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Allianz Global Investors Insights

Global View

Why Bears and Oil Don't Mix

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Global Strategist

In an article we published in May 2017, when Brent crude was around USD 50 per barrel, we explained why we expected the price of oil to grind slowly higher. In our view, solid global demand, renewed supply constraints and still-significant underinvestment made a clear case for investing in the energy sector.

With Brent recently breaking the USD 60-per-barrel barrier, some investors are taking a fresh look at a sector that we have been constructive on for some time. Yet the consensus view on oil is still bearish – a stance that we believe is not supported by the facts. The cure for low oil prices is low oil prices.

Multiple factors are constraining the oil supply

Global demand remains resilient at 97 million barrels a day, but oil fields are being steadily depleted. Oil producers collectively need to add about 7-8 million barrels a day in new production to keep up with demand growth and production declines, but that is difficult to do with prices so low. Increased production requires increased investment – and many firms simply lack the capital to expend after the 2014-2015 collapse in prices. Even though the price of oil has nearly doubled since January 2016, producers still have little scope to invest to grow production or are loathe to do so given price volatility. Short-term survival is winning out over long-term investments.

> Oil at today's prices leaves producers little scope to invest to grow production

There is also a geopolitical angle to the argument for higher oil prices. In May, members of the Organization of the Petroleum Exporting Countries (OPEC) agreed to extend production cuts as a way to boost prices. Yet falling tax revenues are forcing some petro-states to drain the sovereign wealth buffers they built up during the good times. This makes their institutions more vulnerable, which raises the risk of social upheaval. Turmoil in areas such as Libya, Venezuela, Algeria and the Iraqi region of Kurdistan could easily stoke fears of supply constraints – and push up prices.

US shale gas looks better than shale oil

Given that almost none of the large oil-producing nations is happy with the current price of oil, and that OPEC itself has traditionally had the power to rebalance markets, one question arises: What is throwing the traditional supply/demand relationship off kilter?

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Allianz Global Investors

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Global View

The answer is the US shale industry, which has transformed the world order for energy in just five years. By using new technologies to unlock vast reserves of shale oil and gas, US firms caused oil prices to halve, US consumer energy spending to hit multi-decade lows and OPEC to lose much of its market cartel power.

We believe the veritable bonanza in natural gas that the US shale industry created will have profound consequences for many gas projects globally, with the US cementing its status as a low-cost producer sitting atop huge reserves. In our view, the supply growth of US natural gas, driven by shale gas, is not only prolific, but sustainable.

But the boom in US shale *oil*, which currently represents about 60 per cent of all oil-supply growth since 2008, looks less sustainable to us. We challenge the market consensus that this shale-oil growth will be maintained or even accelerated at lower and lower production costs. US shale oil is higher up the cost curve on a full cycle-adjusted basis than the market assumes.

We challenge the consensus view that shale-oil growth will accelerate while production costs move lower

For the shale-oil industry to grow, it must overcome a steep initial decline curve by constantly drilling more wells. However, new wells are being added at an increasingly slower pace as oil-service resources tighten and profitability issues re-emerge. The cost of drilling itself is going up by 10-20 per cent this year, according to some estimates – more evidence that US shale operators need higher prices just to stay operating.

Yet the US shale industry is by and large a cash-flow-negative one, reliant on funding from banks and investors to provide enough cash to stay in business. Indeed, US energy companies have issued approximately USD 100 billion in high-yield bonds in an attempt to raise the capital they need for investment. The problem is that this also raises the spectre of another boom-and-bust event for the industry, particularly in a rising-interest-rate environment.

For their part, US shale producers are seizing opportunities to hedge when prices go up, securing some of their operating cash flows and partially safeguarding future production. Without higher prices and the chance to hedge, many US shale companies will find it increasingly challenging to stay in business. For the first time, we are also beginning to see increasing evidence of US energy and production (E&P) companies becoming more disciplined with their capital, with many pledging to invest at levels at or below their cash flows. This should bolster E&P returns and reduce future growth in oil supply.

