EQUITY

What's Really Driving Oil Market Volatility?

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Recent attacks on oil tankers in the Middle East have grabbed headlines and revived geopolitical fears. However, Fred Fromm, portfolio manager of Franklin Natural Resources Fund, says other factors, namely global oil supply-demand dynamics, are more responsible for the bouts of oil market volatility we've seen this year.

With the June 13 attacks on two oil tankers near the Strait of Hormuz—a vital Gulf of Oman waterway—investors may be wondering if these types of disruptions could derail the global oil market. That's understandable considering about 40% of the world's traded oil passes through the strait.[1]

In our view, it's challenging to forecast the direction of oil prices based on the tanker attacks alone. These types of geopolitical tensions are ever-present and tend to shift in importance over time. Russia's growing influence in the Middle East and coordination with Organization of Petroleum Exporting Countries (OPEC) is one recent example. Another is Iran's regional influence and interplay with the United States, which has led to various proxy wars and the attacks on tankers from other countries.

As long-term investors, we've always had to consider a myriad of issues when analyzing the oil market. As a result, we test a range of outcomes when analyzing companies and their securities.

Is Slowing Demand for Oil Really a Concern?

At the moment, we think the market seems to be more focused on the weak global demand outlook for oil than a supply disruption after the recent tanker attacks. Crude oil prices descended rapidly from April's six-month highs in May and the first half of June as the intensifying US-China trade dispute dimmed the outlook for manufacturing and energy demand growth.

In its June oil market outlook, the International Energy Agency (IEA) slightly lowered its 2019 demand growth forecast to 1.2 mb/d from 1.3 mb/d in May.[2] The IEA also predicted demand would likely begin outstripping supplies in the current quarter—the first such imbalance since early 2018.

US oilfield production helped lessen fears of a supply disruption. Production has been running around a record 12.0 million barrels per day (mb/d), up from 10.6 mb/d a year ago and 9.2 mb/d two years ago.[2] In addition, US oil inventories surged to nearly 477 mb in the latter half of May, the highest total since July 2017. [2]

However, many analysts remained wary that steady US output and higher production from OPEC and its allies will leave the market well supplied if OPEC elects to raise output at the mid-point of 2019. In January, the cartel and its partners reached an agreement to voluntarily curb production through June, which may be extended at a meeting in early July.

Current Oil Outlook and Strategy

The volatility that developed in late April continued in May and June as investors became increasingly concerned with tariff actions and the potential effect on global growth. As fuel—and therefore oil demand—have historically been closely linked to gross domestic product growth, expectations are increasing that demand will weaken and lead to lower realized prices for producers.

As investors in natural resources markets that are highly influenced by economic trends, we think one's view needs to be dynamic. Recent trends seem to clearly show signs of slowing economic activity, although indicators are mixed and could be influenced by US-China trade and tariff concerns that may prove temporary if they can be resolved in the near future.

That said, we believe supply and demand factors need to be considered along with equity valuations and what they imply about investors' prevailing views. Although we're dealing with heightened uncertainty, in our view, the resulting equity market weakness has created many investment opportunities in high-quality companies. We think these equities should prove to be more resilient if a more severe downturn unfolds, while still offering compelling upside potential in a recovery.

While potential supply disruptions always exist—and we have seen it first hand in Venezuela—the recent tanker attacks in the Middle East have increased the potential for more significant curtailments of oil supply. However, it is difficult to predict the timing, severity and longevity of such outcomes, making them difficult to incorporate into scenario analysis.

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Franklin Natural Resources Fund

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Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

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1. Source: Bloomberg.

2. Source: IEA Oil Market Report, June 14, 2019.