Capital Group

Investment insights
Energy sector update

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C20-15700 | 03/2020 | EXP 03/31/2021

CAPITAL GROUP®

Investment insights
March 19, 2020

Energy sector update

Key takeaways

- The energy sector has been hit harder by the COVID-19 outbreak than most areas, as a combination of supply and demand challenges has weighed on crude oil prices.
- U.S. shale E&P companies are more vulnerable due to higher costs and lack of government subsidies.
- Rather than speculating on an oil price bottom, our analysts and portfolio managers have been adjusting expectations for all current holdings by weighing and analyzing a) balance sheet health and overall asset quality, b) dividend sustainability, c) amount of oil price hedges, and d) ability to decrease capex spending.

The following is a look at the main supply and demand issues affecting the energy sector.

Supply and demand dynamics

- **Supply**
  - Supply growth figures had begun to abate in late 2019 in the U.S., as shale producers cut capex in order to focus on returning capital to shareholders through dividends and buybacks.
  - However, the true shock to the system came over the weekend of March 7, 2020, as OPEC and Russia failed to come to an agreement regarding production cuts. Subsequently, Saudi Arabia cut crude prices, initiating a price war that saw WTI and Brent prices fall by more than 20% to their lowest levels since 2016.
  - Production at the levels Saudi Arabia announced (12.3 million barrels per day, as opposed to the current average of under 10 million barrels per day) is unprecedented. This excess could quickly fill global storage capacity and result in a further glut in the market. On an investor call on March 16, 2020, Saudi Aramco confirmed its plan to go above its maximum sustainable oil capacity, keeping production at these levels through year-end 2020.
- **Demand**
  - As the virus has spread beyond China, broader travel restrictions and the resulting decreased economic activity have curbed demand for fossil fuels.
  - Reduced travel in China following Lunar New Year had already begun to weigh on oil prices, resulting in a softening of crude oil prices in early January.
  - Additional restrictions and lockdowns around the world — such as closed schools, canceled events and the travel ban from Europe — have continued to drive down demand projections. For the first time since 2009, a few projections include a decline in absolute oil demand, some displaying a decline of more than 1 million barrels per day.

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- There is considerable debate, both within Capital Group and more broadly, if the failure to reach a consensus on production cuts and the resulting price war is a planned political/economic gambit or posturing between Russia and Saudi Arabia that led to both sides refusing to back down.
- Regardless of the cause, the resulting moves in crude prices have impacted oil-related stocks and credits indiscriminately, pulling the sector down significantly in both equity and bond markets.

U.S. shale E&Ps

- Lower oil prices will likely have a larger impact on U.S. shale producers than on Russia and Saudi Arabia. Fracking/drilling costs are significantly higher than traditional oil exploration, and U.S. companies don't have the benefit of direct government subsidies.
- With lower crude prices, U.S. shale producers (many of whom already had leverage ratios and/or dividends not fully covered by cash flows) will likely face balance sheet and liquidity challenges in the near- to medium-term.
- To this end, we have seen credit spreads widen, particularly for the most leveraged producers, while those with stronger balance sheets have seen less movement.
- Another factor to consider is the extent to which companies have hedged crude oil prices. The types of instruments used for hedging and the associated liquidity, as well as the percentage of production covered, will likely be important factors in mitigating the impact of lower prices.

The oil majors

- The sharp decline in oil prices has put the spotlight on the ability of these firms, especially the oil majors, to sustain their dividends. With the general decline in share prices, many of these companies (RDS, XOM) saw their dividend yields rise above double digits at the current level of dividends.
- Management of these firms is acutely aware that a cut to the dividend could be viewed negatively by the market, and especially by their large retail investor base.
- As a result, some of the majors may be willing to let their credit ratings drop in order to continue paying dividends and/or not divest additional higher quality assets (S&P cutting XOM's rating to AA as an early example).
- Overall, the majors are more insulated from oil price shocks, in part due to their integrated business models and non-U.S. assets, which in many cases operate at lower overhead costs than the shale companies in the U.S.
- In terms of identifying a bottom for share prices or projecting a timeline for higher crude prices, we cannot speculate here. Until the demand picture becomes clearer, we believe there will be significant risk in the global oil industry at current price levels, but also opportunities in well-managed and capitalized companies with quality assets and balance sheets.