Rocaton

INSIGHTS

The Impact of Falling Energy Prices

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EXECUTIVE SUMMARY

* Energy prices, particularly crude oil, have fallen significantly in the second half of 2014
* Investors have meaningful exposure to the energy sector through a number of asset classes, some of which are not obvious
* Despite the decline in energy prices, we remain cautious about making new investments in commodity futures strategies
* Investors should evaluate their exposure to the energy sector in light of potential prospects for this sector

Introduction

While not as dramatic as the decline during the financial crisis, the recent fall in oil prices has been meaningful. From their 2014 highs through the beginning of December, West Texas Intermediate (WTI, the main U.S. benchmark crude oil price) and Brent (the main benchmark for European crude delivered in the North Sea) crude oil prices have fallen more than 35%. This decline has implications on economic, political and social levels. Investors should be aware that diversified portfolios have implicit exposure to the energy sector in nearly every asset class and not exclusively asset classes which are directly invested in crude oil futures or energy businesses. Investments in public equities and broad market fixed income have varying degrees of exposure to the sector and in some cases, such as U.S. High Yield, the exposure can be significant. In the summer of 2013, Rocaton published an *Insights (End of the "Super Cycle"? The Outlook for Commodities)* that highlighted some of our concerns about the energy market and, more broadly, commodities markets as a whole. The balance of this *Insights* will review the implications of the fall in energy prices, examine investors' potential exposure to the energy sector and revisit our thoughts on the commodities market.

Implications of the fall in oil prices

As we have already mentioned, oil prices have fallen significantly from their 2014 highs. The effects of this decline are being felt across the global economy. To begin, the drop in prices effectively acts as a tax cut for U.S., European and Japanese consumers as the cost of filling up at the pump or heating their homes has declined. For example, the retail price for a gallon of regular gasoline in the U.S. was $2.68 at the start of December, a decline of 28% from 2014's peak and the lowest level since 2010. The average U.S. household consumes 1,200 gallons of gasoline a year, which translates into an annual savings of $120 for every 10-cent drop in the price of gasoline. By this measure, the more than 90-cent drop in retail gasoline prices should result in more than $1,000 savings per household annually, assuming prices stay at current levels[1]. The fall in prices across the energy complex could also lead to lower inflation (as measured by Consumer Price Index CPI) which could result in interest rates staying lower

1 Source: Energy Information Administration

for longer, given the Federal Reserve governors' focus on the actual inflation rate. Recent inflation measures remain low as the CPI was unchanged for the month of October on a seasonally adjusted basis and increased just 1.7% year-over-year, below the Federal Reserve's 2% target.

There are, of course, negative repercussions of the fall in energy prices. Recent growth in U.S. energy production has been driven by an increase in shale drilling which has been brought on by improvements in technology including hydraulic fracturing ("fracking") and directional drilling. Importantly, however, the cost of producing a barrel of oil using these unconventional methods is generally higher than the cost associated with extracting a barrel of oil using conventional drilling techniques. Estimates suggest that approximately 30% of U.S. shale production is not profitable based on current oil prices. This is especially true in the "fringe" areas that are not in the core production regions of the major basins. Lower prices should result in reduced investment in new production which also shrinks the domestic oil supply. For countries reliant on oil exports, such as Russia and Venezuela, there is the potential for significant economic weakness. Oil accounts for two-thirds of Russia's exports and the country's budget gets nearly half its revenue from oil and gas.

Portfolio exposures to the energy sector

Unlike problems in a single asset class or single security, problems in a large sector such as energy can impact many investors across a range of asset classes. Figure 1 below highlights the varying degrees of exposure found in a number of commonly held asset classes. An illustrative portfolio that has 60% in global public equities, 25% in core U.S. fixed income and 5% each in high yield, convertibles and commodities would have approximately 9% exposure to the energy sector at the total portfolio level. The figure below also points to some of the weakness experienced in the sector on a year-to-date basis. For example, the emerging market equity energy sector declined 19.2% year-to-date through December 5th, at least a portion of which can be linked to the decline in energy prices. Notably though, the performance of investment-grade corporate bonds has been driven more by the fall in interest rates than the decline in oil prices.

Figure 1:
Asset Class Exposure to Energy Sector

		Energy Sector Weight		2014 Year-to-Date Returns		Energy Sector "Excess" Return
Asset Class	Index	12/31/2013	**12/5/2014**	Energy Sector	Broad Index	
U.S. Equity	Russell 3000	9.3%	7.4%	-9.3%	13.0%	-22.3%
Non-U.S. Developed Equity	MSCI EAFE	7.3%	5.7%	-15.3%	-1.2%	-14.1%
Emerging Equity	MSCI Emerging Markets	11.3%	8.6%	-19.2%	0.9%	-20.1%
Investment Grade Corporates	Barclays Corporate	7.3%	10.9%	4.2%	6.6%	-2.4%
Long Duration Corporates	Barclays Long Corporate	8.6%	13.2%	7.7%	13.4%	-5.6%
High Yield Fixed Income	BofA Merrill Lynch High Yield Master II	14.0%	14.3%	-5.3%	3.0%	-8.3%
Convertibles	BofA Merrill Lynch All Convertibles	7.6%	6.1%	-19.4%	9.8%	-29.2%
Commodities	S&P GSCI	72.0%	71.2%	-31.9%	-23.6%	-8.3%

Data as of December 5, 2014.

