

## The Bearish Case for Oil Price and Energy Stocks

The long-term demand growth of energy products remains intact, mainly arising from rising middle class in emerging market countries. Oil will remain a major source of energy in the coming decades, however, oil-based power source is increasingly replaced by gas and other renewable sources, including solar and wind technologies. EIA projects oil consumption as a share of total energy consumption to decline by 5% in the coming thirty years, whereas renewable energy will increase from by 10% (**Chart 1**).

In the medium term, there are several headwinds to the bullish case for oil price and energy stocks:

- First, spare capacities in global energy sector remains high, as proxied by the drawdown of global rig count from its 2014 peak (**Chart 2 and 3**). The 2010-2014 bull market in oil price and the shale revolution had attracted producers to increase capex in their E&P budget, leading to a tripling number of rigs. Currently, global rig count is still under a third of its peak, meaning that it will be difficult for price to sustainably rise above the average production cost, as an increase above producer's marginal cost will entice them to restart the production of abandoned or closed wells.
- Second, Saudi Arabia and Russia, two major low-cost producers (**Chart 4**), are under increasing pressure to pump and sell more oil to finance their government fiscal budget. Saudi and other Middle Eastern countries require oil price around \$80 to balance their budget (**Chart 5**), while the pressure is somewhat less for Russia, requiring only \$40 oil for its fiscal (**Chart 6**). The cooperation agreement early this year between Russia and Saudi Arabia follows this logic; when either side disagree to cut output during price slump, the other has to pump aggressively and drive prices further down to force both to the negotiation table. This also means that Saudi and Russian producers will always be the first one to profit from an increase in oil prices.
- Lastly, a prolonged period of low oil price bodes poorly for higher-cost producers and will force them to either merge with those having ample liquidity or file for bankruptcy. \$40-50 oil is not high enough for U.S., including Permian, Mexican and Colombian producers to operate. The reaction function already is visible in **Chart 7**, where the number of oil rigs fell over 70% in U.S. compared to the relatively modest fall for Saudi's. This bodes poorly for majority of energy stocks in the world, forcing them to cut cost and shut down wells until price sustainably trade above their breakeven cost, at around \$45-50.

**Investment implication:** overweight Russian and Saudi (ARAMCO) oil producers relative to the overall energy sector due to their cost advantage and the prospect of a prolonged low oil price going forward.

