



Postcard

January 2016

WELLINGTON
MANAGEMENT®

The big squeeze: Why the oil market could remain tight in 2016

A MAJOR REASON WHY I AM POSITIVE ON THE ENERGY SECTOR TODAY

is because of misperceptions around oil-market tightness and resulting asset mispricing. The market is tighter than the price of oil implies and will likely remain so because of rising global demand and overly optimistic supply-side forecasts.

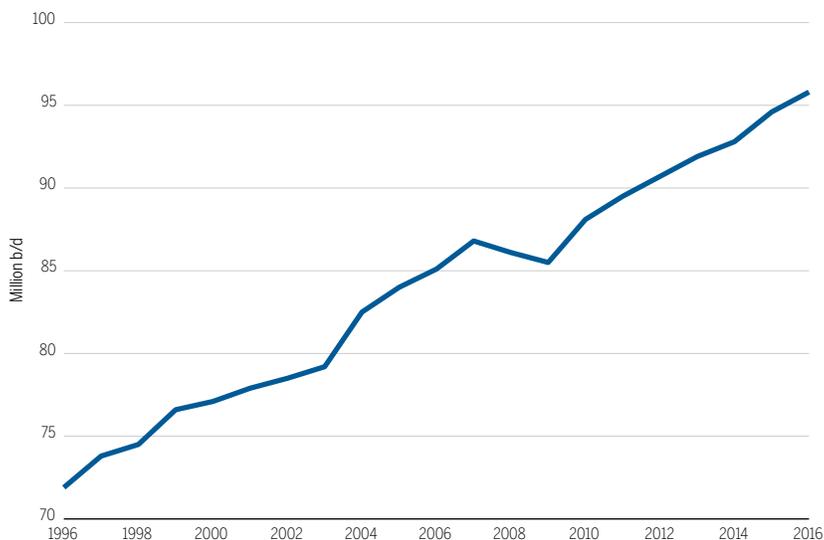
Continued demand growth and supply constraints

The world's thirst for oil does not seem to be abating. The International Energy Agency (IEA) predicts a 1.2 million barrel per day (b/d) demand increase in 2016 (FIGURE 1). While the recent global accord on climate change may eventually lead to decreased demand for fossil fuels, that shift will be very long in coming and is unlikely to change near- to medium-term oil demand trends.

FIGURE 1

Oil demand growth continues

Total oil demand and growth forecast



Source: IEA



Bill Ogrodnick

Global Industry Analyst, Energy

Bill follows the oilfield service, engineering and construction (E&C), and offshore marine sectors on a global basis. He also conducts fundamental research on the global energy sector.

FOR PROFESSIONAL OR
INSTITUTIONAL INVESTORS ONLY

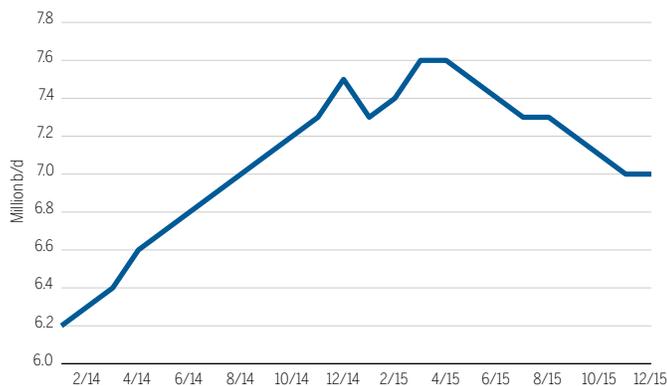
At the same time, the supply side will contribute to market tightness as well. Non-OPEC production is likely to fall, given large spending cuts in exploration and development. **FIGURE 2** shows a fall in US onshore oil production, while **FIGURE 3** shows a significant corresponding decline in the US rig count, relative to history. The US onshore oil-producing regions are notable because drilling activity has fallen by over 60% and new wells in these areas have very high first-year decline rates of 40% – 70%.

