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MACROCOSM

Why Aren't Oil Prices Higher?

Tuesday, February 12, 2019

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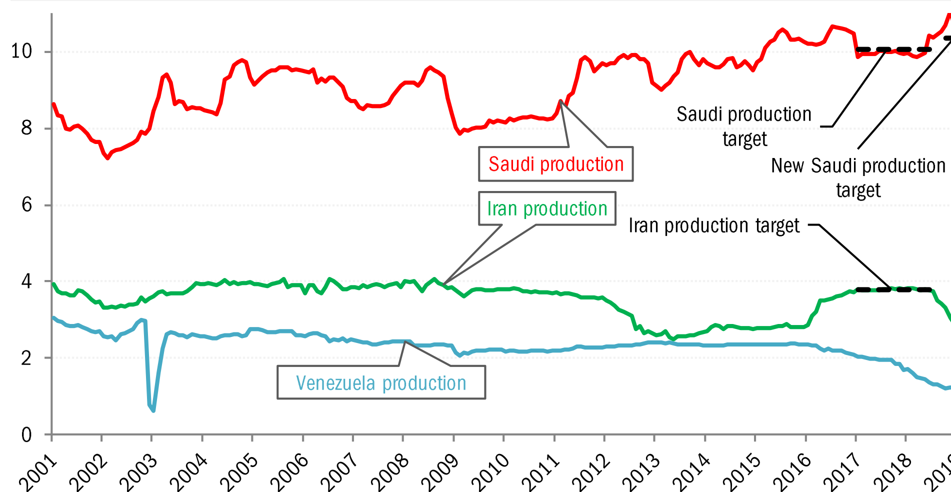
We can sanction Venezuela all we want. All the oil market cares about is growth in China.

It's time to lower our price target for oil again, to a range of $50 to $60. This will have consequences outside the energy market. Long-term, it enables greater global productivity after a secularly stagnant era of too-high oil prices. Short-term, however, it works against the recovery of S&P 500 forward earnings, the narrowing of blown-out credit spreads, the recovery of long-term Treasury yields and the steepening of the curve.

Last quarter we lowered our target price-range for crude oil to $60 to $70 – when it was already trading at $55, yet the consensus was expecting a surge to $80 or beyond (see "OPEC's Gifts to Trump" November 14, 2018). While we were directionally right, we were nevertheless way too optimistic, with WTI falling as low as $42.36 in December, a 45% crash in ten weeks from the early October high at $76.90 (made on the day the news of the death of Jamal Khashoggi first became public; see "Recession Risk at Last?" November 20, 2018).

Now WTI has enjoyed a recovery of as much as 32% since the December lows. But that only brought it back to about $55, where it had been when we last lowered our price target, wrongly calling that a "panic undershoot." *And look what a heavy lift it was to get even that. OPEC production fell by*

Crude oil production, millions of barrels per day



Source: Bloomberg Intelligence, TrendMacro calculations

Update to strategic view

OIL, US STOCKS, US BONDS, US MACRO: We are lowering our price target for oil to a range of $50 to $60. This works against recovery of S&P 500 forward earnings, inflation expectations, bond yields and credit spreads. Lack of oil consumption growth in China, matched with surging production in the US, has produced a global glut. The Trump administration, while jawboning low oil prices, is managing the global oversupply by putting sanctions on Iran and Venezuela, transferring market share from them to Texas. Markets have already absorbed most of the loss of Iranian production, and further losses are able to be absorbed by increased US production this year. Russia is stepping in to prevent the Venezuelan oil ecosystem from collapsing, and Saudi's now well-demonstrated swing capacity hedges against a collapse should it occur. We expect a resumption of Chinese and emerging market oil consumption growth once the trade war is settled, and see that as the only way to stabilize oil prices.

