Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Trump and the Art of an OPEC Deal

Monday, November 28, 2016

Michael Warren and **Donald Luskin**

The Donald's America will be a global oil powerhouse. A deal can make OPEC great again.

When OPEC meets on Wednesday in Vienna, it won't just have to struggle with the challenging petrodiplomacy of delivering on September's promise to limit production (see "On OPEC's Production Target" September 28, 2016). The cartel, and its non-member fellow travelers, will also have to begin to come to terms with a new world of unknowns for the global energy markets as the Trump administration takes power in January.

- *We still think some kind of production deal will emerge.* But, to be sure, the news-flow and rumor-flow ahead of Wednesday's meeting has been mixed. Two weeks ago Iraq claimed that production cuts were possible. Iran said that cuts were "highly likely." Libya said that discussions were going well. And Vladimir Putin has repeatedly vowed that Russia would also freeze production if there is an agreement reached in Vienna. Then on Friday, Saudi Arabia was a no-show at a meeting with Russia, saying that OPEC members had not yet been able to agree on burden-sharing. On Saturday, Iran let it be known that talks with Saudi are ongoing. Yesterday, Algeria and Venezuela went to Moscow to seek help in persuading Saudi – which is now playing hard to get, with oil minister Khalid Al-Falih saying "We don't have a single path which is to cut production." This morning, Iraq is expressing optimism for a deal.
- *What else should we expect? Logic from options-pricing theory and game theory both dictate that deadline-driven deals not be decided until the last possible second.*
- It's easy to sympathize with the negotiating positions of the major-producer players here. Iran doesn't want to have to limit production until it has recovered back to pre-sanctions levels. Saudi doesn't want to take a disproportionate share of the cuts, letting Iran and others – like Iraq, Libya, Nigeria and Venezuela, who can all argue that their production has been held back by exogenous events – be free-riders on the higher oil price generated by Saudi's sacrifice.
- But all that said, we think Saudi has plenty of self-interest in allowing a certain amount of free-riding by others. For one thing, Saudi is seen by its fellow members – wrongly we think, but nevertheless – as having blood on its hands. Former Saudi Oil Minister Ali Al-Naimi's November 2014 *diktat* – that "it is not in the interest of OPEC producers to cut their production, whatever the

Update to strategic view

OIL: The rumor-flow on an OPEC production deal this week is mixed – but we still think a deal can get done. Saudi can permit some free-riding in order to establish a strong income statement and balance sheet for its Aramco IPO. The Trump surprise helps, as it somewhat rebalances regional power away from Iran, allowing Saudi to be more generous. On the other hand, Saudi is indicating it might rely on a Trump-inspired growth surge to exacerbate a short-term demand/supply imbalance that will raise prices even without a deal. But longer term, Trump's energy policy is aimed at growing US supply, with infrastructure build-out, regulatory relief and encouragement of jobs and exports. This challenges OPEC to make itself relevant – and the only way to do that is with a deal. Time is running out on our call for $65 oil by year-end. But we remain steadfastly bullish, deal or no deal. We face an increasing short-term demand/supply imbalance that commands higher prices.

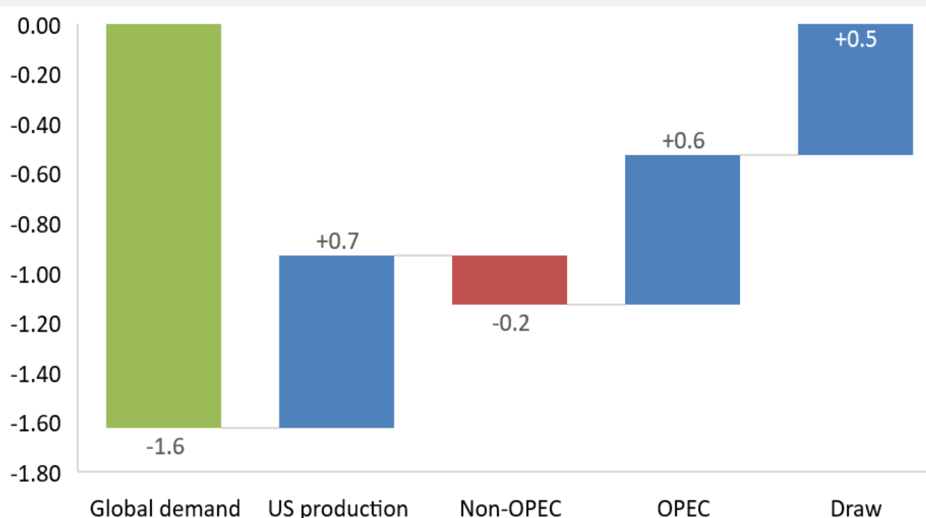
[Strategy dashboard]

