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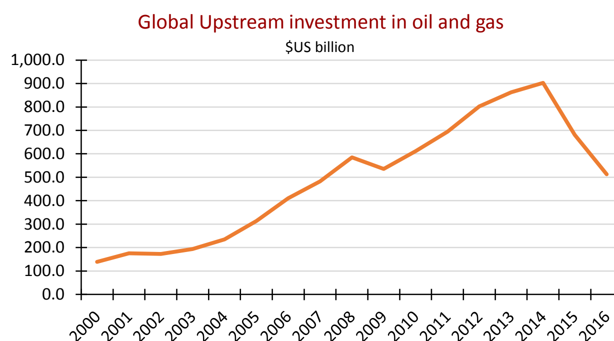
# Trump's oil slick

Over the past few weeks we have been highlighting the growing divergence between stock market performance and accumulating macro and political risks. The growing list of risks include the potential trade war, weakening Chinese growth and funding pressures in emerging markets.

Another risk that will soon be in focus will be the Iran oil embargo. The ban on Iranian oil exports was proposed in May and is due to take effect in early November. It will result in the world losing up to 5% of oil supply depending on the extent of compliance at a time when supply is already tight due to several years of underinvestment.




Source: US Energy Information Administration, Evans & Partners

This raises the prospect of further upward pressure on oil prices over time as supply is affected. However, the impact could be even larger in the short term if Iran retaliates against the embargo. It could escalate tensions across the Middle East or attempt a blockade of the Strait of Hormuz (the narrow channel off the Iranian coast where 20% of global oil flows).

## Recommendation

We have been overweight the energy sector through the Australian companies – particularly Woodside Petroleum (WPL, positive) – for some time. There is now also a compelling case to increase broader energy exposure to act as a hedge against an escalation of geopolitical risk over the rest of the year due to the Iranian issue.

Such exposure could be gained through exposure to individual stocks or ETFs. It is likely that if there is a sharp rise in oil prices that the Australian dollar would fall and the US dollar rise and, as a result, we would prefer unhedged exposure.

Two unhedged global ETF options are:

- Vanguard Energy ETF (VDE.ARC). This contains broad exposure to a range of large cap global companies at a low fee (0.10%).
- iShares US Oil & Gas Exploration and Production ETF (IEO.BZX). This ETF is focussed on the exploration and service companies that are more indirect beneficiaries of higher oil prices. It is a good long-term play on higher oil prices leading to a rise in investment over the medium term.

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# Trump's oil slick

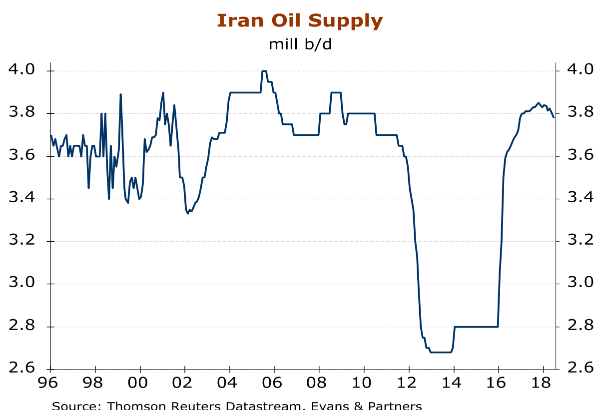
Over the past few weeks we have been highlighting the growing divergence between stock market performance and accumulating macro and political risks. To date investors have been dismissing several potential threats including the potential trade war, weakening Chinese growth and funding pressures in emerging markets.

Another emerging threat that could trump all others is the dispute with Iran. In May the US signalled its plans to reintroduce an embargo on Iranian oil exports. The ban is due to take effect on 4th November unless the US changes its mind, and a change in mind is unlikely since this coincides with US mid-term elections. The Iranian dispute is arguably a greater potential threat than the potential trade war due to the effect it might have on oil prices.

## What happens when Iranian oil stops?

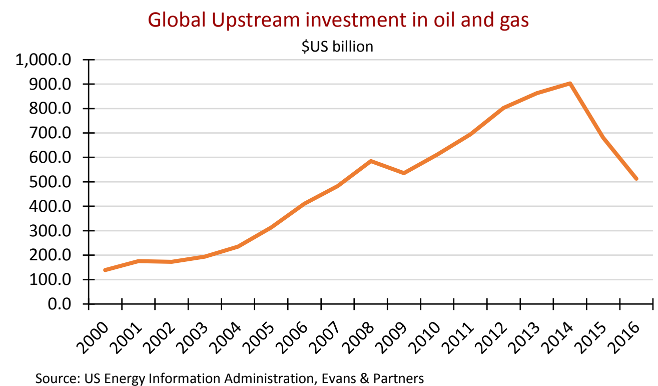
The US has demanded that the world stop receiving oil imports from Iran from 4 November. We think it is likely that most countries will comply due to fears of retribution by the US.

Based on estimates from the US Energy Information Administration (EIA), this will result in the world losing up to 5% of oil supply depending on the extent of compliance at a time when supply is relatively tight and several OPEC members are struggling to even produce to their quota. The US is bullying the Saudis and other producers to lift output but it is unlikely they can fill the void. Since the end of the previous embargo, Iranian exports have surged by around 1 million barrels per day.




