UniSuper

February 2016

Investment market update

The first seven weeks of 2016 have been nothing short of horrible for investors. At the time of writing, the Australian share market is down over 10% for the calendar year but isn't alone, with shares down more than 9% in the US, 17% in Japan and more than 20% in China.

Though several factors have been at play including the usual concerns over the slowing of the Chinese economy and the impact of higher US interest rates, this month we explore the impact of recent oil price moves on markets.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (S&P/ASX 300)	-5.4	-5.8	-5.8	5.3	5.5
US Shares (S&P 500) in US Dollars	-5.0	-4.8	-0.7	11.3	10.9
US Shares (S&P 500) in Australian Dollars	-2.1	3.4	9.4	26.7	18.8
Asian Shares (MSCI All Country Asia ex Japan)	-6.8	-18.1	-16.2	-3.0	-1.8
Australian Dollar (AUD/USD)	-2.9	-7.9	-9.2	-12.1	-6.6
Australian Fixed Interest (Bloomberg Composite)	1.2	3.2	2.2	5.2	6.7
Cash (Bloomberg Bank Bill)	0.2	1.3	2.3	2.6	3.3
Balanced option*	**-1.9**	**0.9**	**3.1**	**10.1**	**8.7**

Returns are for periods to 31 January 2016. Past performance is not an indication of future performance.

* *Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

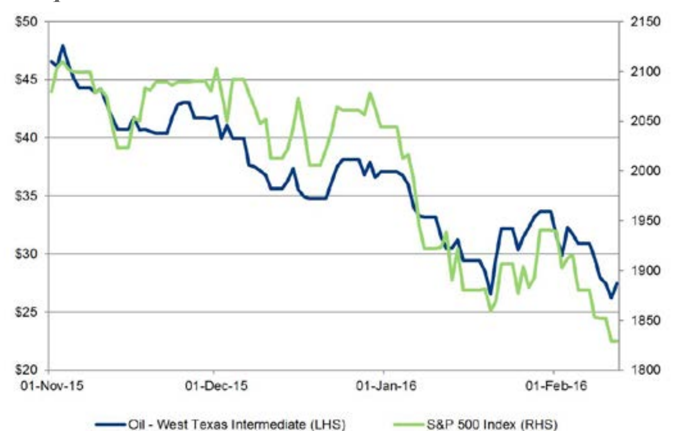
See performance information for all options

The trouble with oil

After a four-year period of being stable at a historically high level of over $100 per barrel, the crude oil price has been in virtual freefall since mid-2014, crashing to recent lows of $26.

Falling oil prices create winners and losers at an individual, company and economy-wide level, so it's not surprising that moves in the oil price impact financial markets. What is surprising of late is just how highly correlated these moves have become, as shown in the following graph.

Oil prices vs. US share market



Source: Bloomberg

In 'normal' times a fall in the price of oil would be welcome, operating like a tax cut for global consumers and positive for the economy.

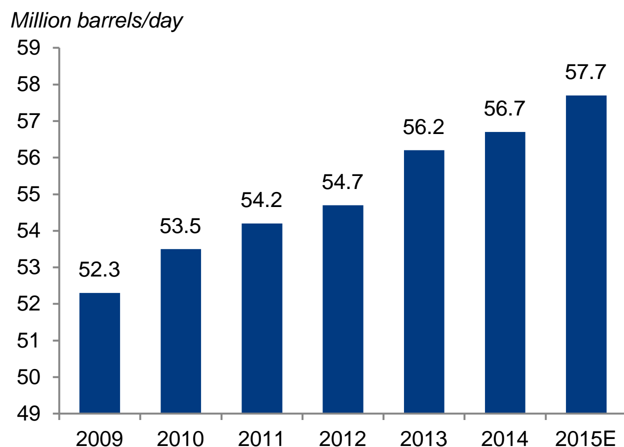
Unfortunately in this case the positive impact on consumers is being overshadowed by the negative impact on other sectors.

