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MACROCOSM

While the World Cuts, the US Pumps

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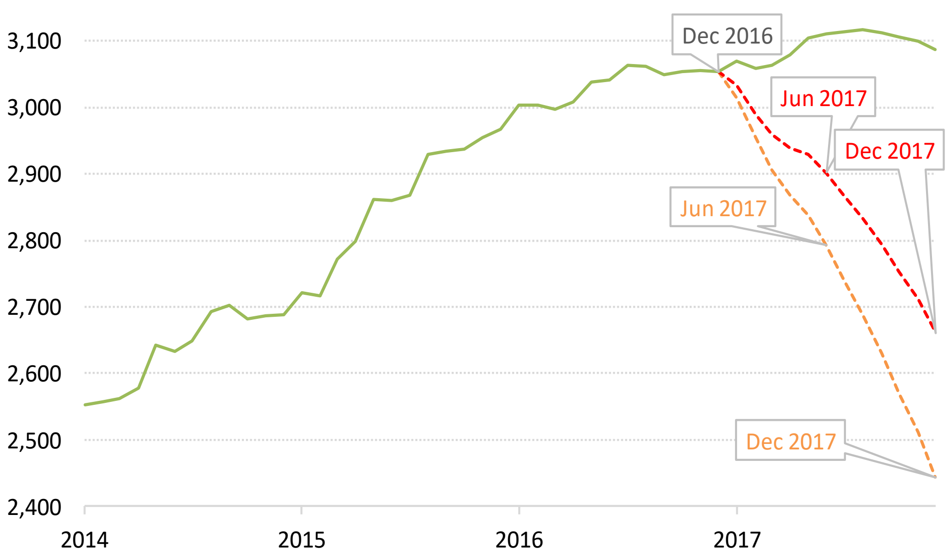
Michael Warren and **Donald Luskin**

$65 oil is in sight. OPEC non-members sign up for cuts, and Saudi offers even more.

Maybe our out-of-the-money call on crude hitting $65 by year-end, after we called the bottom in January (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016), is gonna make it after all. A Saturday ministerial meeting of OPEC members and non-members agreed to cut production by 558,000 barrels/day on top of the 1.2 million cut that had already been agreed by members two weeks ago.

- Let's put this into perspective: this is the first time since 2001 that OPEC and non-OPEC producers decided to coordinate a cut in production. Many thought this day would never come. Like Army beating Navy, also for the first time since 2001, which also happened on Saturday.
- But wait. It gets better. In case anyone is disappointed that the non-member cut isn't quite the 600,000 that had been originally estimated, on Saturday Saudi Arabia's oil minister Khalid al-Falih declared, "I can tell you with absolute certainty" that the Kingdom is "going to cut and cut substantially to be below the level that we

Actual and forecasted OECD ending petroleum stocks Millions barrels
Assuming OPEC + non-OPEC cuts **Assuming OPEC cuts only**



Source: DOE, OPEC, TrendMacro calculations

Update to strategic view

OIL, US ENERGY STOCKS: With Saturday's formal agreement by OPEC non-members to add 558,000 barrels per day to members' already announced 1.2 million cut – and with Saudi promising even deeper unilateral cuts – we are in sight of our $65 price target for crude at year-end. We think this decision by producers only ratifies an intensifying mismatch of demand over supply – but it focuses the market's attention on that mismatch, and will make sure that such a mismatch occurs even if our reasons for having expected it all along prove wrong. Though US production fell furthest during oil's two-and-a-half year bear market, production rose for only four OPEC members. The US emerges as the world's swing producer, able to ramp up production in response to higher prices while everyone else cuts production to assure those higher prices.