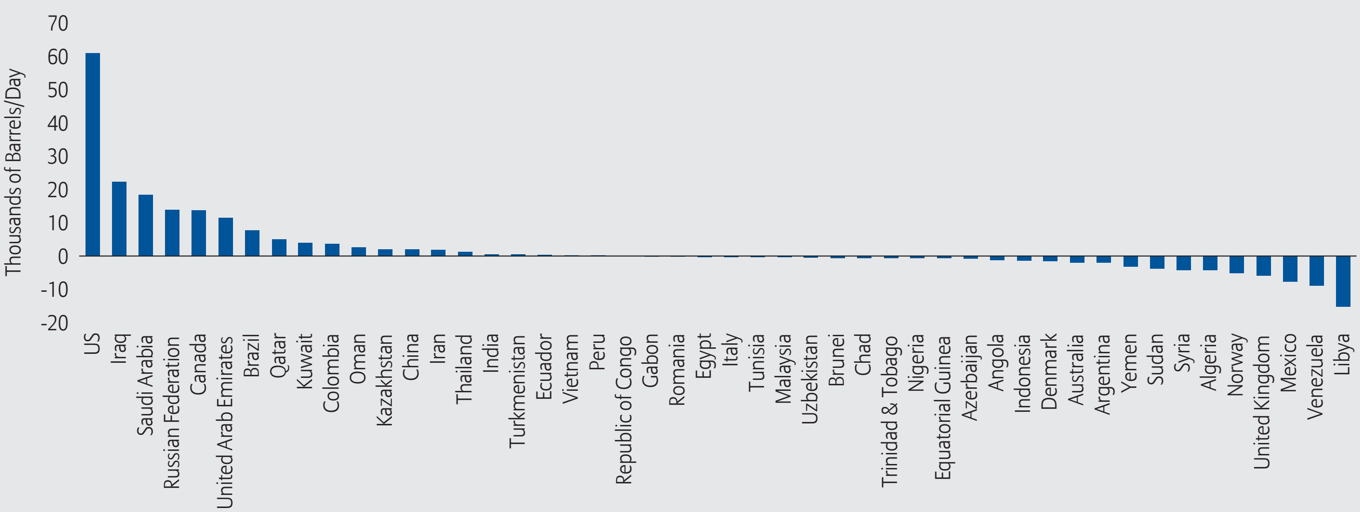
Without higher oil prices, many US shale companies could face financial challenges

Investment implications

We believe that excessive optimism over the prospects for US shale oil has contributed to unnecessarily low valuations for many global energy companies. Without this dream of US energy independence in the market, we believe energy names would be more highly valued. This, in turn, would enable the energy sector to offer stronger returns to investors – and it would enable energy companies to make much-needed investments in their businesses to address the prospect of oil-price spikes on supply shortages.

Can US Shale Continue Its Sky-High Growth?

Country-by-country share of world oil production growth, 2016 vs 2008.



Source: BP Statistical Review of World Energy. Data as at 23 June 2017.

Perspective on Asia Pacific

Mr Xi Reveals His Blueprint for China's 'New Era'

Raymond Chan, CFA
CIO Equity Asia Pacific

Every five years, the top governing body of China's communist party meets to endorse important decisions and announce changes to its leadership. Since the 24 October conclusion of the latest National Party Congress (NPC) in Beijing, investors have been analysing the results to determine the direction of the world's second-largest economy.

While no major surprises were announced, some investors expressed concerns about the continued lack of transparency on how the Communist Party of China (CPC) makes its decisions. At the same time, the market seems to have been reassured by the appearance of improved political stability and policy continuity – and by the CPC's clear vote of confidence for the continued leadership of General Secretary Xi Jinping.

Mr Xi's leadership is firmly established

During the NPC, Mr Xi spent more than three hours delivering his long-anticipated report to Congress members. While his overall objective continues to be "growth with stability", he put more emphasis on the absolute leadership and ideology of the CPC. This was in line with the market's expectations. There were also signs that Mr Xi has strengthened his authority within the CPC:

- The party's new constitution now includes Mr Xi's thoughts among its guiding ideologies – right alongside Mao Zedong's and Deng Xiaoping's.
- Breaking with tradition, the conference concluded without naming a clear successor to Mr Xi, paving the way for him to continue leading the party after his allotted second five-year term expires.

Mr Xi is set to continue leading China after his second five-year term expires

Mr Xi's blueprint: "Socialism with Chinese Characteristics for a New Era"

While many of the general secretary's broad policy objectives have been mentioned repeatedly in the past few years, his new blueprint contains key items that are likely to have a lasting impact on China's future development. Deeper reforms, an emphasis on industry upgrades and innovation, and tighter environmental protection restrictions are among the areas that could have implications for investors.

