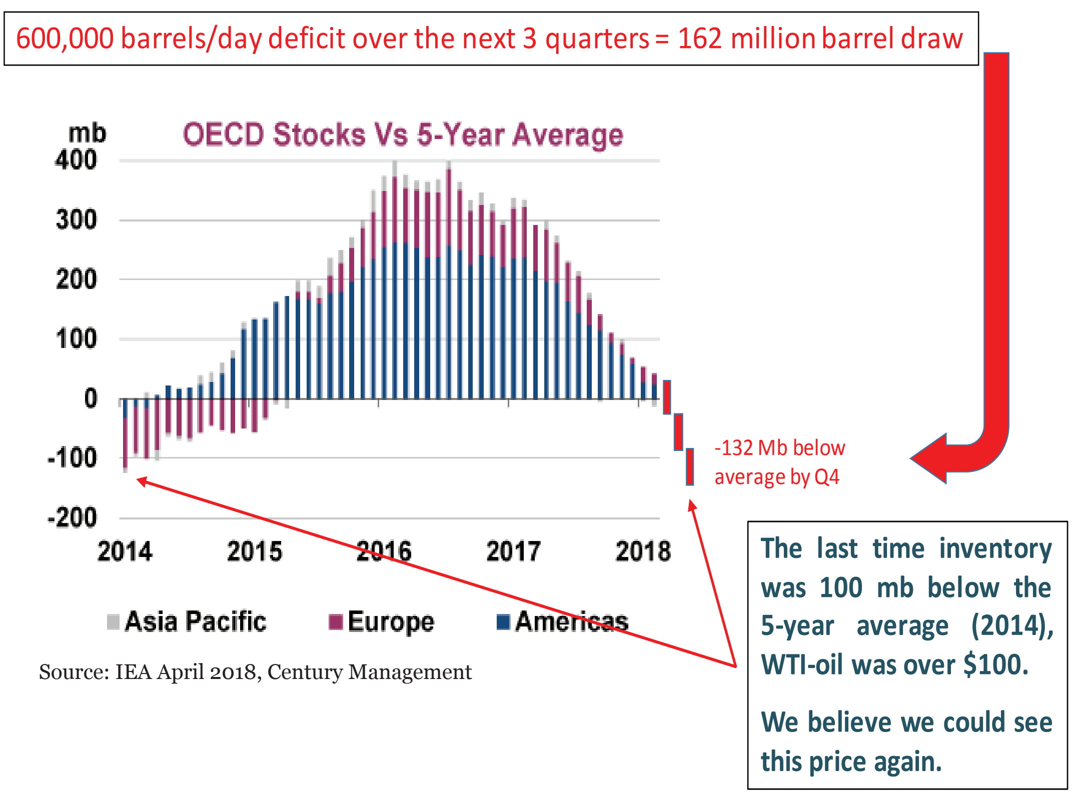
OPEC Contemplates Easing Off Supply Cuts: More Evidence of a Tight Market

As recent as six months ago, much of the world was convinced that oil prices would remain lower for longer, with most experts anticipating oil prices would remain in a band between $40 and $60 for a very long time. It was thought that demand was peaking, shale had boundless growth, and OPEC (*Organization of the Petroleum Exporting Countries*) had abundant spare capacity. However, the fundamentals of oil (supply/demand and oil inventories) have forced this consensus view to change.

In the beginning of 2016, world oil inventories were 400 million barrels above the five-year average. At the beginning of 2017, world inventories were 300 million barrels above the five-year average. As of April 2018, world oil inventories are below the five-year average. **In other words, since the beginning of 2017, world oil inventories have dropped by 300 million barrels as demand has outstripped supply, placing the world in a supply deficit**. This has been the result of much stronger than expected demand and stronger than expected production cuts by OPEC.

While shale production has grown, **it has not been able to fully offset the demand growth and OPEC cuts**. In April 2018, the International Energy Agency's ("IEA") updated projections called for further deficits throughout 2018. Based on the IEA estimates, world inventories would be 132 million barrels below the five-year average by year end, with additional deficits likely for 2019. The last time this occurred was 2014 when oil traded above $100 per barrel.



Source: IEA April 2018, Century Management

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The oil industry has rapidly moved from supply surplus to supply deficit, which is reflected in the recent higher oil price. With Brent oil now trading near $80 per barrel, OPEC, the IEA and the EIA (*U.S. Energy Information Administration*) see several factors that could cause a severe oil price shock that we believe is in no one's long-term interest.

1. OPEC spare capacity is estimated to be just 1.5 million barrels per day (mb/d), which at roughly 1.5% of world demand leaves little margin of safety for either supply shocks or continued stronger-than-expected demand.
2. Shale growth, once considered boundless, is running into bottlenecks in the Permian Basin, as well as resource exhaustion in the Eagle Ford and Bakken.
3. New sanctions set to hit Iran will lead to additional OPEC production cuts if not offset by other members.
4. Venezuela's economy is imploding, and with it, over 1 million barrels per day of oil production is at risk of continued collapse.

The IEA summed up the geopolitical supply issues as follows: **"In Venezuela, the pace of decline of oil production is accelerating and by the end of this year output could have fallen by several hundred thousand barrels a day. Our April data show that Venezuela's production is 550 kb/d lower than its target under the Vienna Agreement and this "excess" is more than Saudi Arabia's total commitment. The potential double supply shortfall represented by Iran and Venezuela could present a major challenge for producers to fend off sharp price rises and fill the gap, not just in terms of the number of barrels but also in terms of oil quality." Source: IEA May 2018 Oil Market Report**

The world is now faced with strong oil demand, along with supply deficits through year end, and additional supply risk as Venezuela implodes. Ordinarily, this means the oil market is tight and prices will rise. However, when you consider the world has just ~1.5 million barrels per day of spare capacity, and the ability to add significant near-term production has been severely limited due to considerable underinvestment by major oil companies over the past few years, the world finds itself at a critical juncture and exposed to the possibility of a significant price spike.

We believe that a spike in the price of oil is in no one's long-term interest. The powers that be (both the consuming and producing nations) now recognize these facts, hence the recent announcements by OPEC and Russia that they might consider easing off their current supply cuts.

The market responded to this news with a typical knee-jerk reaction by selling off oil and energy-related companies in earnest on Friday, May 25, 2018. However, for those with a deeper understanding of the underlying fundamentals, we believe these actions are an admission that surplus oil is gone and there is true concern that expanded supply deficits, the lack of spare capacity, and an increase in geopolitical events all leave oil susceptible to a severe price spike. It is, therefore, the goal of OPEC and Russia to create near-term price stability for the current price of oil. We believe this will help incentivize future production, while at the same time make the price of oil more manageable for consumers. Accordingly, we remain very bullish about our energy investment thesis.

Disclosures on next page

Disclosures

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