Copyright 2016 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

price is" – is seen as ushering in a period of catastrophically low crude prices in the face of surging US fracking production.

- *And just in dollars and cents, mega-producer Saudi simply has more to gain from higher prices than anyone else – not just in cash-flow terms, but in the upward revaluation of its vast reserves.* The Kingdom is now seriously gearing up to launch the initial public offering of Saudi Aramco, guaranteeing that third party auditors will be reviewing oil reserve estimates that were previously a well-guarded state secret. With a launch expected in 2018, the Saudis ought to be looking for Aramco to book solid profits in 2017, and for the reserves to be assigned a commensurably solid present value.
- So we think Crown Prince Mohammed bin Salman has let the governments of fellow OPEC members know that the Saudis will be willing to do most of the production-cutting starting in 2017, allowing deferral of cuts, or disproportionately small cuts, to be made by other members.
- *Be all that as it may, we continue to believe that it would be difficult, even in the absence of any agreement at all, for OPEC to significantly increase production anytime soon. It is the looming imbalance of demand over supply that will drive crude prices higher in the coming weeks and months. This imbalance shows in simple Department of Energy forecasts, even though they assume 600,000 barrels/day of production growth from OPEC* (please see the chart below).

Year-ahead supply/demand balance, global crude oil Millions bbl/day



Source: DOE, TrendMacro calculations

- Saudi oil minister Al-Falih is well aware of this dynamic, saying yesterday, "We expect demand to recover in 2017, then prices will stabilize, and this will happen without an intervention from OPEC… we can also depend on recovery in consumption, especially from the U.S."
- True. But an OPEC agreement this month would draw attention to the coming imbalance that we've been talking about for months, and Al-Falih is now highlighting. And it would put OPEC in the

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

center of it, by refocusing market sentiment away from expectations that the cartel will keep the taps wide-open no matter what. But in the short term – say, a year out – it is that imbalance of demand over supply that will be the true driver of higher prices (see "OPEC Will Lose Its Battle of Algiers" September 9, 2016).