According to the Energy Information Administration (EIA), the US production outlook continues to dim, with the latest forecasts showing a year-over-year drop to 440,000 b/d by the end of 2015 and a decline of 610,000 b/d versus peak production in March 2015. By comparison, during 2014, year-over-year US production increased by 1.3 million b/d. The EIA's forecasts align with estimates from several oil-service companies I have met with recently that are forecasting additional declines in North American production of 900,000 b/d in 2016. Outside the US, growing anecdotal evidence indicates that production is already waning in Mexico and Colombia and that total non-OPEC ex-US production will fall further in 2016.

FIGURE 2

US oil production is falling...

Lower-48 (excluding Gulf of Mexico) production

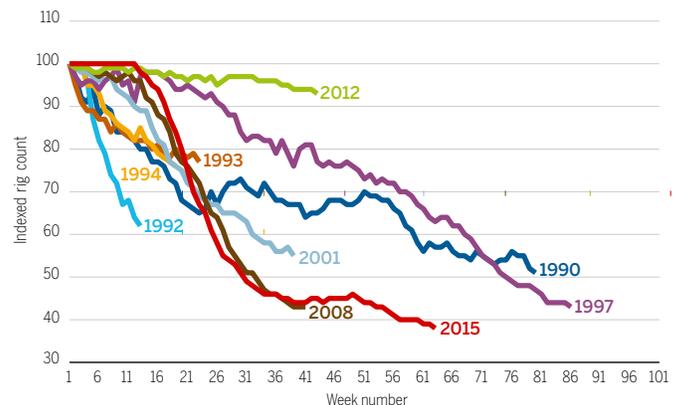


As of 8 December 2015 | Source: EIA

FIGURE 3

...as is the US rig count

2014/2015 US rig-count decline versus history



Source: Baker Hughes

OPEC supplies at risk

The outlook for OPEC production lends further support to the view that the market will tighten in 2016. One key misperception is that the market is significantly oversupplied. In contrast to this view, **FIGURE 4** shows that OPEC spare capacity as a percentage of global oil consumption is a mere 1% — a limited buffer in the event of a supply-side shock. During a recent meeting with one global oil-services company, management shared its view of underappreciated market tightness this way: OPEC has merely moved spare capacity from the ground into the market. Equity valuations do not currently reflect the low level of OPEC spare capacity.

FOR PROFESSIONAL OR INSTITUTIONAL INVESTORS ONLY

As we move into 2016, I believe that OPEC production may disappoint to the downside, particularly given high — and likely unrealistic — production expectations for Iran and Iraq. Iraq has contributed approximately 1 million b/d to OPEC’s oil production growth year over year, over half of the cartel’s total 1.8 million b/d year-over-year growth. This level will likely prove unsustainable in 2016, as large exploration and production (E&P) companies are exiting Iraq because of security concerns and poor economic returns. Kurdistan and Iraq are both struggling to pay E&P companies, and the market seems to be overlooking the striking fact that the rig count in Iraq has declined by 60% in 2015. Notably, this bearish production outlook contrasts with current market expectations that Iraq will be one of the largest sources of incremental oil production growth through 2018 (FIGURE 5). At this point, this expectation seems improbable. The expectation for growth in production from Brazil also seems unrealistic, given Brazil’s ongoing political headwinds.

The market’s expectations for incremental volumes from Iran are overly optimistic as well. Iran has asserted that it can bring 500,000 b/d to market immediately, and eventually ramp up to an additional 1 million b/d. Based on my conversations with equipment and service and E&C companies, I believe there is a risk of disappointment in terms of the timing and magnitude of Iran’s production goals. Apart from the Iranian government’s continued antagonistic approach to its dealings with the West, the country has several high hurdles to overcome before it can increase production. Iran needs to incentivize E&P, E&C, and oil-service companies to enter the country, and it needs to substantially build out its infrastructure, which requires time and money. Contrary to consensus expectations, I believe that it will take Iran longer to meaningfully ramp up production and that they are unlikely to reach those stated goals anytime soon.

Lastly, there are signs that Iranian production may already be reaching the market surreptitiously. As FIGURE 6 shows, Iraqi production of 4.25 million b/d in July and 4.3 million b/d in September 2015 were above that country’s sustainable production capacity of 4.18 million. This means that Iran may be sneaking barrels of oil out of the region through its neighbor, with incremental production volumes already being sold.

