Principal Global
PERSPECTIVES
INSIGHTS FROM THE INVESTMENT MANAGEMENT BOUTIQUES OF PRINCIPAL GLOBAL INVESTORS

SPECIAL REPORT: THE PRICE OF OIL

FROM:
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OIL PRICES AND THE TRIUMPH OF ECONOMISTS OVER GEOLOGISTS

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Principal® Global Investors

by Jim McCaughan
CEO, Principal Global Investors

The most interesting and exciting thing in world markets over the past 12 months has been the weakness in the price of oil. That has surprised some people, but I think that it is important to bear in mind some of the fundamental reasons for it.

I've characterized the weakness in the oil price as a triumph of the economists over the geologists. That may sound a bit strange, but here's what it means. As recently as five years ago, the view from petroleum geologists was that no more oil was being discovered. The specter of "peak oil" was trumpeted in publications from *National Geographic* to the *Wall Street Journal*. The price of oil was bound to go up inexorably. Oil companies would be forced to pour ever more money into the business.

The economists' view would be more nuanced about markets. Economists would point out that higher prices lead to greater economy in usage and greater conservation. Higher prices are also a big inducement for the industry to go find new sources of supply. And that is exactly what has happened.

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The oil price finds a much lower clearing rate, which balances that extra supply and lower demand. I think that structural oversupply in oil has been emerging now for several years. The surprise to me is not that the price has gone down so sharply, it's that it took so long to do it.

In terms of implications, the decline in oil prices is clearly a negative for those who have oil wells. But for most of us who don't own oil wells, this is actually quite good news. For most developed-country consumer, lower energy costs are equivalent to a tax reduction. And in the longer term, people will tend to spend that newly available cash, meaning it will be a boost to the developed economies.

I do think though that we need to take a longer-term view of this because of the implications that it has for different markets. Lower energy costs mean inflation will be low. That will lead directly to interest rates staying lower for longer than they otherwise would have – that's a problem for retirement investors. We have also seen volatility in equities as energy companies get hit, as well as margin calls for oil traders. This is actually one of the main reasons that falling commodities cause falling equity markets; it is a linkage in a very technical sense within the market system.

There's also, perhaps fancifully, the thought that this might be the beginning of the end of the period when oil's influence dominated world economies. We are seeing other sources of energy. We are seeing greater leverage of the amount of oil consumed. This may be, in some ways, the waning years of the Oil Age. That age may end when there is still plenty of oil in the ground. So we take some positive signs from this and will have to assess the negatives as time goes by.

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DECLINING OIL PRICES PRESENT BUYING OPPORTUNITIES IN GLOBAL EQUITY MARKETS

by Arild Holm, Portfolio Manager, Principal Global Equities
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Given the recent decline in crude oil prices, the global energy sector and related industrial suppliers are currently facing significant earnings downgrades. In the equity markets, we advise cautious positioning and an eye for higher-quality companies with resilient balance sheets. Along with this, we see benefit in reducing positions in stocks with weaker fundamentals and higher leverage, where estimates are trailing negative expectations.

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Our research and market experience suggests that during times of significant oil price deterioration, such as the mid-1980s and the late 1990s, the result if often cost cutting and consolidation. In such periods, energy companies with high debt or leverage problems are first to succumb to heavy share-price weakness, making these companies vulnerable to acquisitions or asset sales. Consolidation during such periods is driven by either the desire to gain the "crown jewels" of weaker companies or to aggressively cut costs, especially overhead. In the late 1990s, for example, the domino effect began when BP acquired Amoco to gain access to Russia, expand its deep-water operations, and grow its U.S. downstream segment. This was followed up by BP acquiring Atlantic Richfield for Prudhoe Bay consolidation and U.S. Gulf of Mexico leases.

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Low oil prices during this consolidation period meant there were limited U.S. Justice Department objections. That meant that mergers were getting approved that would have been stopped five years earlier. In all of the cases mentioned above though, costs were slashed significantly and marginal assets were sold to reduce debt and buy back shares. Such changes, combined with the inevitable climb in oil prices drove earnings-per-share estimates higher for the next several years, ultimately driving share prices higher as well. Because of the large focus on cost cutting, however, the companies did not spend sufficiently to maintain their competitive edge, opening the door for independents to dominate the development of unconventional resources, such as the shale oil revolution in the United States.

