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Oil Price Implications

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* Early Assessment
* Global Impact More Relevant
* Direct Energy Exposure/Risk Small
* Economically Positive in 80% of the World

Current energy sector dynamics are increasingly influencing investment strategies, with overly-simplistic local and geographic conclusions that are creating opportunities to buy financials.

While considerable attention is being given to short-term negatives in the U.S. energy sector, particularly to the financial sector servicing it in states like Texas and Oklahoma, the global implications seem more dramatic and worthy of focus. The U.S. economy is growing much more strongly than Europe or Japan and is receiving more of the lower cost energy benefit than regions with weaker currencies than the USD (just about everywhere.)

The biggest negative is clearly the socio-political stress on Russia and the Middle East, where fundamental instabilities have steadily worsened over the last few years. This is largely unknowable and/or unanalyzable for U.S. financial sector investment strategy. The biggest positive is global growth, both in the U.S. and externally.

U.S. interest rate impact is unclear. At first glance bears have seized on the inflation-dampening effects of lower energy prices while bulls see the economic upside driving the Fed closer to tightening. Both conclusions are overplayed in our view. We would lean more toward the latter, partly because the Fed historically defaults to inflation metrics that exclude or adjust for energy and food prices.

The continuing slide in oil prices still remains less than that experienced during the recession. At $67/barrel for West Texas crude ($70 for Brent), the recent 40% drop since summer compares to a 70% decline then, in less than nine months. Even after a rebound, oil prices remained down 45% from the prior peak for another two years.

This comparison is distorted by a demand-driven slide during a severe economic period versus a more supply-driven slide in a moderately growing economy. It is worth noting that the domestic energy sector sustained little direct damage during this far more stressful environment. Conversely, some will argue that robust, aggressive investment in potential production based on higher price assumptions has elevated the sector's overall vulnerability. We lean against this as well. Oil field exploration and development is a mature sector that has experienced both massive historical price swings as well as substantial technological advances. Shale is clearly a new and important dimension in supply, but in reality less vulnerable in that development costs are much lower and field-life much shorter, giving it a more variable, discretionary and manageable investment cycle without the serious, sunk costs of more traditional exploration.

The average loan growth for Southwestern banks declined to 1% by early 2011 compared to a 10-12% trend prior to the recession (un-weighted, year-over-year basis.) The current average growth has been 15% for the last 12 months, already decelerated from 24% during the previous 12 months. It is impossible to ascertain how much was recession-related as the oil price decline was primarily a result of the recession.

Energy-related loans for banks headquartered in the region average approximately 15%+ of total loans. Vulnerability rests in exploration and supporting servicing. Roughly two-thirds of energy portfolios are to existing production and supporting servicing which is comparatively insensitive to the short term price of oil. Consequently, while there will be slower O&G lending by banks, the impact on overall loan growth should be modest with exposure in the vicinity of 5%. The impact on bank credit quality should likewise be modest as relative exposure is small and financial leverage has come heavily from the high-yield bond market. There will obviously be individual exceptions with newcomers to the industry deserving the most scrutiny.

The current outlook for oil price is not expected to meaningfully deteriorate U.S. GDP growth, if at all, as lower energy prices are also an important stimulant to GDP.

Fixed investment in "Explorations, Shafts & Wells" rose by $40 billion (per annum) from its 2008 average to $157 billion as of the third quarter, reflecting an 0.8% increase to 5.6% of total U.S. private fixed investment (PFI). Personal consumption expenditures (PCE) grew by 19% over this period while "Gasoline & Other Energy Goods" remained essentially flat. Had this category kept pace with PCE growth it would have consumed an additional $80 billion (per annum) from PCE. Instead, G&E's share of PCE dropped 0.7% to 3.4% currently.

On the surface, the presumed, direct benefit to consumption was double the increase in fixed investment. Of course these coarse calculations cannot capture other than the most direct ramifications of energy price movement. Additionally, a substantial portion of O&G fixed investment can be considered largely insulated to oil price as it is dedicated to existing production and maintenance, suggesting spending will continue to grow even without production growth.

Data on employment by discrete sector cannot capture the ancillary impact in other sectors. Having said that, the number of jobs in energy exploration and production is probably smaller than most think: Direct oil and gas employment is less than 2/10ths of 1% of national employment. In Texas O&G represents only 1% of the total.

Since the end of the recession approximately 55,000 net new jobs came from the oil and gas sector -- 35,000 from Texas which represented only 2.4% of the total 1.5 million net new jobs in that state. It is also noteworthy that O&G employment fell 30% in the 1990s without dislodging the state's economic prowess relative to the nation. While energy is clearly more important to Texas, other factors better explain the resilience and vibrancy of its economy.

Future repercussions in a global context will depend mostly on the course taken by suppliers. It is too early to know. Historically dominated by OPEC, supply is usually and eventually restrained to preserve longer term value and income from finite hydrocarbon resources. The meaning of "finite" has dramatically changed, however. OPEC has become less influential and is motivated by numerous political cross-currents. We can no longer assume OPEC is a force for price elevation, and its recent inaction supports this contention. If anything, OPEC probably has more reason to allow lower pricing to blunt new supply development.

The U.S. supply factor is new and untested but consequential. Investment, left to the intersection of free demand and supply factors is initially unlikely to succumb to price volatility. Shale, the "new" energy variable, is also easier to modulate with price trends, but its strategic importance for the U.S. is quite high as similar geographies world-wide have been more cautious about fracking.

Oil price, on balance, could remain low for the foreseeable future without a concerted effort to constrain supply. There are various threshold levels that presume to impact production, with below-$60/barrel considered the first tipping point if maintained for multiple months. If this occurs, it remains a broadly-based net plus for global expansion. The top 20 countries represent 79% of global GDP and within them less than 19% of GDP is based in countries that are seen as heavily dependent on oil exports. All of the top 5 countries are net beneficiaries.

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