Towards a low carbon world

In normal times, the oil price is predominantly supply-driven. Changes to the supply status quo, such as the shale oil glut of 2015 and 2016 and the resultant price collapse, were eventually countered by production cuts from OPEC. Meanwhile, demand dynamics tend to be much more stable, related to the steady rise in global GDP, albeit overlaid with some cyclicality related to economic activity.

However, in April 2020 we saw an unparalleled demand shock. Travel bans enforced by governments to control the spread of Covid across the world caused a severe halt on driving, flying and sailing, which account for more than half of global oil consumption. Stockpiles of oil suddenly started ballooning, raising concerns about availability of storage. This in turn pushed energy traders to quickly exit futures contracts for physical delivery of oil taking place in the weeks that followed. As a consequence, the West Texas Intermediate (WTI) crude oil price turned negative for the first time in its history, as contract holders were effectively paying not to receive the pre-paid barrels. The energy industry faced its biggest crisis in decades.

When demand collapses, the remedy generally lies in the control of supply. However, the dynamics were becoming chaotic a year ago. After falling out during a meeting in early March 2020, OPEC+ members Russia and Saudi Arabia both threatened to flood the market, sending the oil price tumbling. As lockdowns were imposed across the globe, the cartel member nations swiftly came back to the table and agreed to cut supply by a massive 13% of global production. The decision did not come soon enough to stop the plunge into negative territory, yet it did help investors see a path to recovery, with oil benchmarks recovering from historic lows.

Fears of an upcoming recession in the early autumn put pressure on oil producer share prices once again. However, fortunes quickly started to reverse again after positive vaccine news in early November, sparking a broad market rally. By the time of this year's OPEC March meeting, the WTI crude oil price had crept back to $65. As it became obvious that lockdowns would continue well into 2021, another round of cautious production cuts were announced.

The scales balancing supply and demand can tilt in either direction, and we do not pretend to be experts on the politics of OPEC. Moreover, the volatility of the oil price could be further exacerbated by virtually unpredictable one-off events like the missile attack on one of the world's largest oil production facilities in Saudi Arabia in 2019 or more recently the case of a huge vessel blocking the Suez Canal, causing disruption in the global supply chain, including oil shipments. However, opportunities often exist in the sector when the market prices the shares of oil companies such that no recovery in the oil price is implied. We believe that bearish sentiment often offers some of the best hunting grounds for stock picking.

Ultimately, we can break down the concerns over demand into the short-term impact of the pandemic and the longer-term effects as the world transitions away from an oil-based economy and towards a low carbon world. In the short term, positive news regarding the vaccination programs and the unlocking of the global economy have been positive for both the oil price and the shares of the oil majors. The longer-term transition away from oil does however remain not only a conversation topic, but also a concern for some investors. ▶▶

Whilst we recognise that the energy world is changing, we believe that the pace of the transition as implied by the current share prices is overestimated. At the end of the day, we use fossil fuels as an energy storage unit. The energy stored within the fossil fuels was effectively deposited there millions of years ago; it can be broken down into units, bought and sold, transported around the globe, stored, and used as needed. Global economies are reliant on the ability to release this energy on demand.

Despite huge improvements in the technology available to produce electricity from renewable sources, the ability to store and transport and then deploy this energy is still not comparable to the use of fossil fuels. One example is electric vehicles, which will require the build-out of a network of charging points (public and private) across the globe to replace the current petrol station network. In addition, even in the UK, where the government will ban the sale of new petrol and diesel cars in 2030, it will take a good number of years for the entire fleet to transition over, with the second hand car market dwarfing new vehicle sales. Finally, battery technology is not readily available to replace the use of oil-based fuel in airplanes, ships, tractors etc. The transition away from fossil fuels will take time.

Furthermore, many of these companies are taking steps to adapt their business models away from oil and towards renewable energy generation. For example, BP is a company that has embarked on a transformational journey towards net zero carbon emissions through diversifying into renewable electricity generation. While the benefits from this new venture are to be delivered in the long term, we believe BP's cashflow-generating core business will be able to support returns for shareholders, while ultimately earning BP a place in the 'new' economy.

If anything, the twists and turns of 2020 have certainly emphasised to us as investors the importance of dynamically evaluating our stance on sectors and themes. What is avoided or discounted today could be the "hit" of tomorrow, hence diligently following stocks throughout their journey in and out of favour, is a key in finding opportunities at the right time for us to reap returns. Reminding ourselves of the famous Buffett saying to be greedy when others are fearful, we are always conscious of scouring the markets free of emotion or prejudice in order to find the best investments on behalf of our clients. ■

Important notice