FIGURE 6
Has Iran already ramped up production?
 2015 OPEC crude production, million b/d

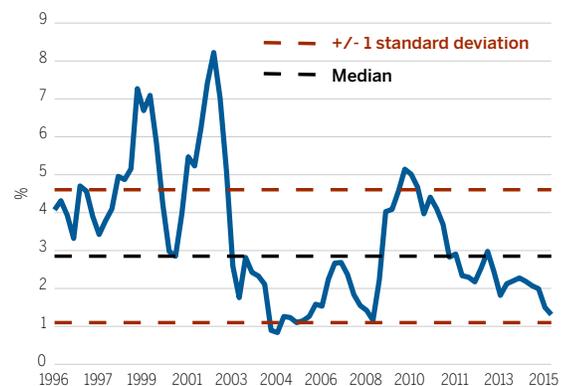
	July	August	September	Sustainable production capacity ¹
Iran	2.87	2.87	2.88	3.60
Iraq	4.25	4.17	4.30	4.18

¹Capacity levels can be reached within 90 days and sustained for an extended period | Source: IEA

Conclusion

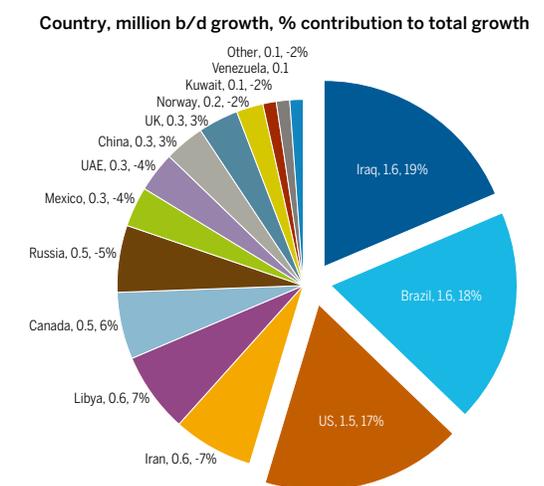
Rising global demand for oil, falling non-OPEC production, and downside risks to OPEC producers Iraq and Iran should contribute to an increase in the call on OPEC (the amount of oil the cartel needs to produce to maintain price stability). Not only do I expect oil-market tightness to continue, but current equity prices also do not adequately reflect this situation, a fact that underscores my positive outlook for the global energy sector. ■

FIGURE 4
The oil market remains tight
 OPEC spare capacity as a percentage of global oil consumption



As of 30 September 2015 | Source: EIA

FIGURE 5
Iraqi oil production expectations may be unrealistic
 Expected contributions to production growth, 2014 – 2018



As of December 2014 | Source: Bernstein

FOR PROFESSIONAL OR INSTITUTIONAL INVESTORS ONLY



The Morning Meeting at Wellington Management

WELLINGTON MANAGEMENT COMPANY LLP Boston | Chicago | Radnor, PA | San Francisco

WELLINGTON MANAGEMENT AUSTRALIA PTY LTD Sydney

WELLINGTON MANAGEMENT CANADA LLC Serviced from Boston and Chicago

WELLINGTON MANAGEMENT HONG KONG LTD Hong Kong | Beijing Representative Office

WELLINGTON MANAGEMENT INTERNATIONAL LTD London | Frankfurt

WELLINGTON MANAGEMENT JAPAN PTE LTD Tokyo

WELLINGTON MANAGEMENT SINGAPORE PTE LTD Singapore

WELLINGTON MANAGEMENT SWITZERLAND GmbH Zurich

www.wellington.com

Wellington Management Company LLP (WMC) is an independently owned investment adviser registered with the US Securities and Exchange Commission (SEC). WMC is also a commodity trading advisor (CTA) registered with the US Commodity Futures Trading Commission. In certain circumstances, WMC provides commodity trading advice to clients in reliance on exemptions from CTA registration. WMC, along with its affiliates (collectively, Wellington Management), provides investment management and investment advisory services to institutions around the world. Located in Boston, Massachusetts, Wellington Management also has offices in Chicago, Illinois; Radnor, Pennsylvania; San Francisco, California; Beijing; Frankfurt; Hong Kong; London; Singapore; Sydney; Tokyo; and Zurich. ■ This material is prepared for, and authorized for internal use by, designated institutional and professional investors and their consultants or for such other use as may be authorized by Wellington Management. This material and/or its contents are current at the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities. Investors should always obtain and read an up-to-date investment services description or prospectus before deciding whether to appoint an investment manager or to invest in a fund. Any views expressed herein are those of the author(s), are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients.

