Strategist's Corner
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Oil: Geopolitics Versus Structural Headwinds

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In brief

- Geopolitical tensions have subsided, and we believe a sustained spike in energy prices is unlikely.
- Global supply and demand dynamics suggest the risk of dramatically higher sustained prices are limited.
- With this in mind, we lay out our framework for how we approach investing in energy companies.

Tensions between Iran, Israel and the United States over Iran's nuclear program have de-escalated, seemingly removing the associated risk premium in energy prices and risk markets. While we generally don't direct capital based on commodity prices, given that vast cyclical forces can affect prices, that doesn't mean we don't have structural views on the energy complex. I thought I'd use this opportunity to share how we think about oil and gas fundamentals, why we didn't, and still don't believe a sustained $100 oil price was a high probability risk, and lay out our framework for how we approach investing in energy companies.

Like many things, oil prices represent the equilibrium between supply and demand, so it makes sense to analyze each.

Supply Dynamics

- **Abundant supply:** Supply remains high, particularly among OPEC+ producers. If Iran's exports were completely shut down, our analysis suggests OPEC+ spare capacity would only revert to historical average levels, providing a buffer against supply disruptions.
- **The US shale revolution:** The US is a major force in the global oil market, supplying one-fifth of the world's crude — almost double that of Saudi Arabia. Although US rig counts and storage levels, including the Strategic Petroleum Reserve (SPR), are low, any material rise in prices would incent US producers to quickly bring more supply to the market. This spare capacity is driven by the attractive economics of shale production, with break-evens of around $60 for some higher-cost producers and mid-to-high $30s for higher-quality producers. In summary, we think great acreage, very strong balance sheets, technology and economic incentives would result in increased US supply in response to higher prices.
- **Vast reserves:** Venezuela has the largest proven oil reserves globally, followed by Saudi Arabia and Canada. While bringing some of these reserves to market faces political and logistical challenges, the scale of the reserves provides long-term supply potential.

Demand Considerations

Demand is a more complex variable. GDP, at its core, is simply energy transformed. While average annual oil demand growth is typically in the range of 1% to 2%, the risk of demand destruction from a slowing global economy is significant. This potential impact stems from several factors:

- **Deficits and debt:** High government debt burdens can strain economic growth.
- **Trade tensions and tariffs:** Tariffs can disrupt supply chains and economic activity.
- **Inflation and weakening consumer confidence:** Persistent inflation erodes purchasing power, potentially reducing demand.
- **Job market and aging population:** A weakening job market and an aging population can also weigh on demand.

Any sustained rise in oil prices would worsen these headwinds, accelerating demand destruction, ultimately putting downward pressure on prices.

Investment Process

Independent of where oil prices live, how should investors differentiate among energy companies? We aim to invest in energy players who possess a combination of what we believe are great acreage and lower cost production capacity, led by skilled operators with successful track records. While we approach valuation from many different angles, in general, we value these stocks by comparing enterprise value with our analysts' debt-adjusted cash flow assumptions.

Conclusion

In the short run, market participants tend to prioritize the unknown, which is logical. When new information has the potential to upend existing cash flow assumptions, prices should adjust. However, the financial materiality of the unknown is the key variable.

In the current environment, it is crucial to acknowledge the tangible realities of supply. The US's capacity to increase supply, the profitability of shale production and the slowing global economy present a counterbalance to geopolitical risks.

This doesn't mean oil prices won't experience short-term volatility. Geopolitical events can, and often do, create market dislocations and will do so again. However, long-term investors should consider the underlying fundamentals. We believe the structural headwinds outlined here make a sustained move to significantly higher oil prices unlikely.

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