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Brompton Insights

October 2021

Is Oil Re-Energized?

Fund in focus: Brompton Oil Split Corp. (OSP)

The energy sector has been the best performing sector both on a one year and year-to-date timeframe as the price of oil rebounded at a record pace since the COVID-19 lows. In addition, the rotation into value given reflation of the yield curve has been a tailwind for energy equities. With oil futures hovering around US$80 per barrel, activity in the options market has been bullish. Options with a US$100 strike price, which is a psychological level for oil, are the most widely held across various expirations, and daily trading activity is equivalent to more than a day's worth of oil output in the global economy, according to Bloomberg. This could mean that oil prices gravitate towards this level over time.

The price of oil can be used as a barometer of economic activity, especially when economic growth is increasing. During past oil demand shocks, both the price of oil and the S&P 500 experience strong returns; however, supply shocks that drive oil higher have historically been a headwind for the equity markets, as shown in the table below. In addition, oil has the strongest inflation beta relative to gold, equities and bonds, according to Bloomberg.

Year	Event		12 Month Forward Returns	
		Shock Type	Oil Price	S&P 500
2020	COVID-19	Demand	258%	39%
2016	Economic Recovery	Demand	72%	22%
2009	Great Financial Crisis	Demand	91%	50%
2003	Iraq Invasion	Supply	58%	11%
2002	Iraq Invasion	Supply	68%	-25%
1998	Economic Recovery	Demand	125%	18%
1989	Iraqi Invasion of Kuwait	Supply	62%	-15%
1986	Economic Recovery	Demand	78%	34%
1979	Iranian Revolution	Supply	118%	-4%
1973	OPEC Oil Embargo	Supply	131%	-35%

Source: Verdad (October 18, 2021), Brompton

While sentiment is bullish, downside risks can be underappreciated in our view, and investors have been wondering if there is further upside for oil and energy equities. The answer to this is a nuanced one. If forward expectations of growth have peaked, which is supported by the ISM manufacturing index that peaked in March and signs of slowing in China's economy, then demand for oil will not be as robust as experienced during the pandemic recovery. There are also only five instances over the past 80 years where the oil price doubled in a year. However, we believe that investors should remain bullish on oil prices given the long-term mismatch between supply and demand resulting from green initiatives. According to the International Energy Agency, in order for countries like the United States to become carbon neutral by 2050, oil use must peak by 2025; however, based on current investments, green power generation won't be enough to supplant oil consumption until 2035.

As a result, we believe investors should adopt active strategies with exposure to energy given the inflationary environment we are currently in. A recent research paper[1] that examined data across the US, UK, and Japan over a 95-year period concluded that commodities have positive returns during inflation surges. Trend-following provides the most reliable protection during important inflation shocks, and active equity factor strategies also provide some degree of hedging ability.

Brompton's Approach

Brompton Oil Split Corp. ("OSP", "OSP.PR.A") offers exposure to large capitalization North American energy issuers with significant exposure to oil. In addition, we actively manage the energy weighting across our global dividend portfolios (BDIV, GDV, DGS, EDGF). We also use an actively managed call writing overlay to harvest volatility risk premium which enhances risk-adjusted returns.

[1] "The Best Strategies for Inflationary Times (March 29, 2021 Neville et al), Man Group, Duke University.

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