will likely take its toll on supply growth.

Adjusted EIA data regarding US production has already shown indications of falling supply, led lower by oil fields outside of the Permian basin. The increasing level of capital discipline does not necessarily bode well for US onshore service companies, which is one of the reasons why we have skewed our service exposure to the service companies that focus on offshore developments, where there are higher barriers to entry.

Outlook

We are growing increasingly confident that an oil price recovery is on firmer footing.

Looking at the wider picture, we believe markets will continue to display signs of tightness feared during much of 2018, but temporarily allayed by Trump's imposition of temporary and largely ineffective waivers on Iranian exports in Q4. We have now had just over two years in succession when oil production growth has not had to meet demand growth in its entirety, with a significant portion of demand growth being supplemented by draws from inventory in 2017 and draws from spare, but unsustainable, capacity in 2018.

We enter 2019 with both of those supply levers having been largely exhausted; OECD inventories are normalised and non-OECD inventories as well as spare capacity are both very low. It is looking increasingly likely that supply for 2019 will fall short of demand, which means that the market will need to continue leaning on inventories and spare capacity to close the gap. Typically, a market that sends inventories and spare capacity lower, sends prices higher.

Fund performance and strategy

Iran, Libya, Canada, Venezuela and Saudi Arabia saw some negative impacts pertaining to supply in January. Consequently our oil outlook improved during the month. This led us to raise our oil price sensitivity to focus on companies that are closer to the source of oil.

Believing that the Q4 sell-off was overdone, the managers raised the oil price sensitivity to 1.2, by increasing the Fund's weighting in the exploration and production (E&P) sub-sector. The Fund outperformed its benchmark, attaining much of its alpha from sector allocation. We also gained much of our alpha through the decision to garner our oil price sensitivity via E&P and not service companies.