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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

How OPEC's decisions and tensions in the Middle East could impact the oil price

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- *We expect the 2018 outlook for oil to remain somewhat stable ($55-60/bbl for WTI and $60-65/bbl for Brent through 2018) as strong demand should be balanced by higher supply from OPEC and Non-OPEC countries.*
- *Escalating tensions in the Middle East could cause oil price volatility, but supply shocks are unlikely.*
- *We believe that in the short term, investors still have limited opportunities from direct investments in oil or in a broad exposure to the oil sector; the most compelling opportunities can be found at single stock level.*

What is your outlook on oil for 2018 in light of the most recent OPEC meeting?
MD: Despite OPEC's last decision to cut output through the end of 2018, prices could calm down as a result of rising US production that is tipped to rise above 10 million barrels per day (mmb/d) at the very least in 2018. US shale supply elasticity is the key variable, at least in the short term, and could be the game changer regarding our target range for 2018: should the US lift production dramatically, to around 11 mmb/d, the range could return to $30-50/bbl. However, a sudden increase in US shale oil production is not our base case scenario.
As such, we expect the 2018 outlook for oil to remain somewhat stable, in a range of $60-65/bbl for Brent throughout the year. The International Energy Agency (IEA) revised up its estimate for global oil-demand growth of 1.5 mmb/d in 2017 (or +1.6%) and 1.3 mmb/d in 2018 (or +1.3%), in line with our expectations. Demand is strong and should come from both emerging and developed markets. On the other hand, oil supply growth (OPEC + non-OPEC) is expected to decline from 3.0 mmb/d to 2.6 mmb/d, which means that the expected oversupply is around 1 mmb/d, the lowest level in the last five years. The OPEC (and 10 non-OPEC oil producers led by Russia) agreement, under which producers are cutting supply by about 1.8 mmb/d until the end of 2018, has been effective, with a very good rate of compliance. The end-goal is to rebalance global oil inventories down to a five-year average (they are still around 154 million barrels above the five-year average) in an effort to keep oil prices within OPEC's comfort zone. If the market were to become too tight, OPEC and non-OPEC countries would be able to adjust the agreement at the next meeting in June 2018.

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What are the key assumptions behind the estimated target price range?
MD: We forecast equilibrium prices to trade in ranges of $55-60/bbl for WTI and $60-65/bbl for Brent through 2018. Target prices result from an econometric model that considers the ongoing changing dynamics in supply/demand fundamentals. On the supply side, within our economic model, we consider the world oil production (OPEC and non-OPEC) and take into account dynamics in oil inventories. On the demand side, we believe it's important to monitor the OECD leading indicators as a proxy for global economic activity. For 2018, we expect still-robust growth which should drive up oil demand.

"The Middle East crisis is not likely to derail the oil price and the Saudis seem committed to not breaching OPEC production agreements".

How will the newly escalating tensions in the Middle East impact crude oil prices?
MD: The events in Middle East (in Saudi Arabia and Lebanon, in particular) have given the oil price extra momentum and raised concerns about oil supply shocks, but we believe that only extreme events (such as a Saudi or Israeli strike against Hezbollah targets) would have significant impacts on the oil price. At the time of writing, we assess the probability of extreme episodes as very low, at least in the near term: none of the players involved has an interest in starting a war that could derail the last 10 years of economic growth in the Gulf. Therefore, the recent oil rally is more related to a catch-up of improving growth conditions and world demand (China being the biggest contributor to this demand with the highest year-on-year growth since 2010, adjusted for strategic petroleum reserves) rather than geopolitical issues.

In conclusion, despite a currently fragile situation, the Middle East crisis is not likely to derail the oil price trajectory and the Saudis seem committed to not breaching OPEC production agreements. The mounting tensions between Saudi Arabia and Iran could lead to higher volatility in oil prices, but fundamentals are in place to pave the way for a medium-term rebalancing of the oil price trend.

From a Multi-Asset perspective, do you see oil-related investment opportunities in 2018?
FS: An assessment of oil price movements is particularly relevant for multi-asset investors. Not only does it relate to investment opportunities per se, but it also drives sector dynamics (both directly, as in the case of the energy sector, and indirectly, for example, in the transportation sector) and affects the macro outlook for countries (importers and exporters).
The outlook for oil in 2018 is constructive in terms of supply/demand dynamics, but close to what we have seen in 2017. So, it will be broadly neutral for country outlooks.
We believe that in the short term, investors still have limited opportunities from direct investments in oil. While we acknowledge that the slope of the futures curve points to a better investment environment (no negative roll yield), we think that most of the assumptions – as described above – are largely priced in, with a current Brent price of $62.5/bbl, exactly in the middle of the range given for 2018. Direct investment in oil has shown an average implied volatility of 30% since 2015, with a slight reduction recently. At present, this qualifies oil as an investment with an asymmetric risk/return profile for investors, where the probability of a stop loss being triggered in the short term exceeds the space for opportunities.

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In this phase of the market, equity investments in the energy sector appear to be following the same pattern as industry breadth (percentage of companies outperforming a one-year moving average) appears quite flat after a meaningful rally from lows in August. Many investors still look at the oil and energy sector a bit like a falling knife, which means still seeking for more consolidation in the sector. While we have a cautious view at present, we are reviewing the sectors seeking a more constructive view because of rapid changes in sentiment and the conservative market positioning. We also acknowledge a higher focus on company profitability than in previous years. However, we believe that due to possible consolidation in the sector, the most compelling opportunities remain in stock picking rather than in directional sector exposures (for example, through derivatives).

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