TAKING STOCK: OIL AND GAS STRUGGLE AS COVID-19 CRUSHES DEMAND

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BLOG POST

April 15, 2020

Oil prices plummeted to an 18-year-low in March and have remained at depressed levels as the Coronavirus pandemic and its restrictions on travel and movement have sharply curtailed global demand for crude at a time of plentiful supply.

The double whammy of excess availability and a demand shock, unprecedented in scope and scale, exacerbates the ongoing uncertainty in the oil and gas industry at a time when US producers were already under pressure. Despite the pact earlier this month between the top oil producers to cut back production, oversupply is expected to weigh on industry performance amid persisting concerns around available storage capacity.

In particular, midstream companies—those that collect, transport and refine the oil and gas produced by exploration and production companies—experienced six of the worst 10 trading days in March. The Alerian Midstream Energy Index has rebounded more than 45% from lows reached in mid-March as many midstream companies have scaled back on dividends and will likely cut down on capital expenditures this year. Companies tied to drilling and production will be under extreme distress as supply slows; for the first time in 40 years, the Texas Railroad Commission is considering limiting production within the state.

At NEPC, we maintain our hold in the midstream space while we evaluate the impact on the overall supply chain; we believe many companies involved in the natural-gas supply chain are likely in a better position to adjust to the macro shifts in supply and/or demand dynamics. The extreme contango—when the futures price of a commodity is above the expected future spot price—in oil markets is a significant drag on returns and will limit the recovery for commodity investors when prices bounce higher as roll yields are steeply negative. Private portfolios will probably experience distress as bankruptcies and consolidation likely accelerate. Cuts to capital expenditure by the industry should support longer-term oil prices as market conditions normalize.

Until there is greater clarity around the timing of an economic recovery, oil and gas markets will continue to be rocked by uncertainty. To this end, NEPC Research has re-constituted its Distressed Energy Group to help clients make sense of the changes in the energy sector. We are re-evaluating this space and are checking in with managers to better understand the strain within portfolios. We remain focused on finding investment opportunities arising from this crisis, but many unknowns remain as the world struggles to comprehend the fallout from the COVID-19 pandemic, including the impact on energy demand. Watch this space for more on this topic.

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