Capital International Asset Management

Capital International Perspectives

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Why the world may keep paying for "black gold"

While Canada's manufacturing sector continues to suffer a series of blows, our commodities sector has powered ahead, thanks to rising global prices — especially for oil. But what is driving this upward trend, and can it continue? We spoke with affiliate Capital World Investors* energy analyst Jacinto Hernandez to get his perspective on the matter.

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How high will oil go?

I don't think it's wise to prognosticate on short-term moves in the oil price. What I will say is that demand is going down because it has to. There's no supply. Demand, by definition, cannot grow faster than supply, unless you have an inventory supply, and you're not seeing inventories build at all right now. That's the dislocation — how do you get from zero supply growth to zero demand growth? The answer is sky-high prices.

Supply constraints are a geologic issue. Over the past 30 years, we have consumed more oil than we've found. We found a lot of oil in the '60s and '70s and we've been living off that backlog of discovery ever since. That's a structural problem, not a cyclical one. Discoveries are also getting smaller. A world-class discovery today is about a billion barrels of oil, which is 15 days of consumption.

Are Alberta's oil sands the answer to global supply worries?

The oil sands contain an enormous amount of supply, but the physics of getting it to market are preventing that oil from filling the gap the world is facing today. The problem, of course, is that oil from the oil sands has no reservoir energy; it doesn't naturally flow. Currently, a $4 billion project in West Africa will produce 250,000 barrels of oil per day in five years and decline at some pace after that. In Canada, a project with a similar budget may get you 30,000 or 40,000 barrels per day.

The oil sands in total right now are producing about a million barrels per day. It took them about 30 years to get there. They will be producing closer to 2 million by 2010. That's meaningful, but it's not enough to change the course of an 85 million barrel per day market.

That said, Capital was one of the earliest investors in the oil sands. We've been the largest shareholder in one of the largest companies there for at least a decade and we funded the Athabasca oil sands project in its private stages. We believe the oil sands remain filled with opportunity.

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*Capital World Investors is a division of Capital Research and Management Company, one of the subadvisors to the Capital International portfolios.

So the difficulty and expense of extracting oil notwithstanding, the oil sands are a good investment?
That's the duality. On the one hand, the oil sands don't make much of a dent in solving the world's supply issues; on the other hand, the oil sands offer great investment prospects. The opportunities lie not just with the producers of the crude; it has knock-on effects for the engineering construction industry, for the companies that have technologies to make the facilities, the pipeline companies and it also has implications for the currency. In my opinion, I believe the oil sands are a good investment.

But the important thing in this climate is to have globally diversified oil holdings. I already mentioned Africa, and one of the most exciting discoveries in a long time just happened off the coast of Brazil. You want to be able to capitalize on the opportunities oil presents wherever they may be.

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Some analysts have said that speculators are driving up the price of oil. Do you agree with them?
I don't think that so-called speculation impacts the price of crude over the medium term. Daily moves can certainly be affected by the paper markets, but oil is a product that's consumed every day and that means the price is, at some level, real. It's not a fiction. Look at supply growth since 1997; non-OPEC supply excluding the former Soviet Union has ceased to grow. And Russia is declining this year for the first time in a decade.

Ten years of no supply growth is a big deal and is the prevailing factor behind the surge in the price of oil from \$20 to \$140.

Who's buying all this oil?
What you're seeing now is a redistribution where emerging markets are continuing to demand oil and the developed world is giving up some of its oil. There is clearly some demand destruction happening in the West — yet prices aren't coming down. That's because, in the global context, you're still seeing demand growth.

In the United States, in particular, oil isn't used very efficiently. That means, when prices spike as they have, there's a lot of room for people to cut back — smaller cars, to take an obvious example. In the emerging world, people are much more efficient with their use of oil. They need that incremental barrel because they don't have any fat to cut.

What is China's role in the current environment?
China is a huge consumer of oil. If, at some point, oil got to be so expensive that China started to pull back its consumption, then you'd start to see global prices come down after a period of time. But as oil prices go down — if it's price that's constricting demand — then lower prices would argue for higher demand. The market would simply rebalance. Now, while a period of slow growth in China is conceivable at some point, I would posit that five or ten years from now, they'll be using more oil than they use today. In the West, we might not be.

We try to think in five-year increments because it's very easy to get one year wrong; so many surprises can occur. But if you think longer term, China wants to develop, India wants to develop, Brazil wants to develop, the Middle East wants to develop, Russia wants to develop. These countries are going to require more energy and they will pay for it.

Is there any reason not to remain bullish?
I have colleagues who don't entirely share my views. For instance, there is a portfolio manager in our London office who has invested in energy and oil services companies for quite a number of years. He was originally of the view that political risks would influence the price of oil. Over

the last couple of years, strong demand for energy from China and India and the strong world economy have made him want to maintain a significant exposure to energy-related companies.

Until recently, he believed that, while it was hard to know exactly how current issues in the credit markets were going to work out, they would not have a major disruptive effect on global demand for commodities. This manager is now more concerned that problems in the credit markets could have an impact on global economic growth. He describes himself as increasingly nervous about bullish convictions on the outlook for energy and commodity companies.

What are your views on natural gas?

In five years we might be very short on gas. But in the near term, there's a reasonable risk of a glut because you had a lot of liquid natural gas (LNG) projects sanctioned in 2004 and 2005 that are coming online in 2009 and 2010. That could create a much looser balance for global gas than we've seen this year, when demand for gas probably grew three billion cubic feet (bcf) per day while the supply for globally traded gas grew by only 1.5 bcf. This probably will not be true come 2010 once the new supply starts to flow.

On the flip side, we haven't really sanctioned any major LNG projects since 2005, so when you get past the hump in 2010, assuming the projects are on time, you really have very little gas coming online. What could be a loose market may tighten very quickly.

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There will also be demand for natural gas for power generation. There's very little room for growth in coal-fired or nuclear plants, so it all has to be gas, which argues for strong demand growth. In addition to that we're probably going to have some sort of carbon legislation, shutting down existing coal-fired plants, which would also boost demand for natural gas.

What advantages do Capital International's affiliates have in markets like this?

If you've followed a company for 10 or 15 years like many of us here have, you may have known the CEO before he was in that role. You have a deep relationship and you're able to calibrate people. You can remember managers who have not been good stewards of capital, which helps avoid problems in the future. You also remember managers who have done well, and that provides a competitive advantage. Most importantly, you're able to put things into perspective when others may not if they've been investing for a shorter period of time or not been following an industry for as long. ■