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MACROCOSM

Who Knew? OPEC Actually Matters Again

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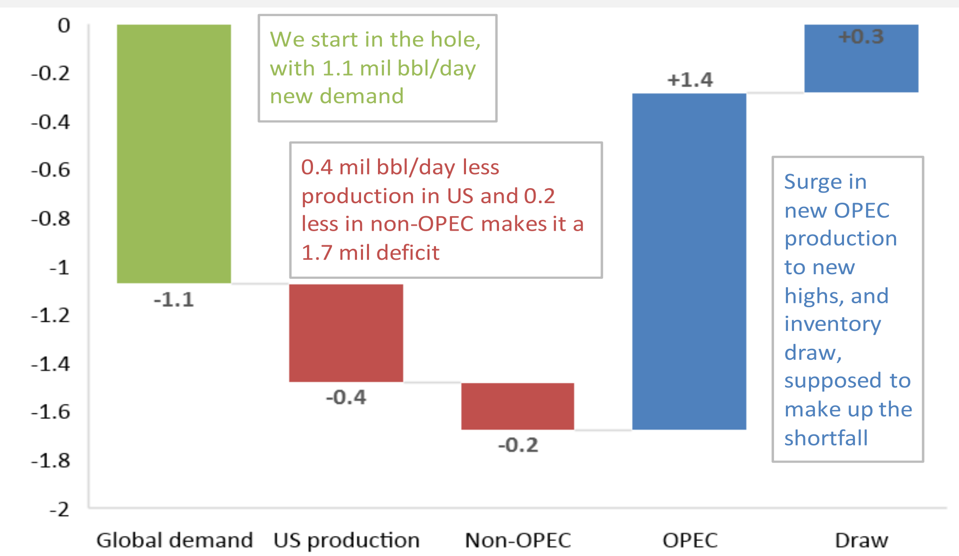
No need for a freeze. OPEC is the swing producer again. Demand beats a path to its door.

Another OPEC meeting has come and gone. It would appear that the global financial media has struggled to come up with [anything interesting to say about it], considering that basically nothing happened there. So it's tempting to write off OPEC as a defunct power. *But the reality is that OPEC is emerging as the swing producer again. The global petroleum supply-and-demand outlook has suddenly transformed from one of glut to one of shortage, at least until US shale producers can get back on their feet* (see "How High Can Oil Go?" May 10, 2016). *With year-ahead global demand to rise 1.1 million barrels per day and US production to fall 400,000, record inventory has already begun to be drawn down, and OPEC will have to increase its already all-time high production by 1.4 million barrels to fill the gap* (please see the chart below).

- Officially, OPEC would seem to have the spare capacity to do what it takes. But the numbers are all over the lot. The International Energy Administration puts OPEC spare capacity at 2.85 million

Year-ahead global demand/supply for petroleum and liquids Mil bbl/day



Source: DOE EIA, TrendMacro calculations

Update to strategic view

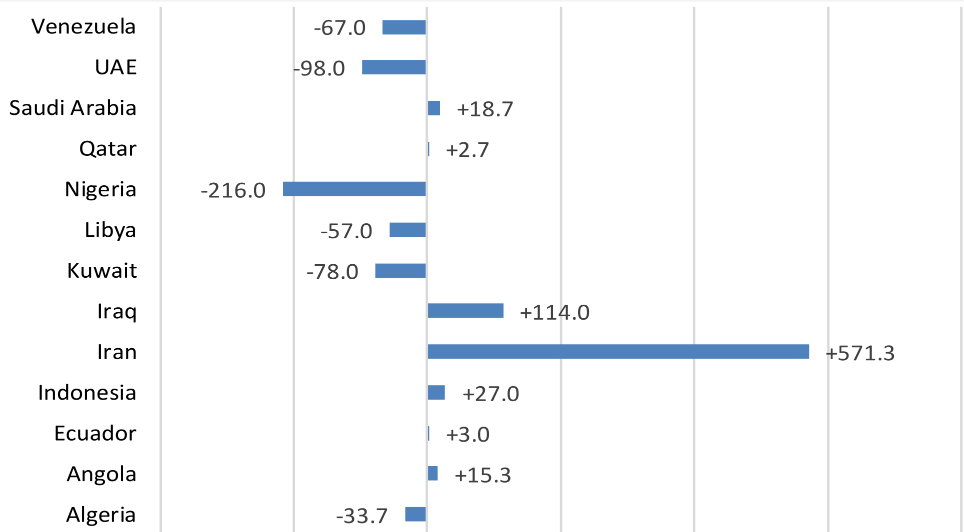
OIL: Last week's OPEC meeting produced no headlines, but it didn't need to. Global petroleum demand is rising, and US production is falling. Only OPEC can fill the gap – suddenly, it is relevant again. Who needs a production freeze, when the post-sanction surge of Iranian production has crested, Nigeria and Venezuela are becoming more deeply impaired, and Libya and Iraq continue at risk? Oil will move higher, to as much as $65 this year. US shale producers will re-activate at that point, and inventory can cushion potential shortages in the meanwhile. But sentiment has changed – from glut to shortage.

[Strategy dashboard]

barrels per day, while the US Department of Energy puts it at only 1.53 million.

