
# The Intelligence Report

**Our views on the latest investment events** - FOR PROFESSIONAL INVESTORS - 8 January 2018

## Overview

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Last month's election of Cyril Ramaphosa to lead the ruling ANC party in South Africa – an event which investors had partially, but not fully, anticipated – has led to an explosive rally in South African asset prices. The rand enjoyed its strongest six-week gains in recent history. Against this heady backdrop, Marina Chernyak assesses the sustainability of current market levels and identifies the factors needed to maintain or extend the recent strength.

By contrast, there is little market euphoria built into the current pricing of energy shares, at least in general. In the second of our Intelligence Report articles, Daniel Morris reviews the performance of the sector over the past year, particularly the experience of lacklustre returns despite broadly rallying crude oil prices. A closer examination of the supply and demand dynamics and the associated changes in the shape of the futures curve yields tentative explanations of this conundrum and hints of what to expect in 2018.

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# South Africa: too soon to jump for joy

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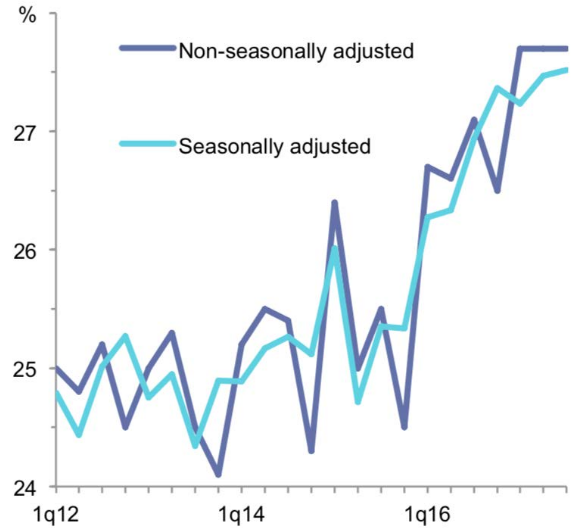
*The choice of Cyril Ramaphosa as the new leader of the African National Congress (ANC) leader is a positive surprise, but it would appear that he is limited in what he can deliver as long as Jacob Zuma remains the country's president and Zuma's allies hold the levers of power. In the absence of further upside surprises from Ramaphosa's 'reformist' camp (see below for signposts, none of which are easy to deliver), disappointment will likely set in.*

A couple of weeks ago, The Economist ran a South Africa doomsday cover, which was a signal to many traders that it was time to consider long positions in South African assets. Recently, however, South Africa received what was arguably the best news in years – Cyril Ramaphosa, the market-friendly candidate for ANC leader, won the ruling party's presidency, gaining 52% of the votes. In the run-up to this result, the South African rand and bonds rallied to eye-watering levels – the rand is now trading around 12.3 against the US dollar (down from 14.5 in November and up by 7.0% over the five days prior to the election) and 10-year government bond yields dropped to 8.7% from almost 9.5% in November. Had Zuma's successor Dlamini-Zuma won, a reversal would have been painful. Ramaphosa's win has instead anchored asset prices at around their current levels for now, a short-term positive for inflation, economic growth and investor sentiment.

Sustaining these levels, however, is predicated on the new leadership being able to deal with the long list of economic challenges –

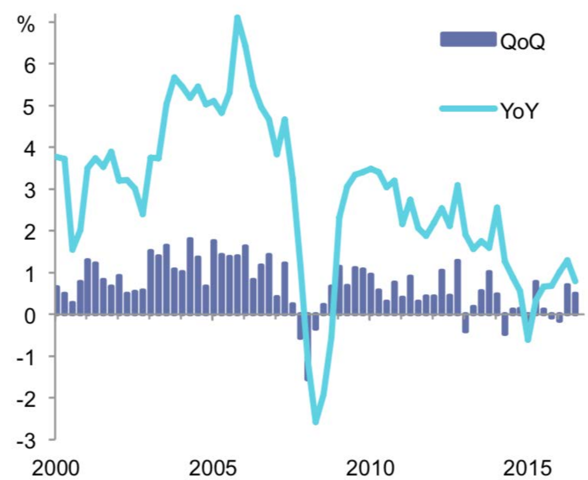
- an unemployment rate peaking at a historical 27.7% high in the last quarter (see Figure 1)
- high and sticky inflation despite economic growth virtually grinding to a halt (see Figure 2-3)
- a lack of foreign direct investment
- a systematic hollowing-out of institutions such as the National Treasury and the Revenue Service.