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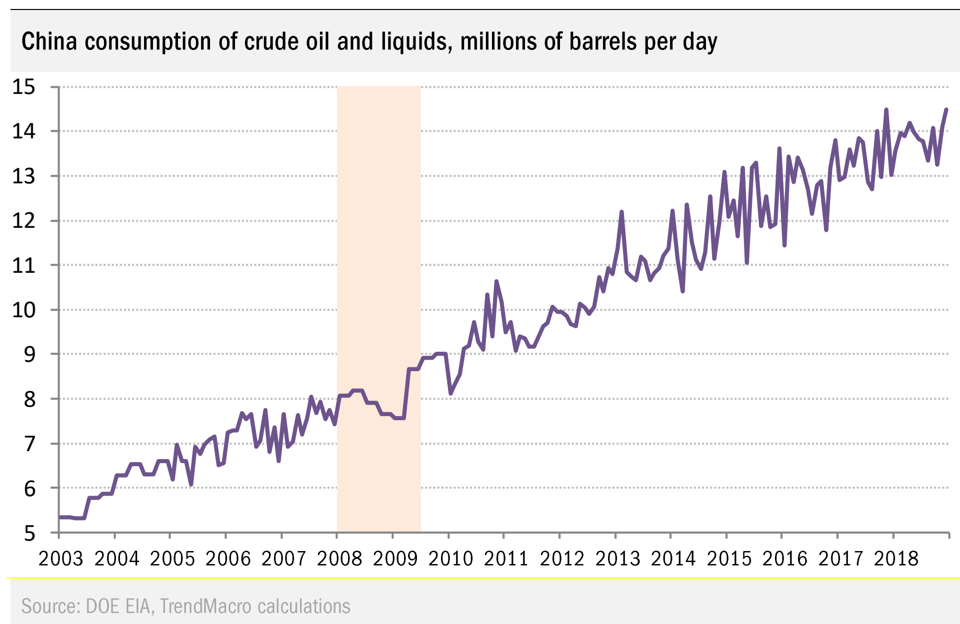
an astonishing 1.52 million barrels per day in just the two months from November 2018 to January 2019, with Saudi Arabia alone curtailing production by 870,000, taking it well below its new production targets (please see the chart on the previous page) – and the US imposed draconian new sanctions against Venezuela in late January.

- *The Venezuelan presidential crisis, and the US sanctions*, make that nation with the world's largest proven reserves a geopolitical wild-card, which we will discuss more in a moment.
- *The strong potential for the full global imposition of secondary sanctions against Iran in May* – deferred last November ahead of the mid-term elections, at the worst of the scandal around the alleged murder of Jamal Khashoggi – is another wild-card.
- But against those potentially bullish supply-reducing factors, the ongoing economic slowdown in China continues to hold back oil consumption growth. China has surpassed Europe as second to the US in overall crude consumption, and for most of the last four years it has explained almost all of global consumption growth. *But over the most recent year, facing internal fragilities and external trade-war shocks, China's consumption growth has slowed to nothing* (please see the chart below and, among others, "Death by China on the Way to Yes" December 17, 2018). *Until further notice, this is a deadweight on the global demand outlook, against which OPEC production cuts – whether by choice in the case of Saudi, or by US sanctions in the case of Iran and Venezuela – are only offsetting compensations.*



China consumption of crude oil and liquids, millions of barrels per day

Source: DOE EIA, TrendMacro calculations

- At the same time – thanks to the fracking revolution that we highlighted years ago, when the consensus was still worried about "peak oil" (see, among many, "Oilmageddon" December 16, 2014) – total US production is now the largest in the world, and the US flirts with becoming a net petroleum exporter (please see "Data Insights: Oil" January 22, 2019, and the chart on the next page).

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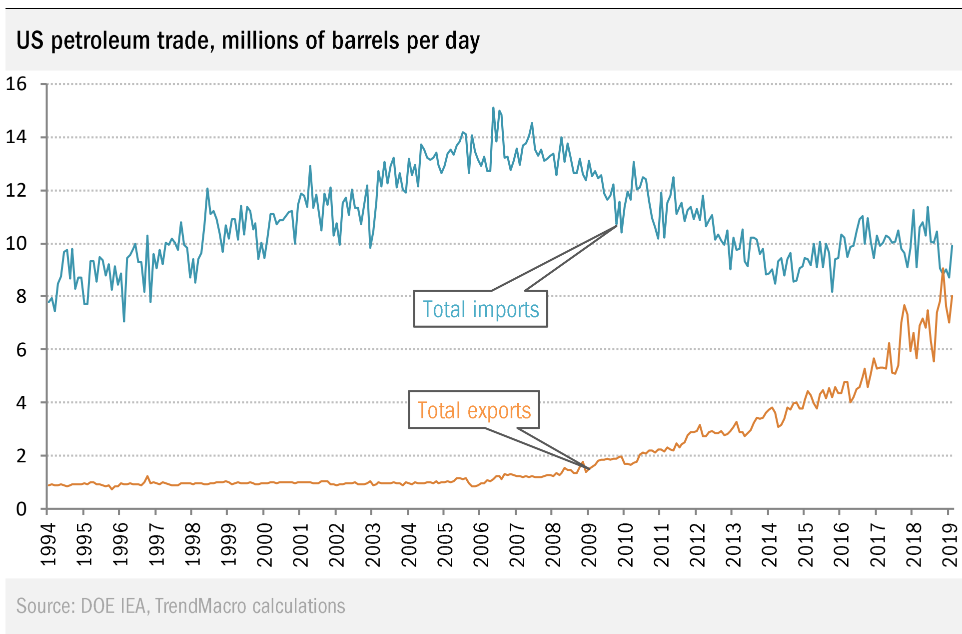
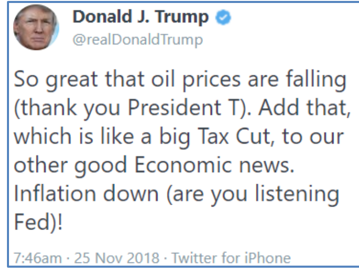