All returns are total returns in USD.

Sources: Bloomberg; Barclays; Merrill Lynch; Wilshire Atlas

The direct and indirect impact on various asset classes from declining energy prices is described in Figure 2 below.

Figure 2:
Energy Impact on Asset Classes

Asset Class	
Treasury Inflation Protected Securities	Energy prices are a large component of the Consumer Price Index (9.3% as of October 2014). Falling prices could keep inflation low, directly impacting the performance of TIPS.[2]
Nominal U.S. Treasury Bonds	The potential for low inflation could keep nominal interest rates low for longer. Additionally, a lack of inflation may prompt the Federal Reserve to keep the Fed Funds Rate at near-zero levels longer than the market expects.
Emerging Market Debt / Equity	Economic growth in some emerging market countries, such as Russia, Venezuela and Brazil, is somewhat dependent on the price of oil. As a result, the performance of both emerging market equity and emerging market debt (hard currency and local currency) may be impacted.
Corporate Bonds	A number of energy-related industries could come under pressure including oilfield services, midstream, and exploration and production. There is also the potential for credit migrations from investment grade companies and defaults for below investment grade issuers.
Private Oil & Gas Partnerships	It is hard to generalize across various types of investment strategies, especially as some are hedged years into the future. The fall in prices will present challenges to existing portfolio but perhaps create opportunities for partnerships still in their investment periods.

[2] Sources: Bureau of Labor Statistics

Revisiting the role of commodities

Although returns in the energy sector broadly have been dismal in recent time periods, investors with outright allocations to commodities futures strategies have been hurt even further. Through the beginning of December, the S&P GSCI Index is down 66% from the index's high reached in 2008. When we first published our views on the asset class in August 2013, we cited increased supply in energy and some metals markets and concerns about global growth as the basis for our outlook. Although production could slow in the energy market, the recent increase in supply will not disappear overnight. Similarly, global demand forecasts are little changed in the last 18 months. However, it should be noted that changes in marginal supply and demand can have a large impact on prices. Speculators have also been cited as one of the causes for the recent decline, although we would put less emphasis on this view as it is difficult to estimate the true impact speculators have on prices.

Despite the recent decline in prices, we are still cautious about making new investments in commodity futures portfolios. Sustained slow growth in Europe and concerns about emerging markets should continue to put downward pressure on the demand for many commodities. Supply in some metals markets should also remain robust as new mines continue to come online in copper, iron ore and gold markets. Aside from spot price changes, the other components of commodities returns, roll return and collateral return, are difficult to forecast and may not add much value. The collateral return piece (often Treasury bills) is expected to add next to nothing in today's zero interest rate world. Roll yield, in our view, is nearly impossible to predict and should not be counted on to add value over long periods of time. To highlight this point, prior to the recent decline, the oil futures curve had been in steep backwardation, contributing positively to returns. Following the sharp decline in prices, the futures curve moved to contango, detracting from returns. Taken together, we are neutral to bearish on the prospects for the asset class. In our opinion, the primary argument for retaining or creating an exposure to commodities at this point remains the ability of that exposure to act as a geopolitical or inflation hedge.

Conclusion

The recent decline in oil prices is not all bad news. Consumers in developed economies are likely to see their disposable income rise and lower inflation may slow the path to higher interest rates. A fall in profitability for energy producers, however, may undermine U.S. oil production, slow the pace of investment in the sector and exert downward pressure on GDP growth, mitigating the boost to incomes from lower prices. Similarly, oil exporting countries may experience economic weakness as a result of declining prices and some will face currency crises and could be forced to restructure. Despite the decline in commodity prices, we are still hesitant about recommending investors re-initiate an allocation to the asset class. However, as we have previously stated, we believe the asset class can potentially hedge against inflation or geopolitical events. We should also point out that accurately forecasting prices is difficult and prices could rise from today's levels. Investors should examine their current exposures to the energy sector and commodities in general to determine if they are comfortable with those exposures.

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Disclosures

Performance Information and Return Expectations

The analysis contained in this document may include projections of long-term return and risk expectations. There is no guarantee that the projected returns or risk will be realized. The projections are based in part on historical performance of various asset classes, and past performance is no guarantee of future performance. The projections include assumptions, including those regarding risk and return. These assumptions are used for modeling purposes only and may not be realized. Because the analysis is based on assumptions and projections, there can be no warranties or guarantees.

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