Energy Prices Rebound, Yet Upside To Long-Term Price Outlook Appears Limited

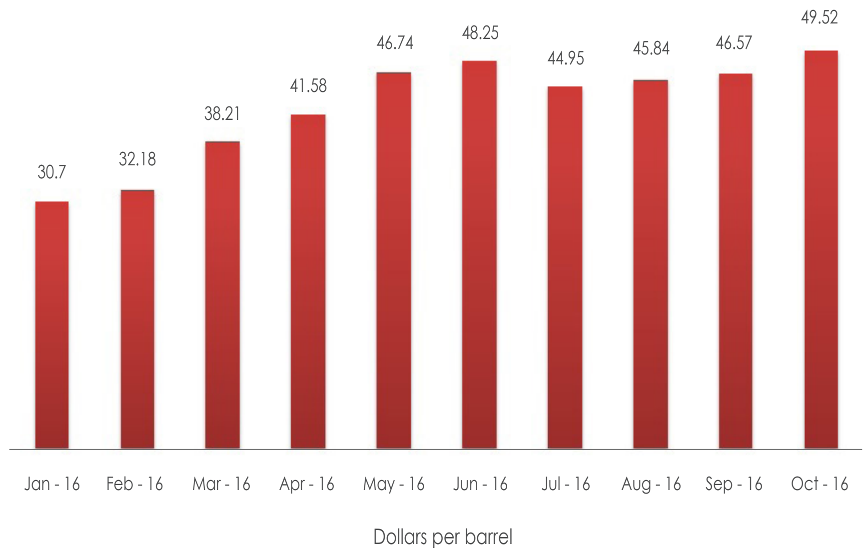
The meaningful rebound in energy prices from the lows seen at the beginning of this year has brought much-needed respite to oil producers across the globe. From below $25 per barrel, oil prices recovered to over $50 during the third quarter before moderating to around $45 per barrel more recently. To support higher prices, the Organization of Petroleum Exporting Countries (OPEC) that represents some of the major producers is meeting later this year to consider production cuts. Nevertheless, the growing supply of renewable energy could continue to limit the long-term outlook for conventional fuels. On the demand side, continuous improvement in efficiency as well as a shift to alternate fuels also has the potential to dampen prices in the long term.

The sharp and sudden decline in energy prices that started in late 2014 was triggered by the steady expansion in supplies even as the demand outlook was turning more muted. Expectations of strong demand growth in China and India were moderated as the economic expansion in these countries has become less energy intensive, compared to other large economies at a similar stage in their development. At the same time, efficiency gains achieved through improved engine technology and other measures limited the demand growth in the U.S. and other developed countries.

KEY TAKEAWAYS

The sharp and sudden decline in energy prices that started in late 2014 was triggered by the steady expansion in supplies even as the demand outlook was turning more muted. Expectations of strong demand growth in China and India were moderated as the economic expansion in these countries has become less energy intensive, compared to other large economies at a similar stage in their development.

Crude oil spot prices (Brent)



Data source: U.S. Energy Information Administration

Average fuel consumption of new vehicles has improved appreciably over the last decade. There is also a shift in consumer preference towards smaller engines even in relatively larger vehicles, further limiting fuel demand.

On the supply side, lower prices have not killed off production at U.S. shale fields in a big way as expected. From a peak of about 9.5 million barrels a day in 2015, U.S. crude oil production has declined only by 1 million barrels, according to the Energy Information Administration (EIA). This shows that U.S. producers are more resilient than thought earlier, while recent EIA reports indicate that shale reserves could be higher than previous estimates. Hence, it is possible that U.S. oil output could remain at the current levels longer and limit price gains.

Lower realizations forced other major producing countries to pump more oil, to protect the oil revenues that are vital for government budgets. This has so far defeated efforts to reduce supplies by forcing producing countries to maintain output ceilings. OPEC is meeting again in November to try and negotiate production limits. However, even if an agreement is reached, maintaining production ceilings when oil prices are volatile could prove difficult. Domestic pressures and weakening fiscal positions could force some member countries to increase output.

New regulatory restrictions and additional taxes on the use of fossil fuels could also restrict future demand. This year's global climate change treaty, if implemented, would require signatory nations to encourage renewable fuel sources. The International Energy Agency estimates that global oil demand could peak by 2020, if the climate change treaty is fully implemented. If it is not, oil demand could continue to rise at modest pace for another two decades, mostly supported by increased consumption in China and India. OPEC believes oil demand is likely to peak over the next decade, if the treaty is successful. Political changes in major economies could make climate change less of a priority, but it would only delay the demand peak.

Meanwhile, current regulations such as average fleet efficiency for automobile manufacturers are likely to sustain capital investments in new technologies and innovation. Electric vehicle technology has matured rapidly in recent years and is likely to become more popular in the near future. The cost of electric vehicles is now comparable to conventional fuel vehicles, after government subsidies, and they are less costly to run. More manufacturers are now introducing electric vehicles and their share of the total vehicle fleet could expand rapidly in the coming years.

Higher geopolitical risks and short-term production disruptions could still lead to sharp increases in oil prices. Nevertheless, it is unlikely that these factors could significantly change the long-term supply outlook. Unless there is an unexpected sharp surge in demand or slower evolution of alternate fuel technologies, further upside to the long-term oil price outlook appears limited.

Higher geopolitical risks and short-term production disruptions could still lead to sharp increases in oil prices. Nevertheless, it is unlikely that these factors could significantly change the long-term supply outlook. Unless there is an unexpected sharp surge in demand or slower evolution of alternate fuel technologies, further upside to the long-term oil price outlook appears limited.

Are You Positioned for a World of Opportunities?

THE THOMAS WHITE DIFFERENCE

Thomas White International manages $2.0 billion in assets across multiple global, international and domestic equity mandates. The diverse client base spans public, corporate, endowment, Taft-Hartley, and separately managed account platforms.

We use Proprietary Research. At Thomas White, we value international stocks within distinct valuation groups based on region, industry, sector, or country, which provide us with an extensive range of investment opportunities.

Our investment process differs from the crowd. Our approach to valuing common stocks combines the execution of thorough historical studies, with the application of in-depth fundamental securities analysis. Valuing global stocks in nearly 50 countries, this industry-based stock selection process employs tailor-made valuation frameworks refined and tested over the 40-year history of the Thomas White organization and its predecessors.

Our veteran analysts on average have more than seventeen years of experience working together as a team. Our research and analysis is generated by our professionals, both in Chicago and in our Asia office in Bangalore, India, most of whom have spent their entire careers at Thomas White.

Our investment approach seeks to benefit from buying undervalued stocks and selling them when they return to fair value. Our analysts find that investors tend to overvalue a company against its industry peers when the intermediate business environment is favorable, producing strong earnings growth and then undervalue a company when the environment depresses its business outlook. This pattern is a reflection of human behavior — it occurs in every industry and country around the world. It is this phenomenon that explains a stock's wide price swings above and below its intrinsic value as a business.

> "Our strategy is to seek smoother, more consistent returns by stressing excellent local stock selection as opposed to betting on major country and sector moves.
>
> To succeed in this approach, we have built an exceptional global research team that uses our proprietary techniques to identify the most attractive stocks in each of the major regions of the world. This in effect is our trump card."
>
> *— Thomas S. White, Jr., Portfolio Manager*

For more information, please contact:

Gabriel J. McNerney, CFA
(312) 663-8318
gmcnerney@thomaswhite.com
thomaswhite.com