With the recent oil price decline, we believe companies will again look to consolidate and that the super majors will become more active in buying independent oil companies that improve their competitive positions. In turn, this will force further cost cutting, thereby lowering the cost to find and develop oil and natural gas, ultimately leading to higher profitability (and higher share prices) when oil prices recover. Our stance is that companies with strong fundamental attributes will have the ability to make such opportunistic acquisitions of assets or companies later in 2015 and into 2016, helping drive earnings growth for these companies.

On the other hand, energy companies that are highly leveraged are poised to see a more challenging earnings-revision period. In fact, we are already seeing clear evidence of reduced capital expenditures and pressure on energy companies to reduce dividends and share buybacks to preserve balance sheets.

OIL EFFECTS ON INVESTMENT GRADE CREDIT

by Dan Kang, Senior Fixed Income Analyst,
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MORLEY FINANCIAL SERVICES, INC.

Over the last seven months, whenever oil prices stabilized for a period of time, market participants undoubtedly speculated on whether energy prices have finally bottomed. In our opinion, however, the path to recovery is just as important. Since energy companies generally hedge large portions of their future production, a sharp rebound in prices in 2015 would have made the recent oil volatility seem like a temporary blip on the path towards ever-higher oil prices. However, recent futures prices have West Texas Intermediate below US$65 over the next three years. As the CEO of Kuwait's state oil company opined at a recent industry conference, $100-a-barrel oil will not be achievable in the next few years.

Through the prism of this "lower prices for longer," we conducted a bottom-up analysis of investment grade credits and asked a series of questions to search for potential risks and opportunities. Are there business models based on $90 to $100 per barrel oil that are no longer viable? Will consumers now be more likely to buy a gas-guzzling pickup or SUV? Alternatively, can airlines justify deferring purchases of new fuel-efficient aircraft when jet fuel prices are at six-year lows?

Obviously, the importance of oil in the global economy has a wider-reaching impact beyond just energy credits, but we can begin our analysis there. Within the energy sector, we believe midstream/pipeline companies have the potential for the best risk-adjusted returns; whereas, oil-field services will face continued pressure. The vast majority of pipeline company earnings have little to no commodity risk, with most of their revenues coming from fee-based contracts. Further, some companies may further benefit from increased storage demand from the futures contango market.

Alternatively, we are only starting to see the curtailments in capital expenditures needed to balance the market. Therefore, we expect oil-field-service firms to face further fundamental and ratings pressure.

Outside of the energy sector, we generally view the plunge in oil prices as a net positive to the rest of investment-grade space. Banks, the largest subcomponents of most credit indices, have miniscule to very manageable exposure to the energy markets. Loans to energy companies are generally less than 3% of total loans, and are mitigated by the quality of the borrower and secured positions. Consumer-oriented banks will benefit from the greater discretionary income that lower gasoline prices bestow on consumers,

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who will be more able to repay their mortgages, credit cards, and auto loans.

One area of concern we identified, though, was Canadian banks. Similar to their U.S. counter-parts, we view their direct exposure to oil and gas industry as manageable. However, we are cautious about two recent data points. Canadian households' debt-to-income ratio recently reached a record 162.6%, driven by increased mortgage borrowing. Further, according to the Bank of Canada's models, their housing market is between 10% and 30% overvalued. Unlike the United States, we see lower energy prices as a decided negative for the Canadian economy, with economists starting to cut GDP estimates. We don't believe an over-levered consumer with significant economic headwinds is a recipe for outperformance. Currently, the Canadian banks are trading at a premium to their U.S. peers in credit. So the risk to the downside appears to be skewed more than any potential upside.

U.S. ASSET ALLOCATION THEMES FROM OIL-PRICE SLUMP

Multi-Asset Advisors
An investment boutique of Principal Global Investors

by Binay Chandgothia, Portfolio Manager, Multi-Asset Advisors & Han Peng, Investment Analyst, Multi-Asset Advisors

The oil-price crash that started in July 2014 is essentially the fourth oil-slump cycle that we have witnessed since 1985, excluding the 1990-1991 cycle that was caused by the first Gulf War. The first of these, in 1986, was caused by a supply glut. The 2000-2001 and 2008-2009 cycles were demand driven. The former sparked the bursting of the tech-bubble in the United States after the Fed hiked its policy rate to a high of 6.5% in May 2000. The later was created by the demand destruction following the global financial crisis.