Figure 1. South Africa unemployment rate



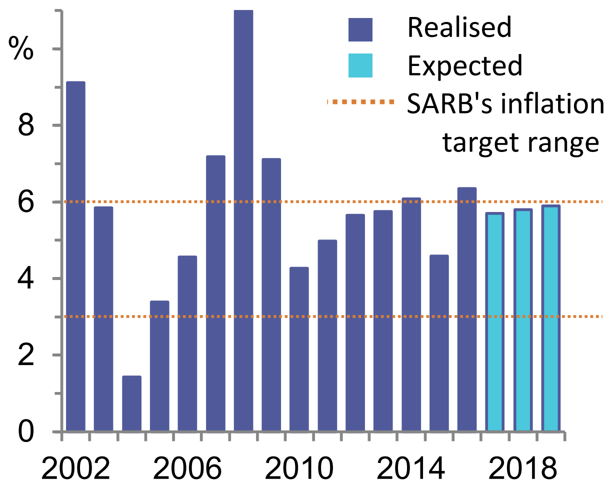

Sources: Haver Analytics, South African Reserve Bank, Bureau of Economic Research, BNP Paribas Asset Management.

Figure 2. South Africa real GDP growth




Sources: Haver Analytics, South African Reserve Bank, Bureau of Economic Research, BNP Paribas Asset Management.

Figure 3. South Africa inflation - actual vs expected




Note: Expectations as of 3q2017. Sources: Haver Analytics, South African Reserve Bank, Bureau of Economic Research, BNP Paribas Asset Management.

The even split of the top six ANC leadership posts between Ramaphosa's 'reformist' camp and Zuma's 'state capture' clique muddies the view of a positive outcome. If the composition of the National Executive Committee, to be agreed upon soon, reflects a similar divide, the 'reformist' agenda could face serious obstacles. It must also be noted that Zuma will remain president until the next election in 2019 and thus effectively represents a second centre of power, with the ability to appoint Cabinet Ministers and stall policy implementation. Basically, financial markets are left with serious question marks over Ramaphosa's ability to turn things around in such difficult circumstances.

"See what they do, not what they say" would therefore be a good rule when trying to gauge Ramaphosa's progress from here. The honeymoon is bound to be short: the clock is ticking on rating agency Moody's 90-day negative watch review. A downgrade would result in South African bonds being removed from Citi's World Government Bond Index. The South African Treasury is scheduled to deliver a budget on 21 February 2018. Financial markets will want to see change-focused decisions from the start of the year and in the run-up to the budget. It remains to be seen whether Ramaphosa 'gets' the urgency of the situation as that was not an ANC strength under Zuma's leadership.

What specifically could the 'reformist' camp do to convince markets they are 'for real'? The following may serve as a guide:

- ▶ A move to remove Zuma as president of the ANC via the National Executive Committee (NEC), in January or soon after. It took nine months for the NEC to remove Thabo Mbeki after he lost power at Polokwane in 2007-2008.
- ▶ Ramaphosa's decision on the new head of the National Prosecution Authority (NPA) (and perhaps other criminal justice units including the Hawks, South Africa's Directorate for Priority Crime Investigation (DPCI). The NPA has constitutional powers over decisions to prosecute corruption cases (for example, targeting Zuma et al.) and, notionally at least, it is meant to be independent.
- ▶ 'Low-hanging' reforms such as refusing to consider nuclear power as an energy option and repealing the mining industry-damaging mining charter.
- ▶ Changes in management/boards of state-owned enterprises such as Eskom, South African Airways, etc., which would be fiscally positive given their growing contingent liabilities.
- ▶ Reshuffling senior figures in the mineral resources, social development, public enterprises and energy ministries – all staffed by Zuma allies.
- ▶ Leadership change in key institutions such as the Treasury and the South African Revenue Service – ideally before the budget is delivered. This would provide a major, positive signal for reversing the 'state capture' narrative.