In a highly indebted world with excess capacity in all commodities, lower oil prices have intensified concerns of a damaging period of deflation and an increased risk of wide-scale defaults by highly indebted energy companies or energy dependent countries. As oil market ructions pushed prices into 'crisis' territory (if you are a producer), we've begun seeing spill over effects into the price of broader financial assets. Banks have been hit particularly hard, as markets factor in the flow on effect of increased defaults. Since the start of the year banking indices in the US, Europe, and Australia are down 19%, 27%, and 15% respectively— largely in response to the fall in oil prices. Australia's major banks have relatively small exposure to the energy sector so the reaction appears to be excessive. Nevertheless, markets loathe uncertainty so we may not see a bounce back until well after the dust has settled and the actual defaults have worked through the system.

Why such a rapid decline in the price of oil?

Before discussing why the oil price has seen such a steep decline it's important to rule out a commonly held misconception—it's *not* due to a collapse in Chinese demand. As the following graph shows, Chinese demand for oil has in fact steadily increased, albeit a little more slowly than before. In line with China's rebalancing program, the fall in oil demand for industrial purposes has been more than offset by strong growth in consumer demand.

Chinese crude oil imports



Data through 2015. Note: ISG estimate for 2015

Source: Investment Strategy Group, US Department of Energy

The fall in the oil price (and all commodities) has been a story of excess supply rather than reduced demand.

Central to the supply story was the emergence of the shale oil industry in North America, which has been nothing short of revolutionary. US production increased from less than six million barrels per day to more than nine million barrels in the space of four years. This has been enough to tip the market from one of excess demand to excess supply as the following graph shows.

Global oil supply and demand

Source: International Energy Agency

The excess supply situation has been exacerbated by events in the Middle East. In particular, the Saudis have made it clear that they won't be cutting their supply of crude regardless of price. This is very significant because Saudis have traditionally acted as the marginal producer—regulating their own supply to broadly control the global price. The Saudi's motivation is open to debate. Some commentators argue it's a tactic to keep the American producers out of the market, while others say that Iran is their main target. A more prosaic explanation is that they simply need the cash flow to fund ever increasing budget deficits.

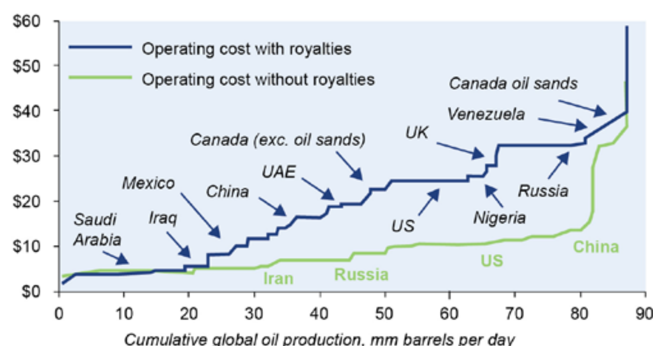
Notwithstanding the Saudi's position, Iran will be adding to 0.5 million barrels within a few months following the lifting of sanctions on that country. This will grow to a few million barrels in the medium term. Furthermore, the havoc created by the Islamic State (IS) has had no discernible impact on the flow of oil from Iraq and Libya.

How low can oil go?

In the short-term, the outlook for oil prices continues to look challenging. While there are signs that supply from the US and Canada has peaked, the market looks likely to remain oversupplied for some time yet—particularly given that storage facilities are full to the brim.

Another sobering point is just how low production costs are for the main oil producing regions in the world. The following graph shows that lowest cost oil producers can still make a profit when oil is as low as $10. Bear in mind that the graph is at December 2014 so the cost curve is likely to have shifted even lower since then.

Operating cost, USD per barrel



Source: Morgan Stanley Commodity Research. December 2014

It's important to remember that the new unconventional oil producers are skewed towards the upper end of breakeven production costs. Given that production experiences a natural rate of decline through time, North American production will continue to recede and the growth in production from non-OPEC producers is likely to show limited growth in 2016.