In Canada, this material is provided by Wellington Management Canada LLC, a US SEC-registered investment adviser also registered in the provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Quebec, and Saskatchewan in the categories of Portfolio Manager and Exempt Market Dealer. ■ In the UK, this material is provided by Wellington Management International Limited (WMIL), a firm authorized and regulated by the Financial Conduct Authority (FCA). This material is directed only at persons (Relevant Persons) who are classified as eligible counterparties or professional clients under the rules of the FCA. This material must not be acted on or relied on by persons who are not Relevant Persons. Any investment or investment service to which this material relates is available only to Relevant Persons and will be engaged in only with Relevant Persons. ■ In Germany, this material is provided by Wellington Management International Limited, Niederlassung Deutschland, the German branch of WMIL, which is authorized and regulated by the FCA and in respect of certain aspects of its activities by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). This material is directed only at persons (Relevant Persons) who are classified as eligible counterparties or professional clients under the German Securities Trading Act. This material does not constitute investment advice, a solicitation to invest in financial instruments or financial analysis within the meaning of Section 34b of the German Securities Trading Act. It does not meet all legal requirements designed to guarantee the independence of financial analyses and is not subject to any prohibition on dealing ahead of the publication of financial analyses. This material does not constitute a prospectus for the purposes of the German Capital Investment Code, the German Securities Sales Prospectus Act or the German Securities Prospectus Act. ■ In Hong Kong, this material is provided to you by Wellington Management Hong Kong Limited (WM Hong Kong), a corporation licensed by the Securities and Futures Commission to conduct Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), and Type 9 (asset management) regulated activities, on the basis that you are a Professional Investor as defined in the Securities and Futures Ordinance. By accepting this material you acknowledge and agree that this material is provided for your use only and that you will not distribute or otherwise make this material available to any person. ■ In Singapore, this material is provided for your use only by Wellington Management Singapore Pte Ltd (WM Singapore) (Registration Number 201415544E). WM Singapore is regulated by the Monetary Authority of Singapore under a Capital Markets Services Licence to conduct fund management activities and is an exempt financial adviser. By accepting this material you represent that you are a non-retail investor and that you will not copy, distribute or otherwise make this material available to any person. ■ In Australia, Wellington Management Australia Pty Ltd (WM Australia) (ABN19 167 091 090) has authorized the issue of this material for use solely by wholesale clients (as defined in the Corporations Act 2001). By accepting this material, you acknowledge and agree that this material is provided for your use only and that you will not distribute or otherwise make this material available to any person. Wellington Management Company LLP is exempt from the requirement to hold an Australian financial services licence (AFSL) under the Corporations Act 2001 in respect of financial services, in reliance on class order O3/1100, a copy of which may be obtained at the web site of the Australian Securities and Investments Commission, <http://www.asic.gov.au>. The class order exempts a registered investment adviser regulated by the SEC, among others, from the need to hold an AFSL for financial services provided to Australian wholesale clients on certain conditions. Financial services provided by Wellington Management Company LLP are regulated by the SEC under the laws and regulatory requirements of the United States, which are different from the laws applying in Australia. ■ In Japan, Wellington Management Japan Pte Ltd (WM Japan) (Registration Number 199504987R) has been registered as a Financial Instruments Firm with registered number: Director General of Kanto Local Finance Bureau (Kin-Sho) Number 428. WM Japan is a member of the Japan Investment Advisers Association (JIAA) and the Investment Trusts Association, Japan (ITA). ■ WMIL, WM Hong Kong, WM Japan, and WM Singapore are also registered as investment advisers with the SEC; however, they will comply with the substantive provisions of the US Investment Advisers Act only with respect to their US clients.