Certainly, none of these things are easy to achieve. And the longer it takes, the less patient financial markets will likely become.

# Energy sector equities: running on empty?

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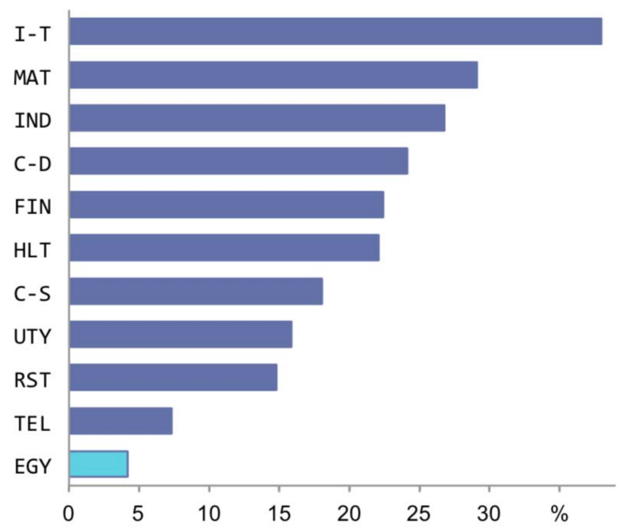
One of the surprises of 2017 was the relatively poor performance of stocks making up the energy sector of the MSCI World Developed Market Equity Index (see Figure 1). The sector gained just 4.2% last year, compared to the 23.1% advance for the broader index. This shortfall is surprising as the principal driver of returns for energy sector stocks, crude oil prices, ended the year up by more than 20%.

Figure 1. Developed world equity total returns in 2017

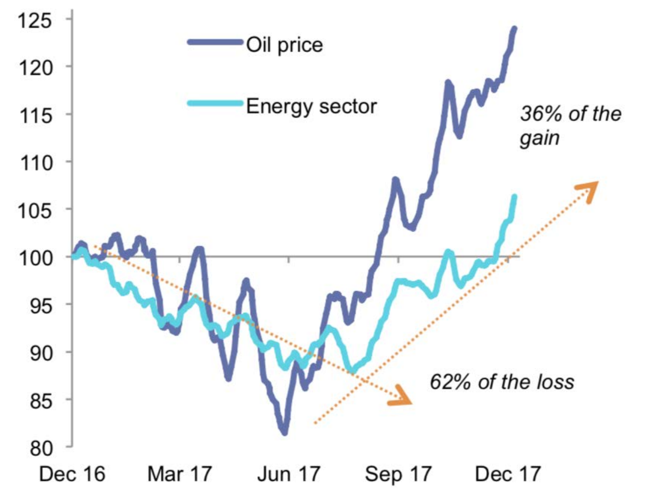



Note: Index is MSCI World IMI. I-T = Information Technology, MAT = Materials, IND = Industrials, C-D = Consumer Discretionary, FIN = Financials, HLT = Health Care, C-S = Consumer Staples, RST = Real Estate, UTY = Utilities, TEL = Telecommunications Services, EGY = Energy. Returns in USD. Source: FactSet, BNP Paribas Asset Management

The fall in oil prices during the first six months of 2017 was matched by a lesser drop in the value of equities in the energy sector. By the end of June, Brent crude oil prices had fallen by nearly 20%, while the sector eventually declined by 62% of that, or 12%. The subsequent rebound in prices was not matched by a commensurate rally in shares, however. By the end of the year, Brent oil had gained over 50% (and has continued to rise in 2018), while the MSCI World IMI Energy Index (which includes large, mid, and small-cap stocks) had advanced by less than 20%.