The current cycle appears to be supply driven. A leading factor was the large increase in U.S. crude production since the 2008 crisis. U.S. oil output, which was in the vicinity of 5.5 million barrels per day (mbpd) in 2010 is now above nine mpbd because a bulk, actually almost 100% of the increase in global supply in the last five years was due to the production increase in the United States. The Energy Intelligence Group's (EIG) estimate of global demand for crude rose from 93 million barrels per day (mbpd) in December 2013 to 94 mbpd in December 2014 (i.e., demand still went up), whereas its supply estimate increased at a much faster rate, rising from 93.5 mbpd to 96.7 mbpd. This puts the oil market into a surplus of 2.7 mbpd, its highest in several years. Other factors that are likely to have played a part in the slump were slowing growth in economies like China, India, Brazil, and the Eurozone, and a collapse of the geopolitical supply-risk premium that had been baked into crude oil prices because of troubles in the Middle East and Russia-Ukraine.

If our assessment of the reasons for the price slump are correct, the revival of oil prices would hinge on either future supplies being taken out through lower capex spending (we are already seeing some signs of this, with several large oil companies recently announcing cuts) or demand catching up faster than expected (e.g., recoveries in Europe and emerging markets, and an increase in U.S. gas consumption).

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RECENT CYCLES IN OIL PRICES

Of the three most recent oil price slumps, two were demand driven and one was supply driven. The current cycle seems to be supply driven as well. The market impacts during these cycles have varied, though.

CYCLES IN OIL PRICES

	Cycle Properties			Market Impact through the Cycle				
Oil Slump Cycles	**Reason for Drop**	**Length of Cycle (months)**	**Magnitude (Oil Price Change)**	**S&P 500**	**U.S. Dollar Index**	**10y U.S. Treasury Yield**	**U.S. Investment Grade Credit Spread**	**U.S. High Yield Credit Spread**
			%	%	%	Basis Points	Basis Points	Basis Points
Cycle 1 (Oct'85-Mar'86)	Supply	5	(66)	26	(9)	(260)	112	N/A
Cycle 2 (Nov'00-Nov'01)	Demand	12	(43)	(13)	1	(72)	(85)	(103)
Cycle 3 (Jun'08-Jan'09)	Demand	7	(70)	(35)	19	(113)	178	811

Source: Bloomberg
U.S. Investment Grade Credit Spread: Derived as Barclays U.S. Aggregate Credit Yield to Worst (LUCRYW Index) less 10-year U.S. Treasury Yield
U.S. High Yield Credit Spread: Derived as Barclays U.S. High Yield Corporate Yield to Worst (LF98YW Index) less 10-year U.S. Treasury Yield

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FROM A U.S. ASSET ALLOCATION PERSPECTIVE, LOOKING AT THE PAST CYCLES, THERE ARE A FEW IMPORTANT TRENDS TO RECOGNIZE:

1. U.S. equities don't exhibit a clear pattern during the slump; they seem to be influenced more by other factors.
2. The U.S. dollar tends to strengthen; this could be both a cause as well as an effect (i.e., stronger dollar is negative for commodities, which are priced in dollars).
3. U.S. Treasury yields always drop because of the headline-disinflation effect (lower oil and commodity-price effects, as well as worries about potential demand slowdown).
4. U.S. corporate credit spreads tend to widen, both for investment grade and high yield (large price drops will make some companies default on their loan commitments, though it is positive for consumers).

WITH ALL THIS IN MIND, HERE ARE SEVEN ASSET ALLOCATION THEMES FROM MULTI-ASSET ADVISORS THAT FLOW FROM THESE INPUTS:

1. This environment has the potential to extend the current U.S. economic expansion into a seventh year (lower oil prices, easy monetary policy, and recovery of consumption).
2. Monetary policy divergence will continue since several global central banks (excluding the Fed) will use the disinflationary environment to cut policy rates. India, China, Indonesia, and European countries fall into this category. The Fed may slow down the pace at which it hikes interest rates.
3. The strength of the U.S. economy, our assessment of continued U.S. dollar strength, and interest rate differentials will keep flows into U.S. dollar-denominated assets fairly strong.
4. U.S. consumption will eventually get a boost from lower oil prices. Higher domestic consumption would benefit domestic cyclical companies and also provide an opportunity for countries exporting to the United States, especially those that supply consumer-oriented goods.
5. The Eurozone and large consumption economies in Asia (e.g., India and China) will be net beneficiaries of lower oil prices, given their dependence on imported oil and their associated savings from lower oil prices.
6. Spending by countries that depend predominantly on oil exports will decline unless they dip into past reserves. Countries in this bracket include Oman, Nigeria, and Iran. Saudi Arabia, the largest oil producer in OPEC, has far greater ability to withstand lower oil prices without cutting its spending budget, given its huge accumulated surpluses.
7. At some stage in the next few months, oil producers will likely become deep-value plays and present long-term investment opportunities.

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