## Oil's investment problem

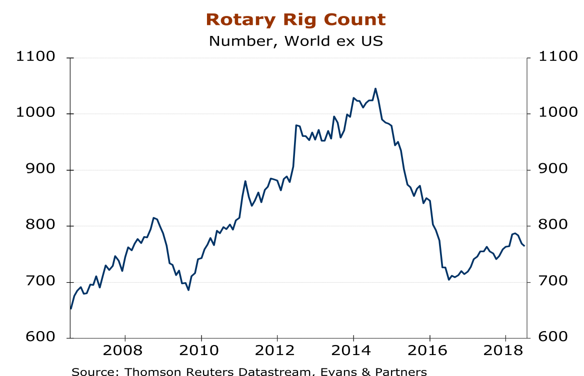
The main reason for the tightness in oil is that there has been underinvestment in the oil sector in recent years. Data from the EIA shows that upstream investment has fallen by around 40% since 2014.




The underinvestment has had a number of likely causes:

- Western oil companies are aware of the threats to long-term oil demand from tightening environmental rules and the rise of electric vehicles.
- Venezuelan supply is falling due to the economic crisis in that country.
- Shale production is not increasing as much as expected due to a range of factors highlighted by research from Andrew Hines – including rising costs, water availability and declining quality[1].

As a result, the rig count has languished at around 2010 levels and has not risen materially since the oil price started rising in 2016.




[1] See "Oil price recovery to continue – Woodside our preferred", February 2018. Available from your adviser or the Evans & Partners website.

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### Could oil prices spike higher?

The tightness in oil supply makes it likely that the exit of Iranian oil imports will lead to further upward pressure on prices over time.

However, the effect could be even larger if Iran decides to retaliate against the embargo. Iran may feel that it will strengthen its position if it can cause some disruption to global oil markets and a spike in prices. A sharp rise in gasoline prices would likely cause a domestic political backlash for Trump.

Iran could retaliate in a number of ways. It could escalate tensions across the Middle East, particularly in Iraq where it retains significant influence.

A more immediate impact could come from blockading the Strait of Hormuz, which is the narrow channel off the Iranian coast where, according to EIA estimates, 20% of global oil must flow to get from Saudi Arabia to the rest of the world. This could be done through a physical blockade using ships, placing mines in the water, anti-ship cruise missiles or suicide attacks. There have been previous attempts at blockades in the 1988 and in 2012, which did create short term disruptions.

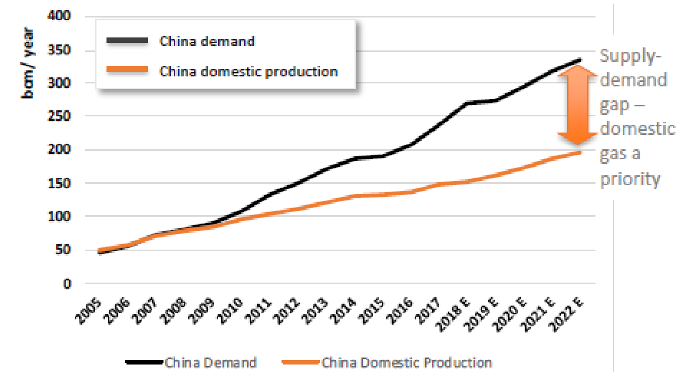
### The strait of Hormuz

Source: Wikipedia

### Energy as a hedge

We have been overweight the energy sector through the Australian companies – particularly Woodside Petroleum (WPL POSITIVE) - for some time[2]. This has been based on the lack of investment and spare capacity in oil, and the long-term opportunity from rising gas demand out of China. Chinese national gas demand is expected to increase five-fold over the next decade due to rising grid demand and its Beautiful China campaign that will see gas increase from 5 to 15% of electricity supply by 2030.

### Chinese gas demand and supply




Source: Sino Gas

There is now also a compelling case to increase broader energy exposure to act as a hedge against an escalation of geopolitical risk over the rest of the year due to the Iranian issue. If oil prices do spike and act as drag on overall equity performance, such exposure will provide some offset for broader portfolios.

Such exposure could be gained through exposure to individual stocks or ETFs. It is likely that if there is a sharp rise in oil prices that the Australian dollar would fall and the US dollar rise and, as a result, we would prefer unhedged exposure. This reflects the flight-to-quality effect that typically occurs during periods of short-term uncertainty that tends to push the US dollar higher.

Two unhedged global ETF options are:

- Vanguard Energy ETF (VDE.ARC). This contains broad exposure to a range of large cap global energy companies at a low fee (0.10%).
- iShares US Oil & Gas Exploration and Production ETF (IEO.BZX). This ETF is focussed on US based

[2] See Energy Sector. 2Q18; strengthening prices, mixed operational performance, 18th July. Available from your adviser or the Evans & Partners website.

exploration and service companies that are more indirect beneficiaries of higher oil prices. It is a good long-term play on higher oil prices leading to a rise in investment over the medium term.

Two other Australian listed ETFs that are hedged into the Australian dollar are:

- BetaShares Global Energy Companies ETF (FUEL.AXW). This tracks the performance of NASDAQ Global ex Australia Energy Companies hedged into Australian dollars.
- BetaShares Crude Oil Index ETF (OOO.AXW). This index seeks to track the crude oil price index hedged back into Australian dollars.

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