If the beta, or correlation coefficient between the two, had remained at 62%, the sector would have ended up the year nearly 16% higher instead of just 4%. Instead of 62%, though, the ratio has been just 36%, that is to say, the correlation was greater when oil prices were falling than when they were rising (see Figure 2). Understanding the reasons for the energy sector's underperformance may give us some perspective on its outlook for 2018.

Figure 2. Oil prices and energy sector equity returns




Note: Indexes rebased to 100 as at 31 December 2016. Oil price is for Brent. Energy sector is MSCI World Energy IMI index. Returns in USD. Sources: Factset, BNP Paribas Asset Management.

One clue as to why the rebound in oil prices was not matched by a commensurate gain in equity prices is the future value of oil priced in by the market. At the beginning of 2017, the futures curve had a positive slope, that is, oil prices were expected to be higher at the end of the year by about USD 2 per barrel. Even as oil prices reached their 2017 low in June, the expected price one year out was more than USD 3/bbl higher. Currently, the future price is more than USD 4/bbl lower, a condition known as backwardation (or an inverted or negatively sloped curve). The inverted curve for oil prices suggests markets are not expecting to be surprised again (perhaps inevitably).

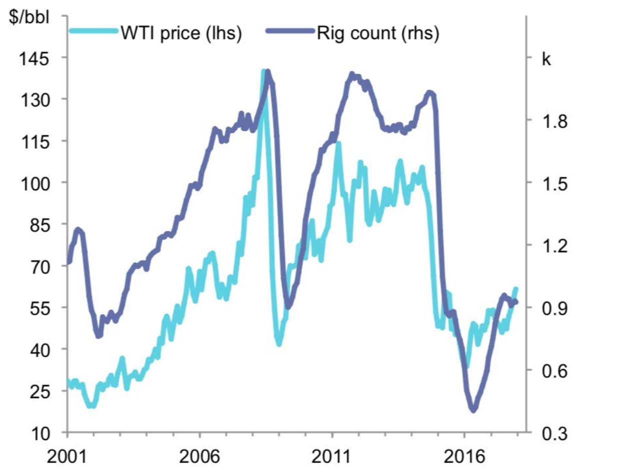
The reasons for the inversion stem from market expectations for oil supply and demand. To take demand first, another surprise in 2017 was that both China and continental Europe achieved higher-than-expected economic growth. This led to higher oil demand, which pushed up prices. We expect, however, that Chinese GDP growth will slow in 2018 and will also be driven less by energy-intensive industrial sectors and more my energy-light service sectors. While

European growth should remain robust (by European standards), we do not expect it to accelerate meaningfully. Extreme temperatures in the US and Australia have added recently to short-term fuel demand, but this should not persist.

Some of the factors affecting supply should be supporting prices, while others might weaken them. Support should come from declining US crude oil inventories: they have fallen to their lowest since 2015, although they are still high compared to the long-run average. Markets have been surprised by OPEC's ability to maintain the quotas limiting production. Investors had understandably been sceptical given the past failure of such agreements, but perhaps the prospect of rising US shale oil production encouraged more discipline.

US shale oil is, in fact, the factor perhaps weighing the most on prices. US shale oil producers are very price-sensitive and unlike with wells in conventional oil fields, they can turn production on and off relatively easily. The number of rigs used in the production of US oil and gas moves closely in line with the price of oil (see Figure 3). Note how the more recent surge in oil prices has not been matched by an increase in the rig count, which can be seen as another indicator that oil prices are not expected to remain at their current levels.

