Is Energy Still Attractive?

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We currently have a favorable view of the energy sector, which is largely driven by attractive fundamentals. However, there are many considerations beyond fundamental valuation that should be taken into account, including stranded assets and an increasing focus on environmental, social, and governance (ESG) factors.

Stranded Assets Should Drive Write-Downs

Oil companies draw on reserves in the ground to produce the raw material that is sold to refiners and then sold again as gasoline, jet fuel, and such.

With the signing of the Paris Accord in 2016, member countries around the world agreed to reduce greenhouse gas emissions, predominantly CO_2. Assuming signing countries actually comply with the agreement, it is likely that significant portions of identified oil reserves will not be used, for fear of creating more pollution than they agreed to through the accord. This essentially leaves oil stranded in the ground. In fact, in following the standards set by the Paris Accord, research suggests that as much as 30% of all oil on the planet will be left in the ground.

There will also be natural gas reserves stranded in the ground. The amount of those reserves is less clear because there exists a very wide range of estimates. Interestingly, while natural gas is clean-burning from a CO_2 perspective, it is dirty-burning from a methane perspective, and methane is a more insidious greenhouse gas than CO_2. But based on our current understanding, we believe about 40% of all natural gas will be left in the ground if the terms of the Paris Accord are met.

With this in mind, we sought to determine the amount of write-downs the companies in the energy sector are likely to take, and it is significant. It appears that about 40% of all energy, oil, and gas assets will be written down. The value of stranded assets is about $31 trillion.

Now, those numbers assume that compliance—which is designed to keep global average temperatures from rising by 2 degrees Celsius—is 100%. But recall that the Paris Accord is voluntary and language is kept purposefully vague. It has so many equivocations and ambiguous statements that it clearly is not intended to be legally enforced.

About 75% of the world's oil reserves are in Venezuela, Iraq, and Iran, and most of the coal in the ground today is located in the United States and China. We do not believe that all of these countries will fully comply. In fact, we estimate that compliance may be about 30%. There would likely still be a significant write-down of assets in the sector, however.

ESG Places Pressure on Oil Assets

At the same time, pressure has been placed on oil prices by an increasing focus on ESG factors. Auto companies, for example, may require their fleets to achieve a certain number of miles per gallon, which ultimately means that cars are more efficient. This in turn drives down demand for oil.

Despite Challenges, Energy Sector Still Attractive

Looking at the impairment of assets by stranding, combined with pressure on earnings from ESG considerations, it might appear that the overall attractiveness of the energy sector is impaired. But, in our view that's not the case. The sector is still fundamentally attractive based on our assumptions, and we have long exposure to the energy sector.

The bulk of our energy-sensitive equity exposure is in the United States, Europe, and the United Kingdom, with some in Russia as well.

We also have exposure that is sensitive to the price of oil through a number of currencies. Five of the constituents of our Energy Macro Theme are actually currencies: the Colombian peso, Russian ruble, Norwegian krona, Canadian dollar, and Mexican peso. Currently, we are long the Colombian peso, Russian ruble, and Mexican peso and slightly short the Canadian dollar. We do not currently have an active position in Norwegian krona.

This is a non-trivial long exposure to energy through our currency positioning.

Commodities Also Compelling

Our broader commodity exposure is also worth noting. We have long exposure to Chilean equities and the Chilean peso, for example—both of which typically move in line with the price of copper. Much of the demand for copper comes from China.

We anticipate that a widely available vaccine for COVID-19, which is an important consideration for demand, will help boost investor confidence and, importantly, economic activity. We continue to see signs that this is taking place.

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