Improved Sentiment Towards the Energy Sector in 2016

Sentiment towards the energy sector has generally improved during 2016. Five months in and we have seen Brent crude oil increase by 34% from $37/barrel(bl) to $50/bl and WTI (West Texas Intermediate) increase by 32% to $49/bl, as of 5/31/16. It is easy to remember the positive performance of the last few months and forget the torrid start to 2016, which saw Brent crude oil trough at $28/bl on January 20. To measure the real recovery in the sector, it is fair to mention that Brent crude oil is up 79%, as of end of May, from that low point in January.

So, do fundamentals support the improved sentiment?

Simply speaking, the rebalancing of the global oil market appears to be progressing well. In fact, temporary supply outages in Canada and Nigeria in May have likely brought the market into a near term supply/demand deficit, the first time this has happened since the start of 2014. More importantly, excluding the temporary factors, we believe that the world oil market is on a journey to rebalance that could ultimately herald higher oil prices. The main factors that are causing this to happen are:

- **US onshore oil production** (i.e shale oil production) has now declined by around 600k(thousand) bl/day between March 2015 and March 2016 and the fact that capital expenditure plans and the oil directed rig count remain at trough levels leaves us confident that US onshore oil production should continue to fall through 2016. The Energy International Agency's (EIA) own forecasts indicate a further 100k bl/day oil production declines in April and May from the major oil shale producing basins, although we note that their expectations have proved to be too optimistic in recent months. While we would argue that efficiency gains and 'high-grading' of drilling activity has allowed US oil production to perform better than guided a few months ago, we still believe that it will take time and significant capital to turn around the declining US onshore shale oil production profile. We think stabilizing US oil production is more likely to occur in 2017.

- **Other non-OPEC production** (OPEC = Oil Producing Exporting Countries) has also been declining. According to the Energy Intelligence Group, non-OPEC (ex-US) oil production has fallen by more than 300k bl/day between December 2015 and April 2016, reflecting lower investment in projects (and does not reflect the temporary reduction in production from the Canadian wildfires, which we estimate will have reduced production by around 1.0m bl/day alone in May 2016). The disruption from the Canadian fires now seems to have passed, so production from Canada could likely recover in June. Russian oil production has been particularly robust over the last 18 months, assisted by the weak Ruble, which has capped drilling and operating costs, but even there, production has started to weaken.

- **Global oil demand** maintains a steady rate of growth, with the International Energy Agency (IEA) expecting 1.2m bl/day growth for 2016. After initial concerns at the start of the year over US and Chinese economic data, it now appears that global demand has continued to react positively to generally lower gasoline prices. Most recent data for the US shows a 2% year-on-year (nearly 400k bl/day) demand increase in March 2016, the strongest demand growth data

since August 2015. All things being equal, we expect 2016 world oil demand growth to end up being higher than 1.2m(million) bl/day, assuming oil prices stay around these levels.

- **OPEC production** has remained relatively steady through 2016, averaging 33.0m bl/day so far in 2016 (most recent OPEC data for April 2016 is 33.2m bl/day). Nigerian oil production has been reduced by around 0.4m bl/day as a result of insurgent attacks on oil producing and exporting infrastructure, while Venezuelan production continues its steady decline (now at less than 2.4m bl/day). Relative to the temporary disruption from Canada, we believe that the problems in Nigeria and Venezuela reflect structural issues with respect to low oil prices, and could be sustained for some period. We believe that the market has been too sanguine about the ability of OPEC to maintain high production levels, focusing on potential growth from the economically advantaged Middle East OPEC countries rather than problems amongst the more cash-strapped members. On the positive side for OPEC, Iranian oil production is up 700k bl/day since the start of the year as a result of sanctions being lifted.