Chart 1

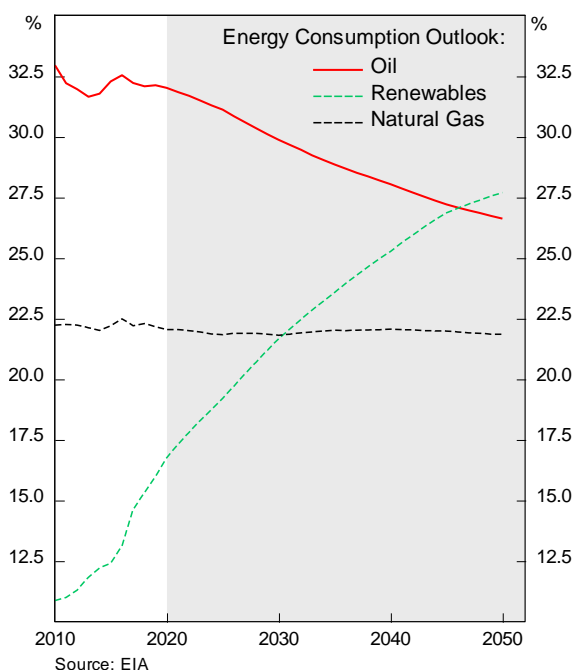


Chart 2

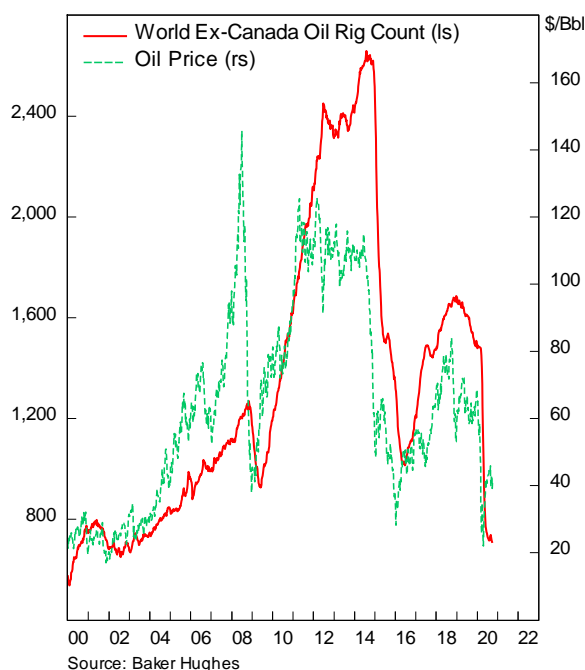


Chart 3

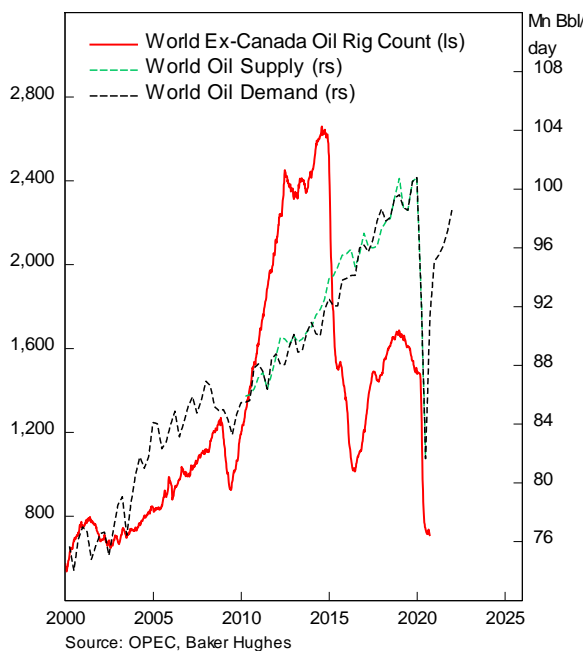
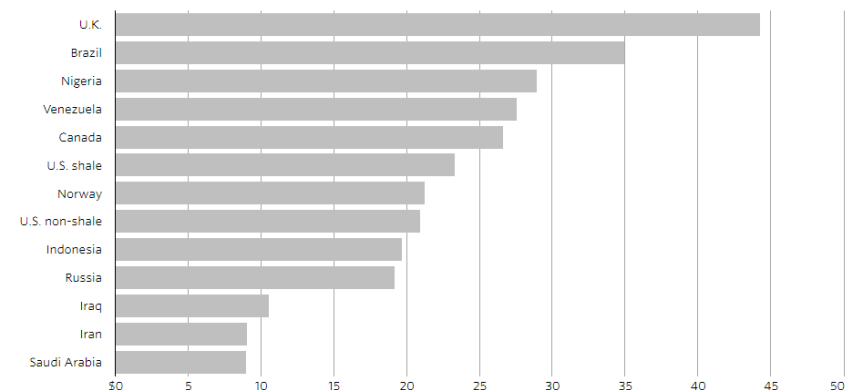


Chart 4

### Cost of producing a barrel of oil and gas

Average cash cost to produce a barrel of oil or gas equivalent in 2016, based on data from March 2016.