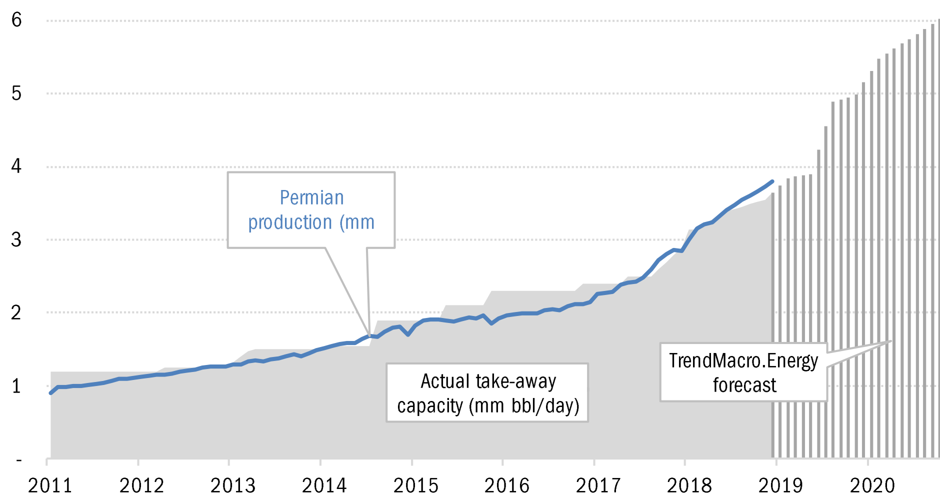
- *We have some sympathy for the Trump administration when, on the one hand*, *the president tweets* *about keeping oil prices low, yet on the other hand seems not to worry about driving prices higher by imposing sanctions designed to destroy Venezuela's global oil trade.* A White House fact sheet on the sanctions sensibly says,

  > *"The United States is confident that energy markets will remain well supplied despite reduced imports of Venezuelan oil.*
  > *• Respected forecasters like the United States Energy Information Administration expect global oil supply to exceed demand in 2019 and 2020.*
  > *• Over the next year, United States production is forecasted to increase to an all-time high of more than 12 million barrels per day."*



- We could almost convince ourselves that the administration is publicly jawboning low prices by way of bringing home a trophy for voters, while privately working to be sure they are not *too low*, seemingly recognizing that *oil prices need to be a sustainable equilibrium at which exploration and production is incentivized and frackers can make the payments on their junk bonds*. Remember, the low oil prices of 2015 and 2016 didn't, in the end, do the consumer any favors. Through their negative impact on inflation expectations, credit spreads and bank soundness they very nearly caused a recession (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- Every day that goes by, there is more and more planned-and-permitted pipeline capacity in the Permian. In two years, it will enable Permian production to increase by about half, that is, by about 2 million barrels per day (please see the chart on the following page). All else equal, unless and until global demand revives (which at this point is the same as saying: *until Chinese*

Permian production and transport capacity



Source: DOE IEA, various, TrendMacro calculations

growth recovers), this would only drive oil prices relentlessly lower, courting a repeat of 2015-2016. *Trump's geopolitical strategy to topple the regimes in Iran and Venezuela attempts to do so by taking them out of competition in the global oil market. That prevents a catastrophic glut as the Permian gets built out. Or just call it a great transfer of global oil production market-share from America's enemies to Texas.*

- It's a dangerous balancing act. With the move against Venezuela, the bet seems to be that the global market is sufficiently plastic and regenerative to be able to deal with the dislocations imposed by the sudden sanctions. They were especially disruptive because they were imposed during the government shutdown when the relevant agencies were unable to promptly post the usual "frequently asked questions" that allow market participants to figure out what to do next without going to jail.
- By now all the "general licenses" and their interpretations are available. The upshot is that financial institutions anywhere in the world are forbidden from processing payments for Venezuela's state-owned oil company Petróleos de Venezuela or its affiliates such as Citgo. There is a three-month adjustment period during which business can still go on, provided payments to PdVSA or Citgo are escrowed in a trust account maintained by the US Treasury for the benefit of the legitimate government of Venezuela, whatever that may someday be. But after three months, no trading.
- US refiners, who will certainly have to fully comply, are saying they have several months of feedstocks on hand. Looking beyond that, Canada's oil-producing province Alberta is stepping up to replace the heavy sour crude shipped by Venezuela, by loosening up production limits that had been slapped into place just two months ago.
- It is unknown to what extent Venezuela's large non-US customers will comply. There are only three of consequence.

