Real-time insight from DuPont Capital Management's Global Equity Team (November 2021)

Over the last decade, the consensus oil pricing scenario was based on a significant drop in demand between 2019 and 2030, driven by environmental, technological (EV) and regulatory pressures (e.g. Net Zero targets). And with the window of opportunity to monetize the resources closing, actors with the largest and cheapest reserves would drive the price down to their marginal cost of production (possibly the mid-$20 range).

Yet, over the last 12 months we have seen oil prices (WTI) move from the mid 30 $ level to the mid 80'ies. When we take a step back, we can wonder whether the equity market has been underestimating the long-term supply demand drivers, overestimating demand elasticity and whether we are witnessing an alternative supply response.

Things we tend to forget in the energy debate …

- The largest publicly listed companies already started cutting back on capex more than 7 years ago (shown in chart 1, on following page). The impact of this sustained capex reduction on aggregate oil supply is now being felt, as it takes multiple years for major projects to reach production. Supply demand conditions for oil and natural gas could be impacted for longer as capex is not expected to pick up before 2023. Investments in traditional oil, natural gas, coal and refining is probably still declining as the number in chart one includes rising capex in renewables.

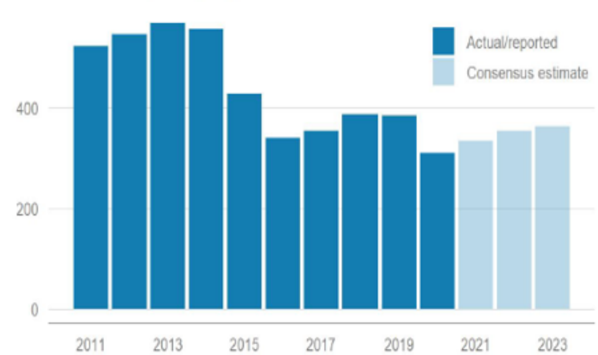
- Focused on the stellar stock market performance of Tesla, we tend to forget that passenger cars only represent 25% of global energy consumption.

- Focused on fast increasing market share of electric vehicles in new car sales, we also tend to forget the impact of a large installed base (and increasing life span) of ICE-vehicles on the demand for oil. Norway is the most striking example of this (chart 2, on the following page). Despite EV's reaching over 60% of new vehicle registrations, oil consumption has yet to show signs of decline.

- We tend to forget that two of the most important drivers of long-term energy demand are population growth and growing GDP per capita (rising average wealth). Chart 3, on the following page, shows that despite lower oil intensity of GDP globally, economic growth and development in non-OECD countries is tied to growing energy consumption.

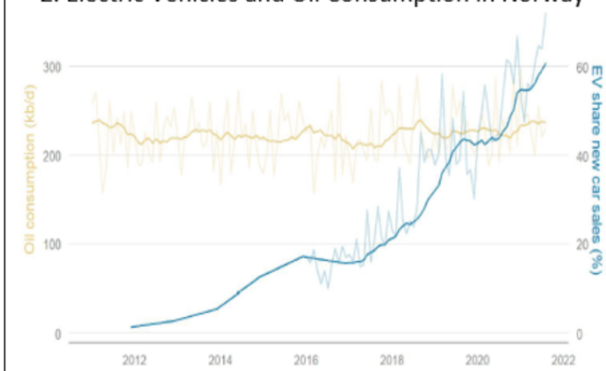
- Focused on the regulatory frameworks to support alternative energy sources in developed markets, we tend to forget the outsized dependency on oil, coal and natural gas in the fastest growing regions of the world like Asia Pacific, Middle East, Africa (chart 4).

1. Capex by publicly listed Oil & Gas Companies



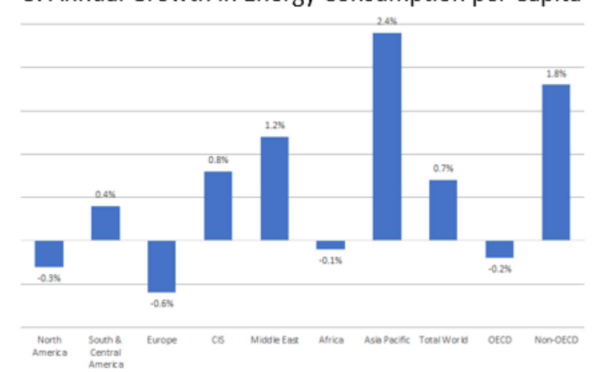
Note: 120 companies, in USD billion
Source: Bloomberg, Morgan Stanley

2. Electric Vehicles and Oil Consumption in Norway



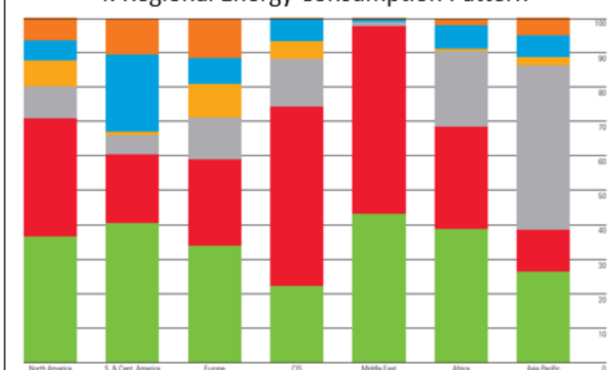
Note: Chart shows monthly data and 12-month moving average
Source: IEA, OFV, Morgan Stanley

3. Annual Growth in Energy Consumption per Capita



Period: 2009-2019
Source: BP Statistical Review of World Energy 2021

4. Regional Energy Consumption Pattern



Green: Oil / Red: Natural Gas / Grey: Coal / Yellow: Nuclear / Blue: Hydroelectricity / Dark Orange: Renewables
Source: BP Statistical Review of World Energy 2021

As a result of all these elements, we have reached a (temporary) situation where supply of renewable primary energy sources cannot be added at a fast enough pace to cover the growing energy demand (also spiked by the post-pandemic recovery) and the natural attrition rate of historic primary energy resources. If we want a global and orderly energy transition, the sector needs to be part of the solution.

While there are obvious reasons to label oil the new tobacco, we tend to forget that it took a long time before the tobacco sector reached the tipping point of becoming quasi un-investable from a values and financial point of view. Tobacco litigation started as early as the fifties, the US Master Settlement Agreement was enacted in 1998 and Marlboro Friday took place on April 2, 1993, yet tobacco stocks only seriously started to underperform in 2018. While we do not expect the energy sector to structurally re-rate because of the long-tern overhangs, the timing mismatch between the supply and demand can lead to pricing power and serious cash flow generation for a prolonged period. This cash flow can be used to either enhance shareholder returns and/or fund capex in renewable energy. Most major energy companies (especially in Europe) are already embarking on serious Energy Transition and ESG voyages. While they clearly start from a bad place on the ESG spectrum, the direction is at least encouraging.

As a result of these different insights in the supply demand dynamics, we would no longer bet aggressively against the sector in the short to medium term.

Sources:
Morgan Stanley: The Oil Manual: Which will peak earlier? Supply? Or Demand?, 10/19/21
BP: Statistical Review of World Energy 2021
The Hill: Fossil Fuels are definitely the new tobacco, 06/07/2021