Note: Brent crude price as of Invalid date BST.  
Source: Rystad Energy UCube

Chart 5

### Fiscal breakeven oil prices (US\$/bbl)

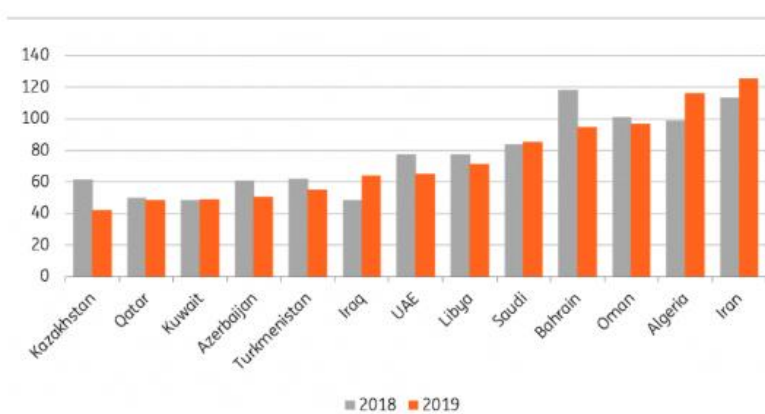


Chart 6

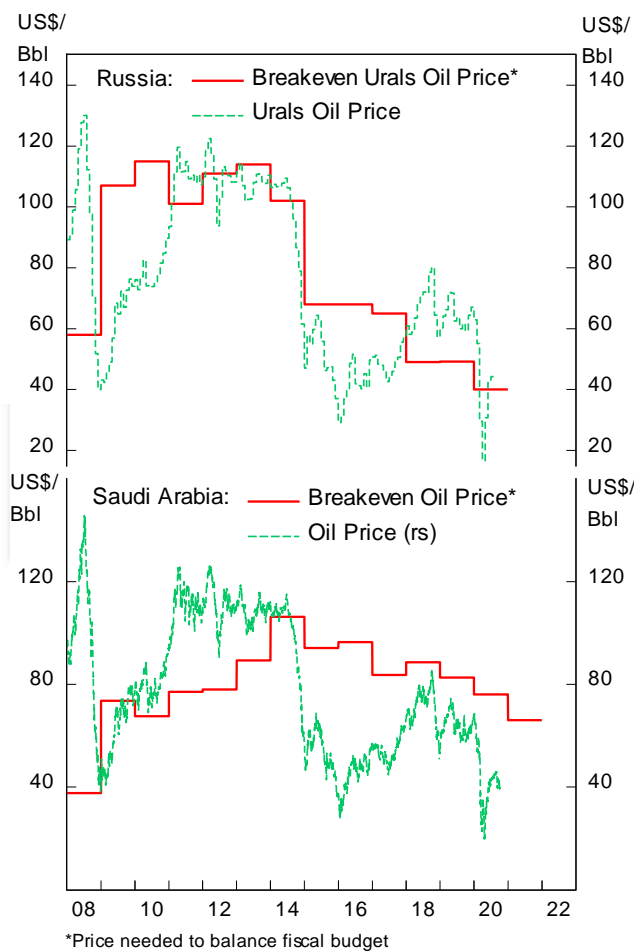
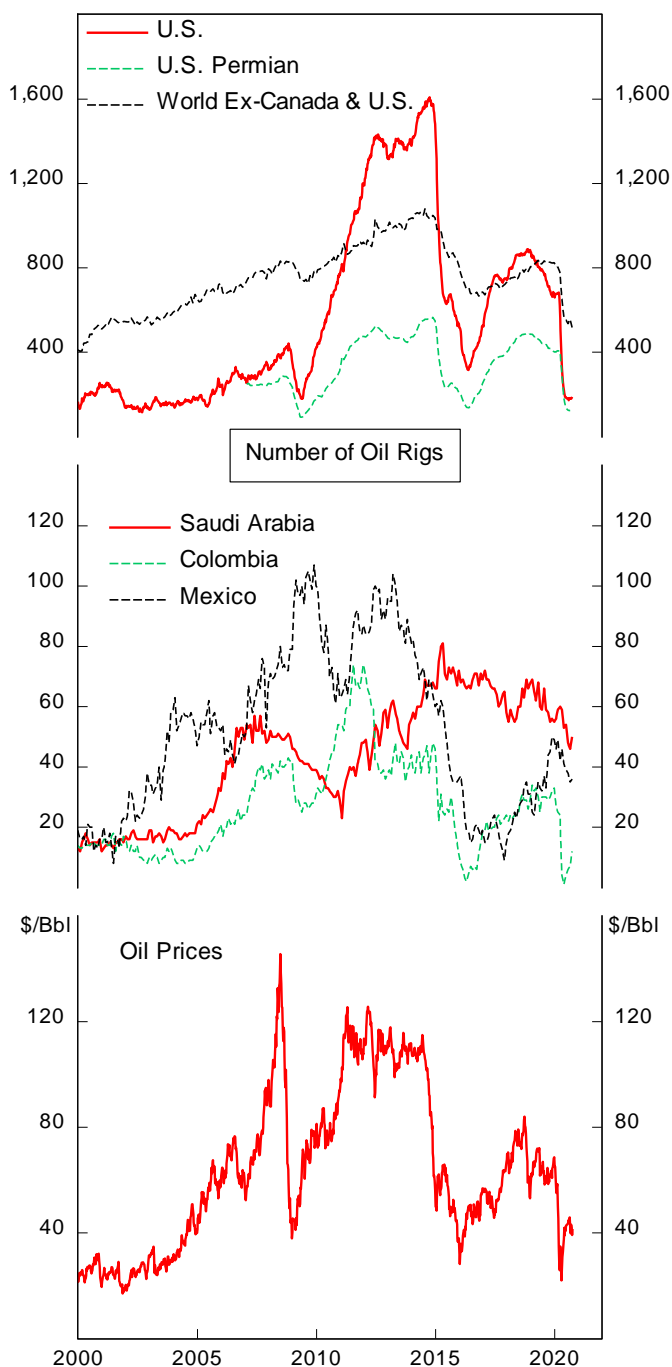


Chart 7



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