OPEC completed its 169th ordinary meeting in Vienna on June 2, with no significant new information provided at the end of the meeting. Prior to the event, there was some hope that Saudi Arabia may rekindle the production freeze agreement that it scuppered in April 2016, but ultimately no freeze agreement came to pass. The commentary from OPEC remains increasingly positive however, underlined in the press release comment

> *"… supply and demand is converging and oil and product stock levels in the OECD* have recently shown relative moderation. This is testament to the fact that the market is moving through the balancing process"*.
>
> **Organisation for Economic Co-operation Development*

We also noted an interesting comment from Saudi's new oil minister Falih when he was asked if Saudi would add more barrels to the market, his response was *"There is no reason to expect that Saudi Arabia is going to go on a flooding campaign".*

This comes in contrast to comments made by Saudi in the immediate aftermath of the Doha meeting on April 16, when suggestions were made that Saudi were ready to raise production.

What does the recent market developments mean for energy equities?

Pulling the various factors together, we still think that the world oil market should rebalance during 3Q 2016. We remind investors that in the 1998/1999 cycle, this point of rebalancing coincided with the trough in oil prices and the trough in energy equities, as represented by MSCI World Energy Index. Given the move in energy equities and oil prices so far this year, it would appear that oil prices and energy equities have already started to move ahead of the rebalancing point this time around.
The factors mentioned above make us increasingly confident in a longer-term recovery to around $75/bl. We believe that $75/bl is not a big stretch in terms of affordability; at this price the 'world oil bill' will still only represent 2.5% of world gross domestic product (GDP) versus a 20 year average of 3.2%.

Energy equities have outperformed the broad market in the first five months of 2016, but remember this in the context that the MSCI World Energy Index underperformed the MSCI World Index for 91 months to the end of December 2015.

The valuation sensitivity work that we regularly perform tells us that energy equities, as of 5/31/16, have been discounting an oil price (into perpetuity) of around $55/barrel. (i.e. broadly in line with the four year forward Brent oil price which is currently at $58/bl). When the sector troughed in January 2016, we estimate that the market priced around $45-50/bl into energy equities and for reference, we believe that $80-85/bl was priced in when oil prices were $100/bl in 2013-2014; i.e. we are still near the bottom of the 'trading range' for oil prices that are implied in energy equities.

As a group, we see energy equities screening very attractively on a number of longer term valuation metrics. The weighting to Energy in the S&P 500 Index, as of end of May, is still only 7.1% (relative to a long run average of 9.5%), and US energy equities, as represented by energy sector in the S&P 500 Index, are still only trading at 0.48x of the price/book value of the S&P 500 Index, having historically averaged 0.86x. While we do not expect Brent oil prices to recover to $100/bl in the medium term, we do believe that the profitability of the energy industry can improve significantly, as a result of both oil price rising and sustained cost control. Both will be key drivers of improvements in return on capital in the sector, and valuation metrics.

If you believe, as we do, that a recovery in the oil price to $70+/bl is likely, the case for accumulating energy equities at this level looks good, with what we believe to be significant upside potential across the energy complex.

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Mutual fund investing involves risk and loss of principal is possible. The Fund invests in foreign securities which will involve greater volatility, political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning it concentrates its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. The Fund also invests in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund's focus on the energy sector to the exclusion of other sectors exposes the Fund to greater market risk and potential monetary losses than if the Fund's assets were diversified among various sectors. The decline in the prices of energy (oil, gas, electricity) or alternative energy supplies would likely have a negative effect on the Fund's holdings.

The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contain this and other important information about the investment company, and they can be obtained by calling 800-915-6565, or visiting gafunds.com. Read it carefully before investing.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

The MSCI World Index with net dividends is an unmanaged, free fl oat-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of 24 developed market country indices. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

The MSCI World Energy Index is an unmanaged index composed of more than 1,400 stocks listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand and the Far East. The MSCI World Energy Index is the Energy sector of the MSCI World Index.

The Price to Book (P/B) Ratio is calculated by dividing the current price of the stock by the company's book value per share.

Return on capital measures how effectively a company uses the money (borrowed or owned) invested in its operations.

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