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An Oil-Services ETF Ready for Rising Prices

Look to domestic service providers in a rising oil-price environment.

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Fueled by geopolitical uncertainty and tightening global supplies, oil prices have risen and production has increased in North America. Unconventional sources of production in the United States have led to a reduction in import levels not seen in a decade, but tensions in historical hot spots continue to keep current oil production only slightly above consumption.

Geopolitical tensions have failed to abate, as the U.S. recently placed a second aircraft carrier in the Persian Gulf. The potential closure of the Strait of Hormuz has fueled fears of a globally impactful supply shock. At the same time, spare capacity among big-name oil-producing nations has become exceedingly tight. We estimate that with only 2 million barrels per day of excess capacity, versus global oil demand of 75 million barrels a day, prices may remain elevated for quite some time. This creates the potential for an outsized runup in the event of a production shortfall.

While the potential for a supply shock exists over the near term, laggardly global macroeconomic growth could depress demand for and prices of crude. Perhaps the largest risk factor for the energy complex is the growth and sustainability of emerging-markets demand. Emerging markets, particularly China, continue to consume virtually all new crude production. We will note, however, that demand has demonstrated considerable strength even though structural weakness in China and Europe has already come to fruition.

An ETF Solution

Given these events, we see the potential economic beneficiaries to be domestic oil-service providers that cater to unconventional producers. For that exposure, we like Market Vectors Oil Services ETF (OIH), which aims to deliver the performance of the U.S. oil-equipment and -services sector. Given its extremely narrow focus, this exchange-traded fund should be treated as a satellite specialty holding to complement a diversified portfolio, albeit one that could be held for several consecutive years.

Unlike large vertically integrated oil companies Exxon Mobil (XOM) and Chevron (CVX), the companies held by this fund are highly subject to the capital-spending cycle of the industry because the bulk of their revenues are generated while companies drill new wells. This fund has little exposure to firms that actually sell, refine, and distribute oil, adding to the intensity of its exposure to cyclicality. Investors holding a position in this fund will have a positive outlook on the expansion of drilling operations.

Although this fund maintains ample exposure to some of the industry's strongest firms, given the cyclicality of commodity markets, the oil-services business is unforgiving to companies both large and small. Energy behemoths, like the aforementioned Exxon Mobil and Chevron, gauge their exploration and production needs based on the price of crude oil. As crude prices rise or are expected to, these oil majors expand drilling operations, spurring demand for rigs and related services, and vice versa. Thus, crude prices and related expectations, rather than secular factors, act as the fulcrum for oil-services demand.

Absent product differentiation, many oil-services firms lack the leverage to negotiate higher prices. These firms can, however, raise prices dramatically during periods of rabid drilling expansion when equipment and services are tight in the near term.

Portfolio Construction

The fund passively invests no less than 80% of its assets in the constituents of the Market Vectors US Listed Oil Services 25 Index. The index identifies the largest 50 firms in the oil-services sector by full market capitalization and includes the top 25, as measured by free-float market capitalization and three-month average daily trading volume. OIH levies a 0.35% annual fee.

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