Commentary

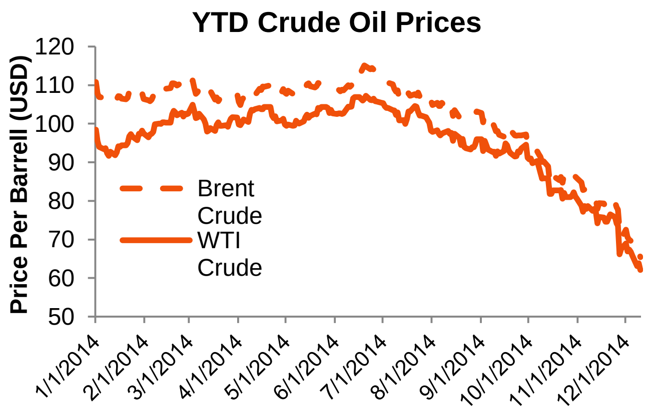
December 2014

Crude Surprise

- The dramatic drop in oil prices has made consumers happy and investors nervous.
- While the magnitude of the decline remains unclear, we expect prices to recover over the longer-term.
- We expect the net result to be a boost to the global economy.

Global oil prices have plunged as U.S. production from shale deposits has resulted in a dramatic increase in supply. North American net petroleum imports, which ran at a pace of about 10 million barrels a day in 2007, have dropped to just over 2 million today according to Barclays. Meanwhile, the OPEC nations, Russia and other big producers have not reduced the pace of oil production and continue to pump out about 30 million barrels a day. The resulting supply glut has caused global oil prices to plunge from $110 per barrel at mid-year to just below $60 today.

Exhibit 1: Prices Plunge



Source Bloomberg, as of 12/9/14.

The recent weakness was likely exaggerated by the timing of OPEC's meeting which was during the holiday in the U.S., resulting in constrained liquidity. Nonetheless, the oil market is over supplied. With global growth still anemic (but improving modestly), it's going to take more of a supply response than what we have seen to date (last meeting, OPEC merely reaffirmed their target output level but made no effort to rein in their own over-production). We don't anticipate a significant bounce back until OPEC meets again in few months, at the earliest.

Good News for Many; Bad News for a Few

In the U.S., lower oil prices are good news for consumers. Falling gasoline prices act as a tax cut, with every dollar saved at the gas pump becoming one more dollar that can be spent elsewhere. With consumer expenditures accounting for just nearly 70% of gross domestic product according to the Bureau of Economic Analysis, any uptick in spending is good news for the economy. Those extra dollars are already being put to work, as sales of pricey, gas-guzzling pickup trucks and sport utility vehicles surged in November, posting double digit gains across most categories.

For Canada, oil is a big theme. Energy accounts for 21% of the stock market versus 8% for the U.S. Exploration makes up the bulk of that at 13%. Heavy oil production can continue to be profitable in Canada at $30 per barrel, excluding costs for transportation and new exploration. Roy Borzellino, Portfolio Manager for SEI's Canadian Equity strategies believes that Canadian producers are prepared for short-term price challenges and that a response from them will likely be a year or more away. Longer-term he believes the prospect of energy independence for the United States will present continued challenges for the oil industry.

Looking beyond North America, lower oil prices are a mixed bag. For nations categorized as net importers (think Japan and India), lower prices are good news. In similar fashion, Europe should benefit on balance, as well as Taiwan and China. The price fall will present some challenges for the Middle East and, in so far as it creates a sympathetic decline in other commodity prices, it may hurt markets in Australia and Canada. Select emerging economies (notably, Russia and Brazil) are also suffering.

How Low Can it Go?

SEI believes that the price of oil is nearing its low point, but the exact dollar level of that floor is difficult to determine. It is easy to forget that we saw oil prices as low as the mid- $30s per barrel as recently as 2008. The global economy, while still a bit shaky, is in a much better place than it was in 2008, however. Since oil helps to grease the economy's gears in more than one way, prices won't fall forever.

Profitability estimates for U.S. shale operations suggest that the least efficient drillers require oil at $70 per barrel, and the most efficient require it at $50 according to most new reports. Technological innovation will continue to drive down cost and enhance production as the industry finds more efficient extraction methodologies. Saudi Arabia can continue to produce at below $10 per barrel. Saudi Arabia and other nations that rely on oil revenues will continue production regardless of price. Although pundits have focused on the fact that Russia needs oil at $110 a barrel to balance its budget, balanced budgets aren't high on the priority list for most nations these days. Even corporate producers operating at a loss will continue production as long as they can, as they may lose even more money if they stopped. At present, the futures markets are pricing oil at $70 twelve months from now.