2020 vision and beyond

No specific economic growth targets were announced during this NPC; instead, a longer-term development plan for the period between 2020 and 2050 was unveiled for the first time. Mr Xi aims to make China a modern socialist country by 2035 by boosting its cultural influence, growing the size of its middle class, establishing a more equal society, improving public services and a creating a cleaner environment. Building on this foundation, China aims to become an affluent country of advanced and balanced development by 2050 – though finding the right combination of growth, stability and reform will continue to be the key challenge ahead.

6 focus areas for China's economic development

General Secretary Xi reiterated the importance of structural transformation in China and highlighted six areas of economic development focus:

1. Supply-side reform – In addition to removing excess capacity, Mr Xi is emphasizing an efficient use of resources
2. Research and innovation
3. Rural area development
4. Collaborated regional development
5. Improving China's socialist economic system (for example, by reforming state-owned enterprises and promoting private-sector development)
6. Economic liberalization – Achieved through China's "One Belt, One Road" policies to boost regional trade and investment, and through trade liberalization

Investment implications

We expect the market to have a mixed reaction to the news – or lack of news – announced at the latest NPC. While the low level of transparency and the absence of checks and balances may make some investors sceptical about China's system, the market should welcome improved political stability, policy continuity, deeper reforms and financial deleveraging.

Mr Xi's comments in Beijing also suggest that certain investment themes – including consumption upgrades, electric vehicles, automation, IT infrastructure, medical services and environmental protection – may be growth areas for China's market, at least until the next NPC in five years' time.

Key China-related investment themes include electric vehicles, automation, IT infrastructure and environmental protection

RiskMonitor 2017

How to Be a Risk Leader, Not a Follower

A strong showing by equity markets in 2017 may simply have added to investors' uncertainty as they gauge what to do next. Taking some risk to earn some return may be the best way forward, but finding the optimal balance between upside potential and downside protection can be difficult.

The good news is that a select group of investors are getting a grip on what we call the "risk-return conundrum". We've called them Risk Leaders because their attributes pave the way for others to enhance their own risk approaches.

This insight is based on our *RiskMonitor 2017* study, which canvassed the views of more than 750 institutional investors globally. The findings underscore the unique challenges of today's investment environment, with geopolitics emerging as investors' primary concern for the first time. Nearly three out of five (59 per cent) say that recent political events have led to an increased focus on risk management in their institutions.

Optimizing the "risk budget" against this backdrop is tougher than ever. But there's evidence that our Risk Leaders – numbering around one-fifth of the investors we surveyed – are better-equipped for this challenge: Not only do they express greater confidence in their risk capabilities, but they outperform their peers in several key areas related to risk-taking and their investment approach.

So what are the hallmarks of Risk Leaders – and how do their practices translate into improved potential investment performance?

> **We've found a group of Risk Leaders who have greater confidence in their risk capabilities and outperform in key areas**

Risk leadership starts at the top

Our research shows that Risk Leaders have strong risk cultures that start at the highest levels of their organizations. Compared with other investors, a significantly higher percentage of Risk Leaders say that senior management at their organization is dedicated to ensuring and supporting sound risk management practices (88 per cent vs 62 per cent of other investors).

This is perhaps the most startling way in which Risk Leaders differ from their peers, indicating that the focus on risk needs to be driven from the top to set the tone for the rest of the organization.

Among the other key characteristics of Risk Leaders:

- They are more likely to see risk management as the responsibility of everyone in their organization, putting in place organization-wide incentives to reward risk management across teams (48 per cent of Risk Leaders vs 28 per cent of others).
- They are more willing to invest in improving risk management. Within this group, 59 per cent say their organization is putting more money towards investment risk management strategies this year (vs 41 per cent of others).
- They are also more likely to seek a second opinion: A greater number of Risk Leaders (70 per cent vs 55 per cent of others) say their organization conducts independent risk analyses of their portfolios.

> **Risk Leaders have strong risk cultures and see risk management as an organization-wide responsibility**

Improved investment performance

Given these characteristics of Risk Leaders, what is the pay-off in terms of improved performance?

