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Running on Fumes

Ripple effects and opportunity from energy market dislocation

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Q**4** has offered a pronounced bout of volatility across asset classes. In particular, volatility compressed extreme market movements into a relatively short space of time. Broad equity indicies have twice in the quarter sold off from 6 – 15%. In the case of October, equities finished the month unchanged to marginally positive. US Treasury and German Bund 10-year rates have steadily continued to compress – again reaching 2012 levels. To this end, the importance of continuously managing portfolios to preserve capital is clear.

Commodities highlighted this quarter's volatility. There is also ample evidence of a feedback loop between financial investments, macroeconomics, and the effects of rapidly evolving commodity markets. Oil has increasingly stolen the headlines as prices accelerated their decline through year end. Consolidation of supply and the entrenched importer/exporter balance has been a fixture of the modern investment landscape for a generation. Historically, the ability for crude to circulate freely has been the obsession of oil traders, transporters, and macroeconomic forecasters. No other commodity has proven as broadly informative as this black lifeblood of the global economy.

However, the status quo is evolving. Geopolitics still matters – but today there is more, not less, free supply capacity. Production data from September through December have hammered this point home – several key exporting countries have vastly exceeded production expectations. The spot prices of various EMEA crude blends adjusted to reflect this reality. In addition, the current production glut masks considerable sidelined capacity in traditional exporters, a condition which is having a parallel effect on longer-dated oil futures. While OPEC production at the well-head remains the world's lowest cost and easiest-to-adjust supply, the table above illustrates the budgetary considerations which also apply. Ultimately, the market price of oil may become a trigger for geopolitical events – rather than the other way around.

Export Production Breakeven Spectrum ($/Brent bbl)

Nat'l Exporter:	Qatar: $45/bbl	KSA: $90/bbl	Russia: $110/bbl	Venezuela: $150/bbl
Fragmented Commercial Capacity:	Offshore Brazil/Norway; US shale (Permian, Bakken)	W.Africa, Gulf of Mex.	Oil sands, Aus. LNG	

Source: Citi Research, National Exporter figures refer to Fiscal Breakeven 2014(e)

Above all stands the transformation of the United States' production profile as a result of shale gas and, now, oil. US crude production at 8.5+ mmboe/d (and rising 10%+ per year) has upended the global supply/

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demand balance like nothing else. While producing oil at a level comparable to Saudi Arabia or Russia, the United States also continues to lead the list of importers. This not only reflects some legacy transport imbalances, but also highlights the flexiblity of supply for developed economies in an era of excess crude oil.

Similarly, for global operators, the ability to continue committing capital to incremental, long-lived prod- surprises, the supply/demand balance for crude has shifted relentlessly in favour of importers. The ripple effects are already spilling over from transportation, refining, and petrochemicals to power generation, manufacturing, and retail. The IMF's own calculation holds that global GDP is boosted by 0.2% (or nearly 10% of current expected 2014 growth) for every $10/bbl decline in average annual crude prices. Put

	Breakeven Development Cost ($/bbl)	Trend	Reserve Replacement Success
BP	$52	Easing	X
Total	$46	Rising sharply	X
Shell	$30	Easing	~
Chevron	$26	Rising sharply	+
Exxon	$21	Steady	+
BG	$20	Steady	++
Anadarko	$15	Steady	++

Source: Liberum; Breakeven Development: '11-'13 F&D average cost; Trend: 2013 vs '11-'13.

uction opportunities is shaped by the relative project commercial viability, as well as absolute oil price and cost of capital. Investors today can see on-going development and success rates from ultra-deep Brazil and Norway, as scale and infrastructure yield higher returns. With over 163 mega-projects in pre-production, rationalization of fragmented commercial capacity is a natural outcome. Investors should expect a wave of M&A. The table above suggests the economic underpinning of "replacing reserves on Wall Street" versus at the drill-bit.

Despite geopolitical shocks, and due to production differently, downstream consumers in oil importing economies are due a $1 trillion bonus as oil resets from $115/bbl to $85/bbl.

Volatility – especially in commodities such as oil – is one dimension of this fundamental transition underway in the economic and investing landscape. The discipline of active management combined with rigorous risk awareness is crucial for capital stewardship in a rapidly evolving investment landscape.

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