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MARCH 2016

STARR COMPANIES
GLOBAL INSURANCE & INVESTMENTS

EXECUTIVE INTELLIGENCE BRIEF

EXECUTIVE HIGHLIGHTS

The March edition of the *Executive Intelligence Brief* presents the following in-depth, strategic analyses:

CHINA MONTHLY REPORT

China's leaders have set a target for GDP growth this year and next in the range of 6.5% to 7%. However, this is higher than the rate at which many western economists estimate the Chinese economy is currently operating. The target may be feasible only through fiscal and monetary stimulus measures that could entail propping up inefficient sectors and a renewed bout of bad loans that would hobble the banking system.

GLOBAL/OIL RECOVERY

Amid the collapse in oil prices, energy companies are slashing investment — a move that threatens supply shortages and higher prices when demand hardens. In the longer term, demand growth for oil will come from the most populous emerging markets, where car use has the potential to expand exponentially.

CHINA/ECONOMIC MANAGEMENT

China's growth slowdown and rising debt levels, which are spurring currency weakness and capital flight, increase the odds of a sharp economic correction. Leaders are resorting to renewed credit expansion to keep growth on track, but ultimately the key to progress will be financial and structural reforms.

INDIA/GROWTH CALCULATIONS

India is, statistically, the world's fastest-growing large economy. However, its performance is open to question and there are signs that the growth rate is slowing. Even with a burgeoning labor force and other positive dynamics, India will struggle to become the global manufacturing hub envisioned by Prime Minister Modi.

AFRICA/COPPER SLUMP

The tumble in global copper prices, precipitated by China's economic slowdown, is a devastating blow to the Democratic Republic of Congo and Zambia. Mine closures in both states are also the result of structural weaknesses — including, notably, the shortage of power supplies — and a resurgence of political risk.

March 8, 2016

GLOBAL
OIL RECOVERY

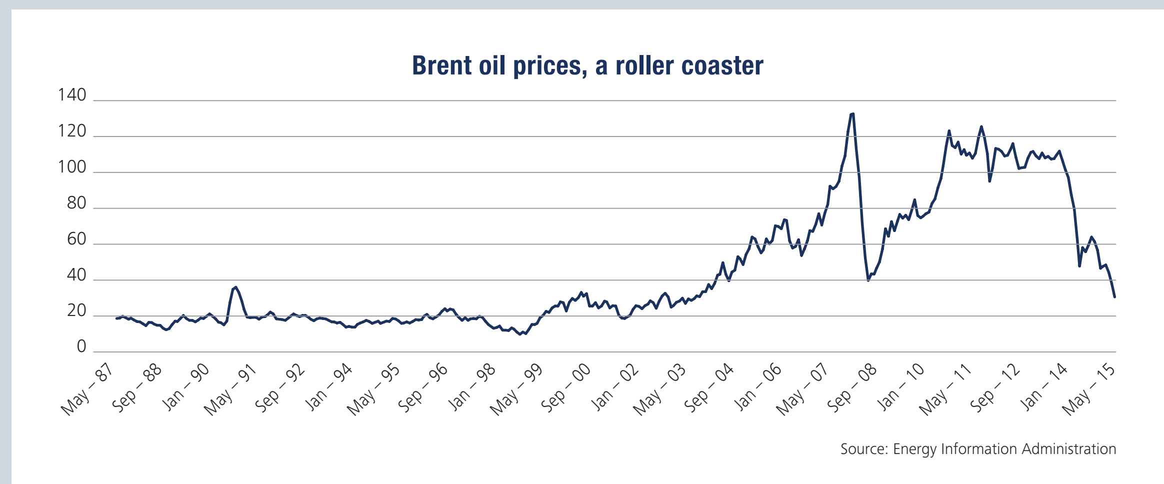
Rising vehicle ownership in emerging markets holds the key to stronger oil demand in the long term.

KEY FINDINGS

- Amid the collapse in oil prices, energy companies are slashing investment — which threatens supply shortages and higher prices when demand hardens.
- Demand growth for oil in the longer term will come from the most populous emerging markets, where car use has the potential to expand exponentially.
- Among oil producers, the Gulf Arab states and the most resilient of US shale drillers will be best placed to rapidly exploit the next upswing in the cycle.

ANALYSIS

Although China's economic slowdown has played an important role in the 70% crash in oil prices since the summer of 2014, the more decisive influence has been overproduction by Saudi Arabia, as the kingdom aims to curb US shale output and regain market share from fellow OPEC states and Russia. The world is now awash with oil. However, deep cuts to investment and capital expenditure by energy producers have set the scene for a strong recovery in oil prices once demand catches up with supply. That rebound may take 18 to 24 months to materialize.



Source: Energy Information Administration

Reduced investment will quickly erode current production levels and thus begin to drain the global surplus, which could be as high as 1.5 million barrels per day. The present decline rate across US shale oil basins is 5% per month, and more wells will be shut down this year. Russia can no longer produce at full throttle without committing fresh investment. Even if Iran and Iraq raise output in 2016, and Libya returns to the market, this extra oil will be insufficient to offset the global loss inflicted by investment cutbacks.