Is there light at the end of the tunnel?

If we didn't already know, the extreme movement in oil prices has confirmed that any forecasts of future prices should be treated with caution, if not totally dismissed.

However, one thing we do know is that over a sufficiently long period, the commodity investment cycle follows the same pattern. That is, high prices and profit margins encourage more investment which gets immediately rewarded, leading to overinvestment and overcapacity, leading to a fall in price and sometimes a crash. As the saying goes: "the best cure for high prices is high prices."

As per the normal pattern we're now seeing early signs of the cycle reversing. Low prices have already put the highest cost producers out of business. Unlike most other industries, oil producers face a constant battle just to stand still. As existing production facilities mature, their output declines without new investment. Current prices are too low to incentivise this new investment and producers have been slashing their capital expenditure budgets in recent months. A telling statistic is the number of oil and gas rigs operating in North America. 'Rig count' has fallen 70% from a peak of 2700 rigs in 2012, to around 800 today.

All things being equal, the cuts to investment today mean slower supply growth tomorrow. At some point in the future demand and supply will be back to equilibrium and oil prices will recover. For what it's worth, most forecasts see equilibrium in early to mid-2017.

While timing is impossible to predict, it's reasonable to expect that oil prices are likely to fluctuate within a range much lower than we've experienced over the past decade. Even the high cost producers can make good profits at $40 a barrel of oil so any increase in price will be quickly met with new supply, as modern technology enables the rigs to be functional within a few months.

A sustainably lower oil price is unequivocally good news for consumers, and this will ultimately provide a boost for global growth.

Exposure to the energy sector within UniSuper's portfolios

The following table shows that direct equity exposure to all forms of energy is actually quite low across our investment options.

Out of 16 investment options, 13 have less than 2% invested in the shares of companies directly involved in the energy sector.

The Australian Shares option has the highest exposure at 4.6% of the total portfolio, largely comprising investments in BHP and Woodside.

Note that the energy exposure in the Global Environmental Opportunities option is renewables.

Share market exposure to the energy sector as at 31 December 2015

OPTION	% OF TOTAL OPTION
Australian Shares	4.6
International Shares	3.7
High Growth	2.7
Growth	2.3
Balanced	1.7
Defined Benefit	0.6
Conservative Balanced	0.5
Global Environmental	0.3
Capital Stable	0.2
Sustainable High Growth	0.0
Sustainable Balanced	0.0
Cash	0.0
Listed Property	0.0
Australian Bonds	0.0
Australian Equity Income	0.0
Global Companies in Asia	0.0
Diversified Credit Income	0.0

Generally speaking, we have a lower weighting to commodities across portfolios than our peers, which has been a factor contributing to strong *relative* performance.

Members are more primarily concerned with the *absolute* performance of their investments, and in this regard we haven't escaped the carnage that is enveloping markets. As mentioned before, the crash in commodity prices has consequences for the whole market, and banks have been one of the hardest hit sectors. We're heavily exposed to Australia's major banks and their sinking share prices will show up in option returns.

Time will tell whether the sharp fall in share prices are a true reflection of distress in banks' loan books or simply a sentiment-driven over-reaction, in the absence of better information. At time of writing the Commonwealth Bank (CBA) just announced its semi-annual results and they were encouraging. Profits grew (a little), dividends were not cut and capital ratios look very healthy. Most importantly, there were no obvious signs of major stress in their loan book.

However, financial statements tell us about history, not the future, so a clean set of numbers to 31 December doesn't mean we can be sanguine. If CBA can at least hold dividends at current levels, the shares are yielding (on a fully franked basis) over 8%. Given bond yields are trading below 2.50%, premiums received for taking risk are high on a historical basis. Investment management is essentially about risk/return trade-offs, and suffice to say we're not selling our bank shares.

This is not intended to be an endorsement of any of the listed securities named above for inclusion in personal portfolios. The above material reflects UniSuper's view at a particular point in time having regard to factors specific to UniSuper and its overall investment objectives and strategies.

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