- *Russia* is the patron of the Maduro regime, keeping Venezuela's oil economy alive with loans and technology assistance through Rosneft. As sanctions deprive Venezuela of much-needed refining and feedstocks and transport blending agents from the US, Russia will move in to make up the gap. Already special-purpose Russian banks, designed to be untouchable by sanctions, are rumored to be stepping in to clear trade transactions. By the way, Russia faces some potentially interesting end-game states with the US, since it effectively owns 49.9% of Citgo as collateral against loans to Venezuela. Canada has claims against Citgo, too, and who is to say in the event of a Maduro default how a US bankruptcy court – or the Committee on Foreign Investment in the United States (CFIUS) – would straighten out the property rights.
- *China* likely has no wish to comply and probably won't, and the US has limited power to do much about it. One opening: as the US-China trade negotiations get near the finish line, the Trump administration may add a new demand for China's compliance, with China having opened the door to such last-minute haggling by conceding so many points early on (see "On the Margin: True Fake News on China Trade" January 18, 2019).
- *India* would like to comply, but it is a poor nation and a key US nuclear ally that borders volatile Pakistan, so the US can't put too much pressure on it to not take advantage of the bargain prices Venezuela will offer.
- So it's not at all clear that the sanctions will actually work, if the idea is to drive Venezuela out of the oil business and topple the Maduro regime. *Indeed, the oil market appears to be saying just that. If there were any serious possibility that Venezuela's 1.2 million barrels per day of crude exports were any more likely than usual to fall to zero, it's hard to believe that prices would be as soft as they are. Even if Venezuela's exports ceased altogether, that would not likely be a permanent state of affairs.*
- *And if it is only temporary, how disruptive to the global market can it really be now what we have learned, over the last couple months of on-again off-again sanctions on Iran, that Saudi swing capacity is indeed able to turn on and turn off flows of a million barrels a day?*
- As to Iran, it's possible that US sanctions can squeeze another 500,000 barrels per day out of production by mid-year. But by then, US production just in the Permian will have increased by about that much, because that's the expected increase in pipeline takeaway capacity.
- And even now, the Sharara oil field in Libya, which had virtually stopped producing due to a conflict with local tribesmen, will be coming back to life. General Haftar, leader of the Eastern Alliance and adversary of the UN-backed government in Tripoli, has taken control of the field and it should add up to 340,000 barrels per day, most of which will get to market because the general also controls the ports.
- Looks like a glut to us, and the only natural safety valve would be for OPEC to impose deeper production cuts. God help the oil markets if democracy is restored in Venezuela, or if Iran agrees to a more robust nuclear deal.

- But there are endogenous safety valves, too. The Trump administration could find some other oil producer to sanction (Russia?).
- *Or – most fundamentally – the US and China could reach a satisfactory conclusion to their trade war. Then growth (and oil consumption growth) would resume not just in China, but in the whole emerging markets ecosystem that has been dragged down with it.*
- *That's how we think it will turn out. But even if we're right, it will take time for that demand growth to recover – time during which US supply will just keep increasing. But make no mistake about it – if we didn't expect China and EM demand growth to recover, we'd be taking our target price range for oil a lot lower.*

Bottom line

We are lowering our price target for oil to a range of $50 to $60. This works against recovery of S&P 500 forward earnings, inflation expectations, bond yields and credit spreads. Lack of oil consumption growth in China, matched with surging production in the US, has produced a global glut. The Trump administration, while jawboning low oil prices, is managing the global oversupply by putting sanctions on Iran and Venezuela, transferring market share from them to Texas. Markets have already absorbed most of the loss of Iranian production, and further losses are able to be absorbed by increased US production this year. Russia is stepping in to prevent the Venezuelan oil ecosystem from collapsing, and Saudi's now well-demonstrated swing capacity hedges against a collapse should it occur. We expect a resumption of Chinese and emerging market oil consumption growth once the trade war is settled, and see that as the only way to stabilize oil prices.