



Oil Prices and the Economics of Extraction

By Robin Wehbé, CFA, CMT
Portfolio Manager
Global Natural Resources
The Boston Company Asset
Management, LLC

A supply correction is in the cards, but it is still many months away.

The precipitous drop in oil prices reflects how the economics of extraction are now the primary concern for energy sector investors, rather than the geological or geopolitical limitations that used to be part of the calculus. Development of abundant US resources has boosted supply growth faster than trend-line global demand growth, an impressive performance by a single country within any geographical, geological or historical context. The market is still digesting the extent of crude oversupply and adjusting the trajectory of expected growth.

At \$60 to 70 per barrel, the price of oil becomes lower than the cost of new investment. Given this, low crude prices will ultimately prompt a supply response, but it could take 12 to 18 months. Right now, there is still far too much momentum in US unconventional liquids growth, aside from the inventory where capital has been sunk and production is imminent. Hedge books, continued cost efficiencies, lower transportation costs/bottlenecks and scalable infrastructure are just some of the reasons why production growth is likely to remain in the 1.0-1.2 million barrels-per-day (bpd) range. Our most aggressive demand forecast is about 1 million bpd globally for 2015.

Because reduced investment will take a long time to impact supply, the only way to balance supply quickly is through shut-ins, when oil wells are essentially turned off. Shut-ins take place when oil prices fall below the cost of operating a well, estimated at about \$30-40 per barrel on the high end. Shut-ins, much like OPEC cuts, generally impact supply within three months.

In the near term, we see downside risk to oil prices into the \$50s or lower. In looking for a bottom, we are keeping an eye on the forward futures curve, which has moved into contango over the past several weeks. Contango occurs when prices in the future are expected to be higher than those today. Liquidity in out months is largely supplied by producers hedging an investment. If that liquidity dries up, it means that producers are no longer willing to invest fresh capital and lock in that future price for when the asset comes online (assuming a 12-month average cycle), demonstrating the impairment of investment economics. We think a supply correction is in the cards, but it is still many months away.

THE BOSTON COMPANY

ASSET MANAGEMENT, LLC



BNY MELLON

We have great confidence
that investment economics
will ultimately balance
markets.

The only way we see the oil market getting balanced to an \$80-90 range would be through:

- A surprise cut from OPEC (more than 1 million bpd)
- US production curtailment
- Continued recovery of global demand, which is on pace and may actually accelerate with lower oil prices (though it will still take 9 to 12 months to absorb supply)

Within OPEC, Saudi Arabia is the only producer that has ever really cut production, but it is unlikely to shoulder this burden alone again, especially given the challenges posed by its own fiscal budget and the realization that the US may overwhelm OPEC policy decisions. Saudi Arabia would only cut if everyone else in the cartel would share the pain. A cut of more than 1 million bpd would be needed to impact the market, and that represents 10% of Saudi Arabia's production and oil revenues. Venezuela had sought a 2.0 million-2.5 million bpd cut, far more than OPEC could stomach, but probably an indication of concerns about US supply momentum and OPEC's irrelevance to supply growth.

Another factor affecting the future of oil prices is the Dodd-Frank Act. During the last period of contango, investment banks purchased oil to sell at higher prices in the future, booking a profit as long as the spread exceeded storage costs. However, the Volcker Rule has led most banks to exit speculative commodity behavior with their balance sheets.

We have great confidence that investment economics will ultimately balance markets. A wild-card event could challenge production economics, but we believe the US energy revolution, even in the absence of demand growth, will take global market share and thus provide an oil-volume investment story, if no longer an oil-price story.

As part of our focus on oil volume over oil prices, we look for bottlenecks in the energy supply chain, which remain transportation and infrastructure. We view investments in pipes, barges and railways as still attractive. More tactically, with near-term oil-price uncertainty, we are looking at hedging with stocks of companies that consume oil, as the pullback has been significant enough to benefit costs and economies continue to grow.

If we suspect stabilization in oil prices, we think investors should consider looking into increasing positions in service companies. They too are volume beneficiaries and represent a better balance between risk and reward than direct commodity producers, as we view prices to be structurally lower in a non-OPEC, short-investment-cycle, US-shale-driven world.

BNY Mellon Investment Management is one of the world's leading investment management organizations and one of the top U.S. wealth managers, encompassing BNY Mellon's affiliated investment management firms, wealth management organization and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally.

The information in this document is not intended to be investment advice, and it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for Professional Clients only. This material is not for onward distribution to, or to be relied upon by, retail investors.

Any statements and opinions expressed in this document are as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. The information contained in this document has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This document is not investment research or a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. To the extent that these materials contain statements about future performance, such statements are forward looking and are subject to a number of risks and uncertainties. Information and opinions presented in this material have been obtained or derived from sources which BNY Mellon believed to be reliable, but BNY Mellon makes no representation to its accuracy and completeness. BNY Mellon accepts no liability for loss arising from use of this material. If nothing is indicated to the contrary, all figures are unaudited.

Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so you may get back less than you originally invested.

This document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.**

This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Investment Management.

This document is approved for Global distribution and is issued in the following jurisdictions by the named local entities or divisions: **UK and in mainland Europe (excluding Germany):** BNYMIM EMEA, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Conduct Authority. • **Germany:** Meriten Investment Management GmbH which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. • **Dubai, United Arab Emirates:** Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. This material is intended for Professional Clients only and no other person should act upon it. • **Singapore:** BNY Mellon Investment Management Singapore Pte. Limited Co. Reg. 201230427E. Regulated by the Monetary Authority of Singapore. • **Hong Kong:** BNY Mellon Investment Management Hong Kong Limited. Regulated by the Hong Kong Securities and Futures Commission. • **Japan:** BNY Mellon Asset Management Japan Limited. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • **Australia:** BNY Mellon Investment Management Australia Ltd (ABN 56 102 482 815, AFS License No. 227865). Authorized and regulated by the Australian Securities & Investments Commission. • **United States:** BNY Mellon Investment Management. • **Canada:** Securities are offered through BNY Mellon Asset Management Canada Ltd., registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. • **Brazil:** this document is issued by ARX Investimentos Ltda., Av. Borges de Medeiros, 633, 4th floor, Rio de Janeiro, RJ, Brazil, CEP 22430-041. Authorized and regulated by the Brazilian Securities and Exchange Commission (CVM). The issuing entities above are BNY Mellon entities ultimately owned by The Bank of New York Mellon Corporation

BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western FMC, Insight Investment Management Limited and Meriten Investment Management GmbH do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • BNY Mellon owns 90% of The Boston Company Asset Management, LLC and the remainder is owned by employees of the firm. • The Newton Group ("Newton") is comprised of the following affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited (NCM Ltd), Newton Capital Management LLC (NCM LLC), Newton International Investment Management Limited and Newton Fund Managers (C.I.) Limited. NCM LLC personnel are supervised persons of NCM Ltd and NCM LLC does not provide investment advice, all of which is conducted by NCM Ltd. Only NCM LLC and NCM Ltd offer services in the U.S. • BNY Mellon owns a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC).

The Alcentra Group
ARX Investimentos Ltda
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management
Company Limited
The Boston Company Asset Management, LLC
CenterSquare Investment Management, Inc.
CenterSquare Investment Management Holdings, Inc.
The Dreyfus Corporation
EACM Advisors LLC
Insight Investment
Mellon Capital Management Corporation
Meriten Investment Management
The Newton Group
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Walter Scott & Partners Limited



BNY MELLON