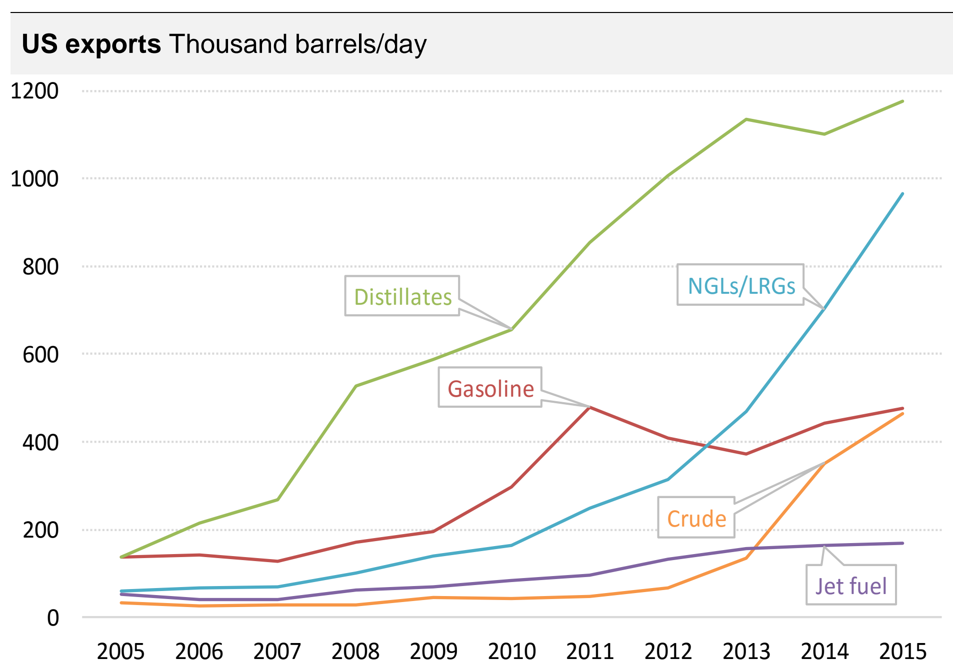
- *The unexpected emergence of Donald Trump as president – as a force to be reckoned with in the global oil markets – may make a deal more likely.*
- Perhaps Al-Falih is caught up in post-election Trump growth-fever (see "Trump and the 'Reflation Trade'" November 15, 2016) when he cites demand growth "especially from the U.S." The Department of Energy's forecast of 1.6 million barrels/day demand global demand growth only attributes 230,000 of that the US. And while Trump may very well trigger a period of higher growth, that might somewhat exacerbate the short-term demand/supply squeeze we foresee, in the long-run his energy policies are most targeted at increasing *supply* growth.
- *Broadly, Trump is committed to developing US energy infrastructure and production, with the shale revolution having already made the US the world's swing producer. Now, ironically, having failed to kill US frackers by letting prices fall in 2014 and 2015 in the face of a shale glut, OPEC's only road back to any sort of relevance is to induce a short-term global shortage that will raise prices* (see "Who Knew? OPEC Actually Matters Again" June 6, 2016). *OPEC – and Saudi in particular – is just going to have to accept that, in a global market, the US will free-ride on those higher prices, and the shale revolution will march on.*
- Iran faces particularly intense unknowns in a Trump presidency. On the campaign trail, Trump bashed the Obama administration's Iran nuclear deal. His CIA chief-designate Mike Pompeo says he looks forward to "rolling back this disastrous deal." On the other hand, Trump has said he regards the deal to be a "contract" – one that cannot easily be broken, but must be rigorously enforced. It wasn't important enough to even be mentioned in Trump's Contract with the American Voter.
- "Rolling back" the deal is impossible for the US to do unilaterally, as it includes other signatory nations that likely will want to keep the *status quo*. But if the Trump administration sees that Iran is not keeping its side of the deal, there are many enforcement countermeasures – and Trump is likelier to employ them than his predecessor. US sanctions on banking, insurance and shipping services for Iran – or threatening to impose sanctions on other nations who do business with Iran – could be quite effective.
- The deal was a double-whammy against Saudi – rebalancing economic power toward regional rival Iran, and triggering another leg down in oil prices in anticipation of new supply from Iran (see "Iran: The New New World Oil Order, Volume I" July 20, 2015). Geopolitically, the arrival of Trump – with his skepticism about the deal and his greater likelihood to enforce it – re-rebalances regional power back toward Saudi. In sheer economic terms, Trump represents a probabilistic threat to Iranian production. *So perhaps it*

could be reasoned that Saudi can afford to be more generous to Iran now, under Trump, in crafting a production deal.

