The Falling Price of Oil

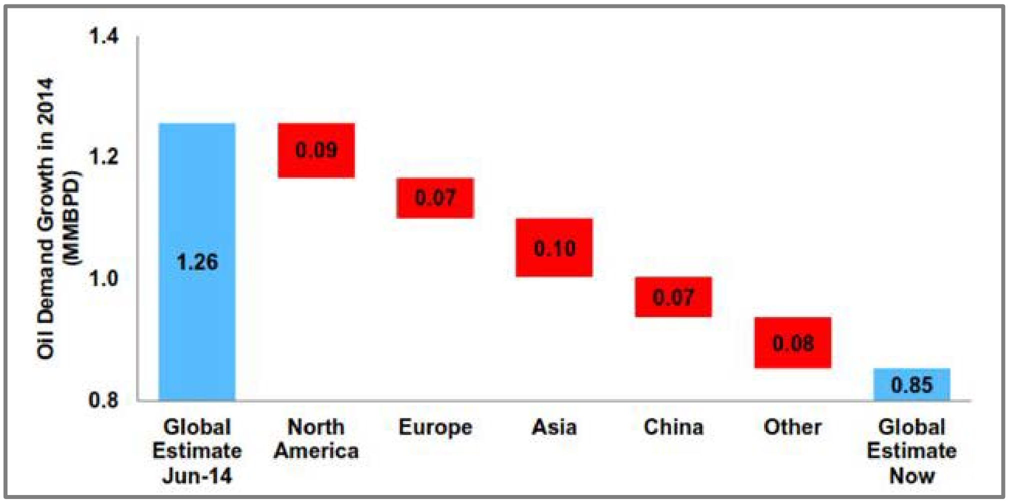
Over the past six months, the price of crude oil has decreased by over 40%. The pace of the decline has accelerated since Thanksgiving, when OPEC could not reach an agreement to reduce production. Given this large decline, we wanted to offer our thoughts on oil prices as well as the impact to our investments.

What caused this drop in oil prices?

We believe the decline was primarily caused by 3 factors:

1. Weakening global demand

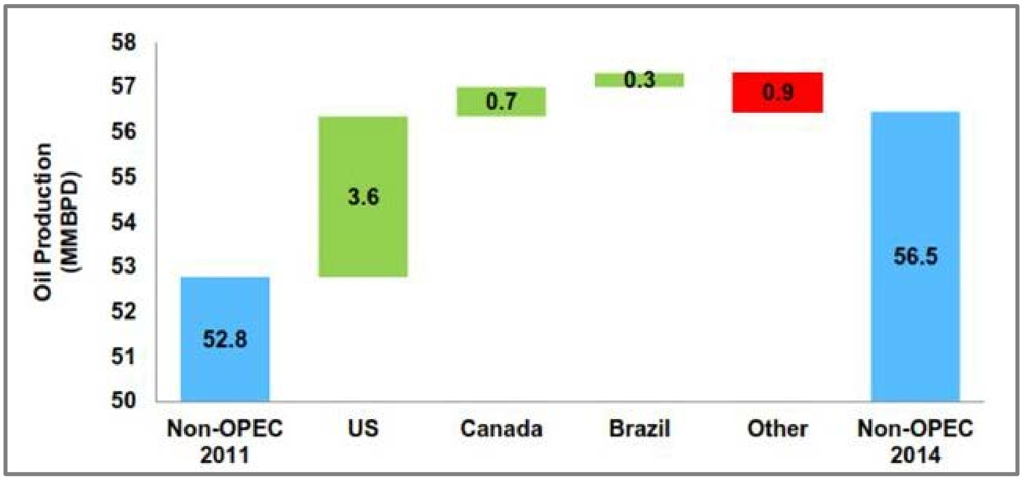
While the media has largely focused on North American supply growth, the reduction in expectations for oil demand has actually been a bigger driver. Since June 2014, demand expectations for 2015 have been revised lower by 400,000 barrels per day (bpd). Since the price of oil is set by the marginal barrel, small changes in supply/demand balance can have a meaningful price impact.



Source: Evercore ISI, Bloomberg, Platts

2. Increasing supply driven by North America

Oil supply for 2015 is now expected to rise by 1.35 million bpd, outpacing the expected increase in demand. However, supply growth expectations for 2015 have only increased modestly in the past six months. In recent years, strong production growth from North America has driven supply. Interestingly, the rest of the world has struggled to grow production even with $100+ Brent oil for most of the past 3 years. If the rest of the world couldn't grow production with $100+ oil, it's highly unlikely to do so in a sub $70 price environment.