Supply is not the Only Factor

While the shale boom is certainly helping to drive prices lower, it is not the only factor in play. The global economy is a complex organism. Serj Teslic, a senior analyst in SEI's Alternative Investment group, notes that appreciation of the U.S. dollar accounts for between 20% and 30% of the price move in crude oil.

Greg McIntire, portfolio manager for SEI's U.S. equity strategies, said "Keep in mind that refining capacity is a limiting factor. Most U.S. refineries are set up for Middle East crude. Shale oil is already being pumped faster than it can be refined, so the downward price pressure of continued extraction will be somewhat offset by the ability of refiners to absorb it."

Geopolitics and long-term economics also play a role says Jim Solloway, Managing Director. "The Saudis want to weaken Iran economically and make the country more amenable to a robust international inspection regime that will materially slow, or even prevent, their nuclear-weapons development program."

The decline may take some pressure off the U.S. Federal Reserve to raise rates quickly because it should extend the current period of low inflation. Across the pond, the European Central Bank may face increased pressure to become more aggressively expansive in the near term as lower oil prices take them further away from their inflation target (at present, the year-over-year gain in the consumer price index is only 0.3%). Even though the declining cost of oil is positive for consumers, it could create even more of a deflationary mindset.

Investment Themes

The dramatic movement in oil prices naturally leads investors to ask about its impact on their portfolios and what, if anything, investment managers intend to do in response. The fact that the move caught nearly everyone by surprise highlights the challenges portfolio managers face when dealing with developments of this nature. SEI believes that speculative changes to portfolios based on unpredictable short-term events are not in the best interests of investors. Our objective is to deliver more consistent returns over time, while attempting to add value with short-term tactical investments when we believe the odds favor our success.

Accordingly, we are focused on investment themes such as the slow global recovery, the eventual rise of interest rates and the declining value of the euro versus the U.S. dollar, to cite a few examples. With this in mind, a prolonged period of low oil prices coupled with Japan's stimulus efforts could make for an attractive investment proposition. Similarly, at the macro-economic level, lower oil prices are bullish for the U.S. economy. They will keep inflation in check and encourage the Federal Reserve to maintain low interest rates, which will have a positive effect on household income and a stimulative effect on the economy.

At a more granular level, we rely on the expertise of the underlying investment managers in our funds for security selection. There, we expect the large, integrated oil companies to ride out the downturn without any lasting damage. Share prices for most oil companies that are household names have moved lower in response to plunging oil prices, but these companies have strong balance sheets and are likely to use the current scenario as an opportunity to make strategic acquisitions at attractive prices. Fuel-dependent industries, such as airlines and trucking firms should also see short-term gains. Weaker companies in the oil patch have not fared as well.

Fixed-Income Portfolio Manager David Aniloff highlighted the decline in dollar-denominated bonds issued by Russia, Nigeria, Iraq, Columbia and Ecuador. Local currency-denominated emerging-market debt has experienced even sharper declines given the broad depreciation of those currencies versus the U.S. dollar. Russian and Nigerian local bonds have been particularly hard hit, declining over 30% and 10%, respectively, over the last few months.

Investment manager's portfolios are suffering short-term declines, and a continued decline in prices will likely result in a corresponding uptick in high-yield bond defaults, but with yield spreads between perceived safe-haven Treasury bonds and high-yield debt from energy companies running at 700 basis points, Aniloff believes investors are being well compensated for the risks and that the top names in the sector are attractive.

Our View

In conclusion, the surprise element of the price decline cannot be overstated. Even alternative investment managers, often known for aggressive strategies, have chosen to follow the trend rather that attempt to predict it. As the price gap between Brent and WTI continues to widen, these managers will seek to take advantage of arbitrage opportunities. While short-term market volatility can be expected as a result of uncertainty in the energy sector, SEI believes the stimulus provided by low oil prices will be a bullish development economy.

Our Strategies

SEI's strategies generally have a modest overweight to oil, with a significant exposure in inflation-sensitive portfolios. Offsetting this is an underweight in the high-yield bond space which is coupled with a bias to higher-quality holdings. While current market volatility is likely to result in short-term pain, we have no plans to make significant allocation changes in response to oil prices.

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