- Perhaps most significantly, they are more confident in their ability to achieve their performance objectives. Fewer Risk Leaders said they had decreased their return expectations for the coming year (47 per cent vs 53 per cent of others).
- Risk Leaders are less likely to be pessimistic about meeting their return

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For Risk Leaders, the Focus on Risk Starts at the Top

Risk Investment

59%
41%

My organization is putting more money towards investment risk management strategies in the coming year.

Independent analysis

70%
55%

My organization conducts independent risk analyses of our portfolios (ie, investment risk analysis independent of portfolio management).

Incentives

48%
28%

My organization has incentives to reward risk management across teams.

Senior Management

88%
62%

The senior management at my organization are dedicated to ensuring and supporting sound risk management practices.

% Agree | Risk Leaders | Others

Source: AllianzGI *RiskMonitor 2017*.

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RiskMonitor 2017

objectives. While 60 per cent say it's increasingly difficult to meet return targets, this is less than the two-thirds of other investors who agree with this statement.

- Risk Leaders are more committed to active investing. A higher number believe actively managed portfolios are worth the cost – 56 per cent compared to 46 per cent of others. They are also more likely to think there is alpha to be found in today's markets.

Agility along the risk-return spectrum

Overall, Risk Leaders have a greater armoury of investment approaches at their disposal as they navigate the risk-return spectrum. Nearly three-quarters say they have a strong understanding of alternative assets, compared with less than two-thirds of other investors, suggesting that Risk Leaders have greater flexibility to diversify their portfolios and optimize their risk budgets.

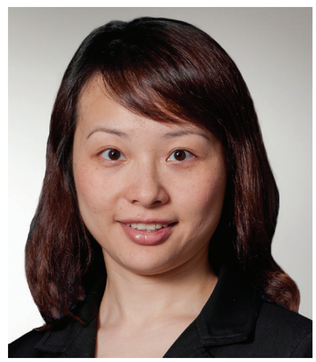
While all of this adds up to a more confident positioning for Risk Leaders, their experience shows that a few simple steps can make a big difference – underscoring an optimistic outlook for the industry as a whole.

To learn more about Risk Leaders, visit **www.allianzgi.com/riskmonitor**

Respondents to our *RiskMonitor 2017* survey were drawn from a variety of "asset owning" institutions: pension funds, foundations, endowments, sovereign wealth funds, family offices, banks and insurance companies. The research was carried out via an extensive global survey during April and May 2017. The 755 institutional respondents were split evenly by region: 250 from Europe, 250 from North America and 255 from Asia Pacific. Our Risk Leaders comprise around one-fifth of global respondents. We define them as those who responded "Agree" or "Strongly Agree" to three questions: "Risk management is an integral part of our investment process and actively addressed on a systematic, ongoing basis", "My organization has a strong risk management culture", and "I am confident that our portfolio has appropriate downside protection for the next tail event."

Grassroots℠ Research

China Is Fuelling Consumption with Consumer Lending



Joey Wong
Grassroots℠ Research Analyst

Short-term consumer loans in China have shown rapid growth in 2017, and a new study from Grassroots℠ Research – Allianz Global Investors' proprietary investigative research division –found that these loans are not only widely available, but are being used largely for personal-consumption purposes. This supports the idea that China's policymakers are succeeding in their goal of moving China from an export-led economy to a consumption-driven one.

Short-term consumer loans are widely available and used largely for personal consumption

To better understand the level of consumer indebtedness in China and the change in attitudes towards taking consumer loans, we recently conducted a two-tier study:

- Interviews with 20 bank branch managers in first- and second-tier cities
- Online surveys with 526 consumers throughout China

What bank branch managers told us

More than three-quarters of the bank branch managers we spoke with reported that non-mortgage consumer loan growth had recently moved higher – in part because China is hoping to tighten up its mortgage loan and corporate loan businesses. As one source explained, "We have been ordered to decrease our mortgage loan business in order to cool the overheated real estate market. However, [interest in] non-mortgage consumer loans is growing fast and receiving more support from all constituents".

The branch managers also told us that these loans typically have durations of two to five years and are primarily used for household expenses (such as home renovations), travel, weddings, car purchases, education and medical expenses. This aligns with China's efforts to strictly regulate these loans so they can be used only for household spending.

These strictly regulated loans can be used only for household spending

What we learned from consumers

When we asked our online respondents about their attitudes towards taking short-term consumer loans, several findings stood out:

- Consumer loans are becoming more widely available: Almost three-quarters of our respondents noted a slight to significant increase in the availability of consumer loans in the last year –

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Grassroots℠ Research

including credit cards, personal loans from banks and other channels such as peer-to-peer (P2P) lending.