These cuts will also have significant longer-term supply and price impacts. They will crimp output expansion when the dominant market pressure becomes a rising demand for transportation fuels in emerging economies.

HOW EXTENSIVELY ARE OIL COMPANIES CUTTING EXPENDITURES?

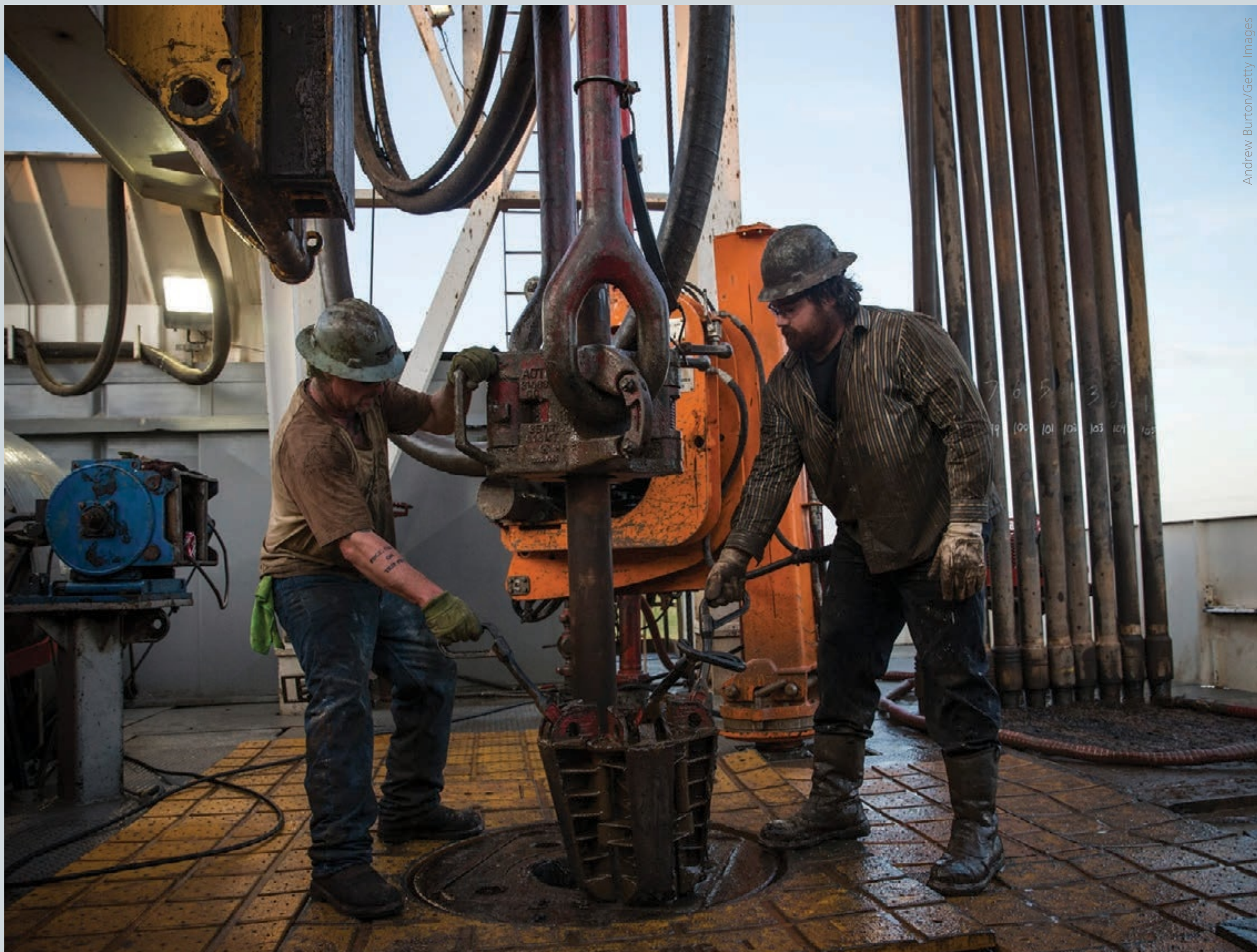
Global spending on capital projects in exploration and production of oil and gas is set to fall by 12% to $522 billion in 2016, following a year-over-year drop of 22% in 2015. This is the first time since 1989 that capital spending in the sector has fallen in consecutive years.

The cuts span the spectrum of oil companies:

- Chevron, an oil major, is reducing capital project spending by a quarter;
- US producer Marathon Oil is slashing capital expenditure by 50%;
- Chinese state-owned CNOOC is cutting by 35%;
- Russia's Gazprom has pared 7% for 2016 after a 40% cut in 2015; and
- Brazil's Petrobras reduced its five-year expenditure by 41%.

Companies are bent on preserving their least risky projects, such as the most productive wells in the US shale oil fields, which have withstood the Saudi assault. Those projects that are being mothballed are expensive, long-term ones. BP and ExxonMobil have said they will not start exploratory drilling in the Arctic before their leases expire in 2020. French major Total has suspended development of an oil sands project in the Canadian province of Alberta. The cuts at Petrobras will impact production from Brazil's deep offshore.