[Strategy dashboard]

have committed to…"

- Saudi Crown Prince Mohammed bin Salman has momentarily made OPEC relevant again. We said that Saudi would bear the brunt of the sacrifices required for "restoring a global oil demand and supply balance, in particular the drawdown in the stocks overhang" (please see the chart on the first page, and see "Trump and the Art of an OPEC Deal" November 28, 2016). Saudi is serving the greater good of all oil producers in working to raise prices back to levels sufficient to enable capital expenditures – and, not incidentally, helping itself even more by setting the stage for a successful Aramco IPO.
- While oil markets rallied following the November 30 OPEC meeting – making oil just about the best-performing asset in the global rally in the wake of the US presidential election – there were nevertheless many questions and much outright doubt surrounding the actual size of the OPEC and non-OPEC cuts, and whether they would be adhered to. Even the Energy Information Agency of the US Department of Energy barely adjusted its global supply/demand forecast last week – leaving its closely-watched forecast of OECD stockpiles almost unchanged, stating that "the extent to which the announced plans will be carried out and actually reduce supply below levels that would have occurred in their absence remains uncertain."
- *To be sure, there's some degree of pure optics here. But optics count for a lot in markets.*
- Russia followed through on its commitment to lower production by 300,000 barrels/day, to 10,900 from 11,200 in November. But this follows a half-million-plus ramp-up in production over the last several months – likely made in anticipation of having to "cut." But at least relative to today's global production levels that include the Russian ramp, it's still a cut.
- And in a larger sense, we've argued all year that there is a looming mismatch of oil demand over oil supply, for which there is no immediate spare production capacity (see, among many, "OPEC Will Lose Its Battle of Algiers" September 9, 2016). These member and non-member cuts turn a mere analytic argument about spare capacity into a easily grasped political reality, forcing the market's attention on the mismatch we've been talking about.
- Yet at the same time the announced cuts by OPEC and non-OPEC producers are quite real – and they are strongly underscored by Saudi's unilateral announcement of even deeper cuts. If it turns out the mismatch of demand over supply we've been talking about doesn't materialize naturally, the cuts will make it occur nevertheless.
- The combined cumulative effect of the cuts averages 53 million barrels per month. So in just six months OECD stockpiles could fall by 315 million barrels to slightly below 2.8 billion barrels – or back to levels not seen since April 2015. Stockpiles would be drawn down to 2.4 billion barrels if OPEC and non-OPEC were to extend the production cuts for another six months after meeting in May to evaluate their impact on pricing (again, please see the chart on the previous page).

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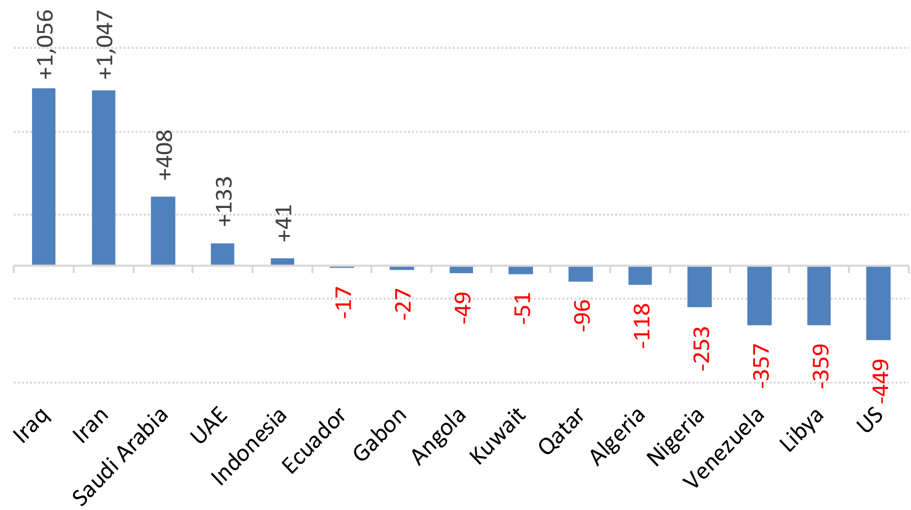
- *Will OPEC stick to the cuts? We think so.* A key compliance issue that was decided prior to the meeting in Vienna two weeks ago was the use of "secondary sources" as production statistics. History has taught us that "official" production figures from individual countries cannot be trusted. There will be a panel – a Ministerial Monitoring Committee – that will keep an eye on member production. While there is no specific enforcement mechanism, at least members are on notice that the cartel will be watching, and using real production numbers.
- Higher production from post-sanctions Iran is not a compliance issue. The announced total cut of 1.2 million barrels per day allows Iran to produce up to 3.797 million, which is 107,000 higher than what it was producing in October. This compromise in favor of a regional super-rival was a price Saudi Arabia was willing to pay to make OPEC relevant again – and increase the stature of Crown Prince Mohammed bin Salman, and assign a solid value for its reserves for the Aramco IPO.
- The big wildcard for actual volumes in the post-cut regime will be uncertain production by members whose volumes have been held back by internal political strife. Nigeria and Libya are effectively exempted from cuts. Venezuela has committed to a cut of 95,000 barrels per day.
- For us, a "low case" could take OPEC production to 31.9 million barrels per day – well below the 32.5 targeted by the announced cuts. This anticipates Venezuela's continued inevitable demise as an oil producer under its suicidal Bolivarian Revolution, with production falling 219,000 barrels per day by June 2017, well beyond the 95,000 barrels officially committed to.
- A "high case" would take OPEC production to 32.8 million barrels per day, slightly higher than the 32.5 million target. This estimate includes higher production from Libya and Nigeria – and assumes Venezuelan production will fall no further than the targeted 95,000.
- Even the "high case" only misses OPEC's target by 300,000 barrels per day. And it's "highly" unlikely.