- *But regional rivalries aside, again, Trump's likely approach to US energy policy moves OPEC toward a deal this week as the only way to reassert its relevance and global price-discipline.* That's because under Trump, once the short-term demand/supply imbalance we see over the coming year has run its course – which will drive prices higher in the near-term – US energy production in the coming years is likely to surge, ultimately moving global prices significantly lower (see, among others, "Just-In-Time Energy" April 27, 2015).
- Trump is committed to permitting the build-out of the connectivity infrastructure – such as the Keystone XL and Dakota Access pipelines. As we have been arguing, such infrastructure is key to lowering the full-cycle breakevens of shale operators (see "Keystone is Key to Low Oil Prices" February 2, 2015).
- Notably, Continental Resources – the operator run by Trump backer Harold Hamm, has moved most of its CAPEX to Oklahoma plays from the Bakken over the past couple of years, due to the lack of pipeline infrastructure to get North Dakota oil to markets.
- Hamm has learned the power of political influence by watching Obama-backer Warren Buffett, whose BNSF Railway benefited mightily when the Obama administration killed the Keystone XL pipeline, leaving North Dakota oil to be railed, at costs as much as five times that of piping. Similarly, the Dakota Access Pipeline imbroglio has Obama coming down on the side of the Native Americans and environmentalists who have been illegally blocking the completion of the lawfully permitted 450,000 barrels/day pipeline that would allow low-cost transport accessibility to "pipeline-stranded" oil in North Dakota.
- More broadly, Trump is committed to reversing Obama's legacy of regulatory overburdening of energy companies, and restrictions on drilling. More Bureau of Land Management and offshore leases will be offered to the industry. We suspect most oil and gas companies will pass on the offshore leases, because they are not cost-competitive with onshore shale. BLM acreage, without heavy federal regulation, might become more competitive in operators' CAPEX calculations going forward, especially with oil and gas companies that have private leases that butt up against BLM land. But with so many drilling targets already in hand – and not developed during the last couple years of low prices – the immediate impact of additional available leases will be muted.
- Trump will want to increase competitiveness in the oil and gas industry to encourage more exports and create more jobs. Ironically, this will build on one of the few pro-industry developments during the Obama years – the lifting of the 40-year ban on crude exports which, as we predicted at the time, would be the domestic political cost, a *quid pro quo,* compensating for the way the nuclear deal, in effect, deregulated Iran, a major global competitor.
- Today, the US exports more condensate and light tight oil than ever before. We believe Trump's pro-energy policies can be the impetus

for the next great wave of energy exports from the US, in which crude will follow the trend of gasoline, diesel, natural gas, and natural gas liquid exports that have all surged since the shale revolution (please see the chart below).

US exports Thousand barrels/day



Source: DOE, TrendMacro calculations

Obviously, after calling the bottom for oil in January (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016), our target of $65 by year-end seems like a seriously out-of-the-money option at this point (see "On the Doha Oil Freeze Failure" April 17, 2016). Directionally, we've been very happy with the call – and stocks and bonds of companies in the energy ecosystem have amply reflected it. *If we get a deal in Vienna this week, we still might make it all the way. But the exact price and the exact timing aren't the important things – indeed, a production deal isn't all that important either. What's important is that for the next year at least, the global demand/supply imbalance in crude commands higher prices.*

We are exiting refinery maintenance season, and November and December typically see large crude drawdowns. Erratic production from several OPEC members cannot be seen as a durable bonanza just because it momentarily exceeds shallow expectations – until the next rebel attack. We remain very bullish on crude going forward, with or without an OPEC deal. We'll give up on our $65 call at midnight on December 31 (but only if oil is under $65).

Bottom line

The rumor-flow on an OPEC production deal this week is mixed – but we still think a deal can get done. Saudi can permit some free-riding in order to establish a strong income statement and balance sheet for its Aramco IPO. The Trump surprise helps, as it somewhat rebalances regional power

away from Iran, allowing Saudi to be more generous. On the other hand, Saudi is indicating it might rely on a Trump-inspired growth surge to exacerbate a short-term demand/supply imbalance that will raise prices even without a deal. But longer-term, Trump's energy policy is aimed at growing US supply, with infrastructure build-out, regulatory relief and encouragement of jobs and exports. This challenges OPEC to make itself relevant – and the only way to do that is with a deal. Time is running out on our call for $65 oil by year-end. But we remain steadfastly bullish, deal or no deal. We face an increasing short-term demand/supply imbalance that commands higher prices.