Figure 3. US oil and gas rotary rig count and West Texas Intermediate (WTI) oil prices

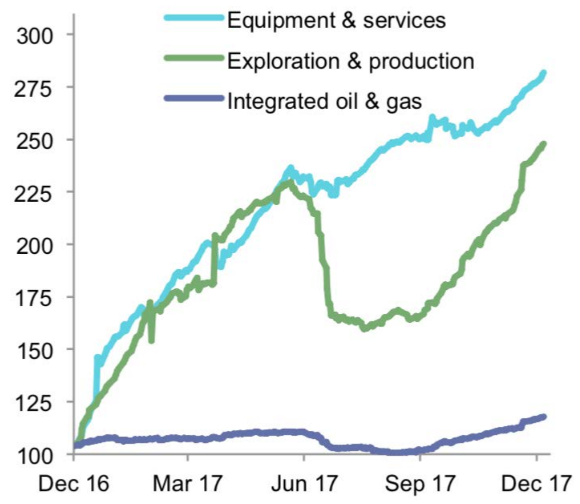



Note: Returns in USD. Sources: Baker Huges, Bloomberg, BNP Paribas Asset Management.

With oil prices now comfortably at above USD 50/bbl, we expect US production to continue to rise modestly, putting downward pressure on oil prices. The reduction in regulations limiting oil exploration in Alaska and off the coasts of the US is likely to increase production in the medium to long term. The balance then between shorter-term factors increasing demand and medium-term factors pushing up supply explains why the oil futures curve is negatively sloped and hence why energy sector shares have not benefited proportionately from the rise in oil prices: investors simply believe the good times will not last.

Despite this rather more cautious outlook for oil prices, might energy sector stocks nonetheless be an attractive investment? As always, it depends on price relative to the earnings outlook. The expectation that oil prices will decline over the next year is reflected in analyst forecasts of limited earnings growth for the integrated oil & gas sector. Expansion of the shale industry, however, means the forecasts for energy equipment & services stocks, as well as those in exploration & production (E&P), are much brighter (see Figure 4).

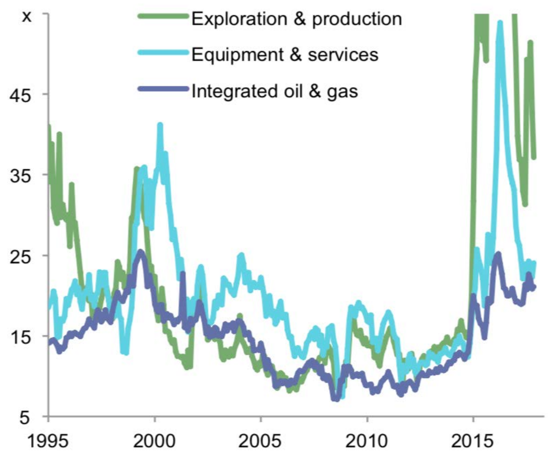
Figure 4. Earnings forecasts (next-twelve-months)




Note: MSCI World IMI Energy indices. Estimates in USD. Sources: Factset, BNP Paribas Asset Management.

Deeply cyclical sectors can show excessively high P/E ratios when prices are temporarily depressed. This is to some the degree the case with energy, where even taking prices compared to earnings expectations in 18 months, multiples are high relative to long-run averages (see Figure 5).

Figure 5. Forward P/Es for S&P 500 indices




Note: Estimate is forward 18-months. Source: IBES, BNP Paribas Asset Management.

On a price-to-book basis, multiples look more attractive, at least for the integrated oil & gas sector (1.8x currently vs. a long-run average of 2.5x) and for equipment & services (1.9x currently vs. a 3.3x average). Exploration & production, however, is still priced at above average, at 2.3x book value of assets today compared to an average since 1999 of 1.6x.

It is likely that the energy sector will again underperform the broad market in 2018. We expect oil prices to weaken over the course of the year, although not dramatically as there is still firm underlying demand thanks to robust global growth. The expansion in shale and off-shore drilling in the US, though, should drive above-trend growth in the equipment & services and the exploration & production segments. That opportunity may already be reflected, however, in valuations. As to the integrated oil companies, while they are not necessarily "running on empty", they are low on fuel and there is still some way to go until the next filling station.

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