From a strategic perspective, OPEC has achieved momentary relevance with its cuts, becoming so to speak the world's swing non-producer. But it has had to do so only because the United States has become the world's swing producer (see "The Shale Boom Shifts Into Higher Gear" June 1, 2015).

- The energy world has changed dramatically since the fracking revolution started to pull first natural gas and then oil from old and new fields in North America (see "Just-In-Time Energy" April 27, 2015). By November 2014, OPEC finally realized that it had enabled the fracking revolution as a market response, adjusting volumes higher to take advantage of manipulated prices. So OPEC stopped manipulating prices, in the hopes of shutting down the frackers. While some US operators went bankrupt and all of them had to reduce employment, OPEC members suffered more – as their governments, whether dictatorship, monarchy, or democracy, saw their social contracts with their citizens weakened to the most dangerous point since Arab Spring.

- So now the cartel has come full circle and is taking production off the market to bolster prices again.
- *What a costly price-war. Only five OPEC members will have more production in January 2017 than they did in October 2014, before the cartel's new production strategy* (please see the chart below). Obviously Iran's jump has nothing to do with OPEC's policies, and everything to do with the nuclear deal announced in mid-2015.

Change in crude production, November 2014 to January 2017



Source: DOE, OPEC, TrendMacro calculations

- While the US lost more production in the war than any OPEC member, its nadir has already occurred. And the future is bright: as OPEC's production cuts assure higher prices, US frackers will be able to afford to gear up higher production. All the more so considering that the ban on US crude oil exports was lifted late last year. And doubly more so when long-delayed pipeline projects get green-lighted by the incoming Trump administration, lowering full-cycle break-evens even as prices rise.

Bottom line

With Saturday's formal agreement by OPEC non-members to add 558,000 barrels per day to members' already announced 1.2 million cut – and with Saudi promising even deeper unilateral cuts – we are in sight of our $65 price target for crude at year-end. We think this decision by producers only ratifies an intensifying mismatch of demand over supply – but it focuses the market's attention on that mismatch, and will make sure that such a mismatch occurs even if our reasons for having expected it all along prove wrong. Though US production fell furthest during oil's two-and-a-half year bear market, production rose for only four OPEC members. The US emerges as the world's swing producer, able to ramp up production in response to higher prices while everyone else cuts production to assure those higher prices.