Source: Evercore, ISI, IEA, OPEC

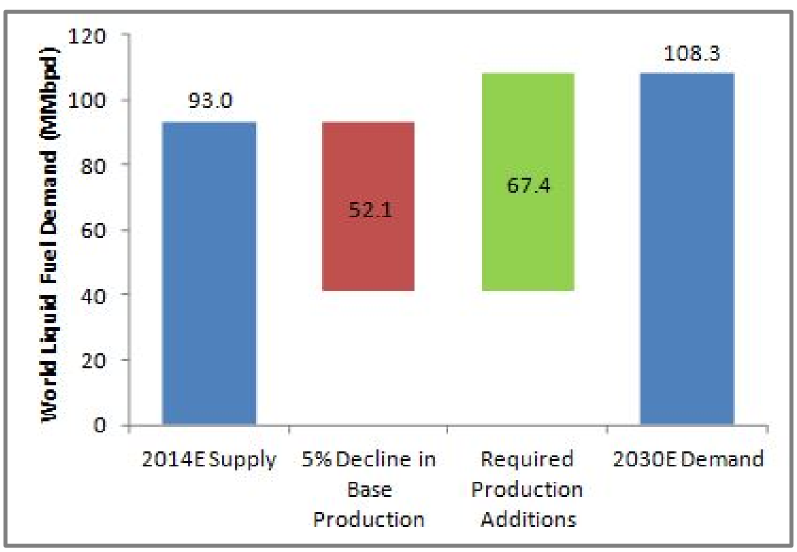
3. OPEC's decision not to cut production

Given that small changes to the supply/demand balance for oil can result in substantial changes in the price, OPEC has usually cooperated over the years to smooth out the price volatility by adding or removing supply. Over the past 3 years, OPEC (primarily Saudi Arabia) has successfully managed to hold oil prices in a fairly tight range. On Thanksgiving OPEC failed to come to an agreement to reduce supply and therefore the market shifted from a cartel pricing model to one where additional supply needs to be curtailed. We were surprised by OPEC's decision since it does not make economic sense. OPEC would clearly be better off selling 29 million bpd at $100 then 30 million bpd at $60. The market is currently in the process of determining how low the price needs to go to reduce supply.

Where do oil prices go from here?

Assuming OPEC does not reverse course and reduce production, we estimate prices are likely to stay below $75 per barrel until the oversupply situation is corrected. That should take approximately 6-12 months if demand does not change from current expectations. The decline in the price of oil will stimulate the global economy and result in higher oil demand over time. The longer-term price will be set by the marginal cost of supply. Our research shows the price needed to encourage operators in these higher-cost developments to drill for new oil is approximately $80 per barrel. Therefore, we believe higher cost developments will remain frozen, allowing oil to rebound to $80 per barrel or more by 2016. Furthermore, most oil exporting countries require $90-$100 per barrel to balance their fiscal budgets and a sustained downturn in prices would prove very challenging. As a result, other OPEC nations outside of Saudi Arabia are more likely to cooperate with a future reduction in supply. The biggest risk to our forecast would be a decline in global economic forecasts. As always, the cure for low oil prices is low oil prices.

While the timing of the rebound in oil prices is difficult to predict, thinking very long-term helps inform our decision making. Since total oil production declines at roughly 5% per year (assuming no new wells are drilled), we will lose 52 million bpd of production by 2030. Furthermore, assuming 1% demand growth, we will need to find 67 million bpd by 2030 to satisfy higher future demand. Finding 67 million bpd of production will require a lot of drilling and higher oil prices.



Source: IEA, EIA

Has the sell off in oil created an opportunity for long-term investors?

We believe the answer is yes since we expect oil prices will eventually rebound. Even prior to the drop in oil prices, we thought energy companies were attractively valued. The decline in stock prices represents a compelling long-term buying opportunity in our opinion. Our preferred investment in the energy sector remains the midstream MLP sector, as these companies are less exposed to the short-term changes in oil prices. Most midstream MLPs will only experience a modest impact to 2015 cash flows from the drop in oil prices. These companies have long-term fee-based contracts that are not dependent on the price of oil. The group has sold off with energy as growth expectations have declined. The MLP sector needs supply growth in the long-term to grow, as more oil and gas requires more pipelines and gathering systems. We believe supply growth in the U.S. will continue over the long-term since U.S. shale production has a cost advantage relative to many regions. In addition, MLPs are also driven by demand for natural gas, which should improve in the coming years as the U.S. begins to export gas. We also see other opportunities within the broader energy sector in Integrated Oil companies, Exploration & Production, and Oilfield Services.