When demand catches up with supply, and reserves start to dwindle, oil and gas companies will need more investment and time to boost production volumes. The longer it takes to bring new supplies on stream, the higher prices will rise. The International Energy Agency (IEA), an intergovernmental oil policy adviser, predicts a price spike by 2021.


Andrew Burton/Getty Images

North Dakota is now a key dynamic in global oil prices

WHY WILL THE DEMAND FOR OIL WEAKEN IN THE DEVELOPED WORLD?

The IEA estimates that US oil consumption will drop by 4 million barrels per day by 2040. Northwest Europe will also experience a slowdown but to a lesser degree. The agency's estimates are based in part on perhaps optimistic assumptions about the response of policy makers to calls for reducing carbon emissions. What is clear in the data is that consumption of transportation fuel is falling in the developed world.

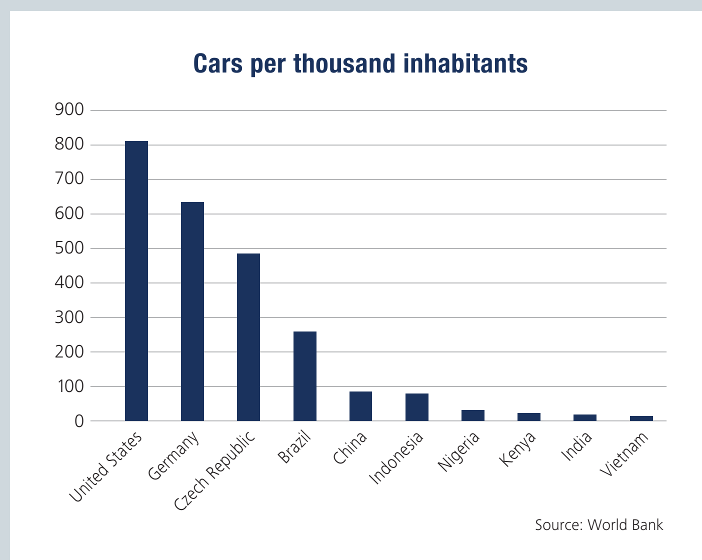
In the US, the number of vehicle miles driven in 2015 broke the record set in 2008 prior to the global recession. Gasoline consumption, though, has remained below the 2008 high. The divergence is explained by higher fuel efficiency. At the same time, car ownership penetration is at a standstill. The US has 812 cars per 1,000 inhabitants, the highest ratio in the world. That number has not changed much in over a decade and risks slipping as the migration from city centers to sprawling suburbs is reversed in many conurbations. In Western Europe and Japan, car ownership and driving are discouraged by higher fuel prices and tighter restrictions on car use.

A growing threat to oil consumption is the shift to hybrids and electric cars. In the US, hybrid car sales grew by an average 39% between the years 2000 and 2014, but represented only 2.8% of all new car sales in 2014. Plug-in electric cars accounted for less than 1% of new car sales during the same year. The hybrids market is even smaller in Germany. But these percentages will grow in the medium term, not least because tax incentives for motorists in the European Union, Japan, and many US states will drive a shift away from gasoline to non-fossil fuels.

HOW WILL EMERGING MARKETS CALL THE SHOTS?

The factors depressing demand in the developed world are likely to be far outweighed by drivers that boost oil consumption in emerging economies. Outside of the Middle East, oil is now used almost exclusively for transportation (and to some extent in petrochemical production). Increasing affluence boosts mobility, putting more motorcycles, cars and trucks on the roads. Fueling these vehicles in the world's most populous states will exert an increasingly powerful pressure on global oil markets and provide a spur to prices.

China, which has overtaken the US as the largest new-car market in the world, still has a car per 1,000 inhabitants ratio of 85, about a tenth of the US level. There is thus huge potential for further market growth. In India, where the government is investing in much-needed road infrastructure, the ratio is 18, well below Indonesia's 79, and lower even than Nigeria's 31. Vietnam's 90 million people have a car to 1,000 inhabitants ratio of 13.



Given the demographic weight of these nations — India has a population of 1.25 billion, Indonesia, 256 million, and Nigeria, 181 million — just a small rise in car-market penetration will translate into large increases in demand for gasoline.

OUTLOOK

Once the market is in balance, a growing demand for oil in emerging economies will stimulate upward pressure on prices — a trend that will be exacerbated by the current lack of investment in new production. Those best placed to take advantage of the next upswing in the cycle are Gulf Arab producers and the surviving US shale drillers. Both can deliver fresh supply to the market quickly and with little investment.

Iran could join the fast club if it were able to finalize new contracts to attract foreign investment and expertise. This, however, faces strong resistance from vested interests and conservative hardliners. Russia is less well positioned, requiring costly investment in the Arctic in order to significantly raise output. Canada and Brazil have some of the most expensive reserves to develop and will be late to the next oil party.

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