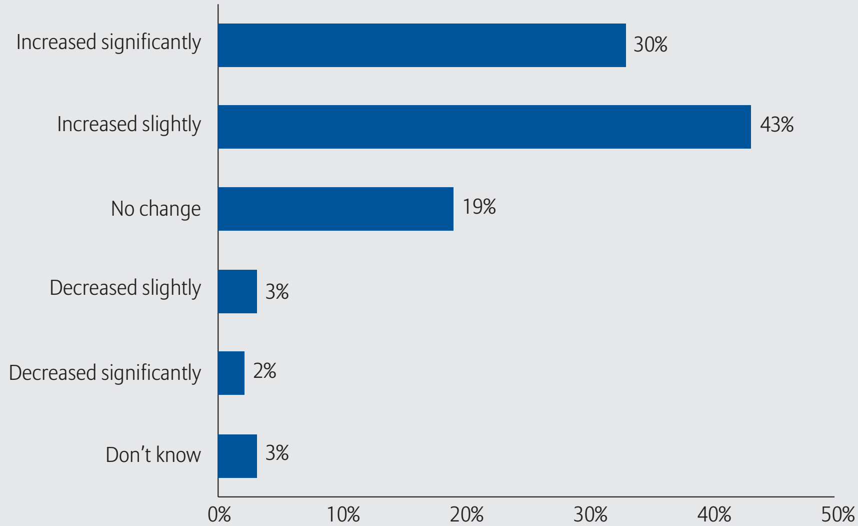
- Most people have consumer loans: 76 per cent of all respondents revealed that they carry some kind of personal loan debt.
- Most use these loans for personal consumption: In an echo of what bank branch managers told us, 71 per cent of our online respondents said that in the last 12 months, they used their consumer loans for personal consumption.

Clear evidence of rising consumer credit levels

Financials Research Analyst Helen Ye finds these results to be insightful when viewed in the context of China's concerted effort to reduce the country's high debt levels: "While broad credit growth has declined in China in the big financial deleveraging trend this year, consumer credit has grown more than 20 per cent year over year – far exceeding the economy's total credit growth of 12-14 per cent. This increased appetite for consumer loans reflects a strong demand for upgraded auto purchases and for increased spending on tourism, health care and education."

Consumer Credit Is Getting Easier to Find

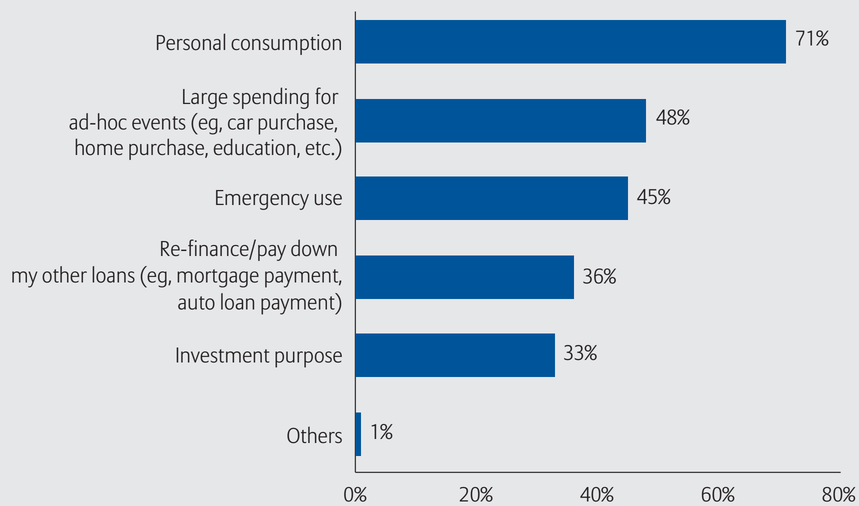
Question: Have you seen a change in the availability of consumer credit (credit cards, consumer loans from banks and credit from other channels) vs 12 months ago?



Source: Grassroots℠ Research. Data as at May 2017.

Consumers Are Using Their Personal Loans for Consumption

Question: What are the major uses of the credit card loans or personal loans that you obtained in the past 12 months?



Source: Grassroots℠ Research. Data as at May 2017.

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