- At 32.4 million barrels per day, OPEC production is already at an all-time high. And despite higher prices, it's now only up 202,000 barrels over the Q4-2015 average. What's worse, more than the entire increase comes from Iran, where the production surge is a one-time artifact arising from the lifting of international sanctions in January (please see the chart below).

Increase in OPEC crude production April 2016 vs Q4-2015, mil bbl/day



Source: OPEC, TrendMacro calculations

So it would seem to us that OPEC needn't bother with its much-anticipated but perpetually-frustrated production freezes (see "On the Doha Oil Freeze Failure" April 17, 2016). All it has to do now in order to be a price-*maker* is to continue to be a passive price-*taker* – do nothing, and demand will beat a path to OPEC's door. For a while, it's the only door in town.

- Who needs a production freeze anyway? Many factors already constrain OPEC production without one.
- *We think from here Iranian production will be able to improve only marginally, a plateau more likely. For that matter, we're not so sure we believe the reported numbers to begin with.*
- *At the same time, it's hard to see how the fall-off in Nigerian production can be fixed anytime soon.*
- Nigeria's only good news is that Mohammed Barkindo was appointed OPEC's new secretary general. He is a technocrat who headed the Nigerian National Petroleum Corporation, and has served on OPEC's Economic Commission for 14 years (and he briefly was acting secretary general a decade ago). Saudi Arabia and Iran were able to approve Barkindo in his new role because Nigeria usually doesn't take sides in Middle East politics.
- For most of this year, the Nigerian oil industry has been under attack by domestic saboteurs. Last week another attack shut down the electrical grid of Chevron's Escravos 160,000 barrels per day

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oil terminal. Production could fall to 1.4 million barrels in May, down from 1.9 million when Muhammadu Buhari was elected president about a year ago.

- We warned that the delicate truce that allowed the flow of oil from the Niger Delta region could be disrupted if the then newly-elected Muslim president were to reduce the patronage paid to protect the pipelines that the former president Goodluck Jonathan had bestowed upon the rebels in the Christian-dominated region (see "Saudisfaction Guaranteed" March 13, 2015).
- The latest attacks are more sinister – the saboteurs now appear more organized and effective than in the past. They identify themselves as Niger Delta Avengers, utilize social media to forewarn those they are targeting, and threaten to bring the attacks from the oil patch to headquarters in Lagos. The message to oil producers have been clear: shut in production or face reprisals.
- The long-term outlook is bleak as well. Nigeria hasn't encouraged foreign direct investment, nor has it invested in its national oil company.
- *In Venezuela, 15 years of strong-man socialism is reaching a chaotic dead-end, and the only question is how far oil production will fall.*
- The combined effects of Venezuela's economic collapse, lack of maintenance at oilfields and refineries, and power shortages could quadruple the reduction in production seen so far this year to 250,000 barrels per day.
- All that has kept the drop-off as mild as it has been so far this year is the government's strategy of cutting refinery operations by half and exporting the difference. But the government is running out of funds to supply refined products for the domestic market, to bring in lighter crude to mix with heavy crude for re-export, and to pay international oil services companies to keep production at current levels (Haliburton and Schlumberger have announced plans to curtail work for lack of payment).
- *We could go on.* Libya and Iraq have well-known issues, for example.
- And while for now Saudi Arabia and Iran would seem to be unlikely bedfellows as beneficiaries of geopolitical difficulties among their OPEC brethren, they themselves are not immune to geopolitical risk. All the more so in the reshuffling of Middle East power in the wake of the Iran nuclear deal (see "Oil and the Obama Doctrine" April 10, 2015). We continue to think that production-risk with these two mega-producers is an underpriced call option embedded in oil prices.

We have been – and still are – calling for a fundamental change in oil market psychology: from glut to shortage. But for all that we have just laid out, we are not looking for lines at gasoline stations. For one thing, there is a great deal of storage world-wide from the glut-years. While it has undoubtedly peaked, it will still buy time in which production can gear up again. In the meantime, the drawdown will only feed the psychology of shortage. We will swing from cries of "we're running out of places to store it" to "oh my God, I wish we'd stored more."

As that psychology takes hold and prices rise, US shale producers will be incentivized to complete wells and drill new ones, and the capital markets will be re-opened for them to do so. The frackers will come back to the fray with more years of acquired knowledge that will drive down their breakeven prices, eventually fulfilling our vision of oil trading durably in its long-term range of $15 to $40 in today's dollars (see "Oilmageddon" December 16, 2014, and "The Shale Boom Shifts Into Higher Gear" June 1, 2015).

For the immediate future, the key is that sentiment has turned. We reiterate our call for oil to trade as high as $65 in 2016.

Bottom line

Last week's OPEC meeting produced no headlines, but it didn't need to. Global petroleum demand is rising, and US production is falling. Only OPEC can fill the gap – suddenly, it is relevant again. Who needs a production freeze, when the post-sanction surge of Iranian production has crested, Nigeria and Venezuela are becoming more deeply impaired, and Libya and Iraq continue at risk? Oil will move higher, to as much as $65 this year. US shale producers will re-activate at that point, and inventory can cushion potential shortages in the meanwhile. But sentiment has changed – from glut to shortage.