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MACROCOSM

Oil's Brexit Crisis

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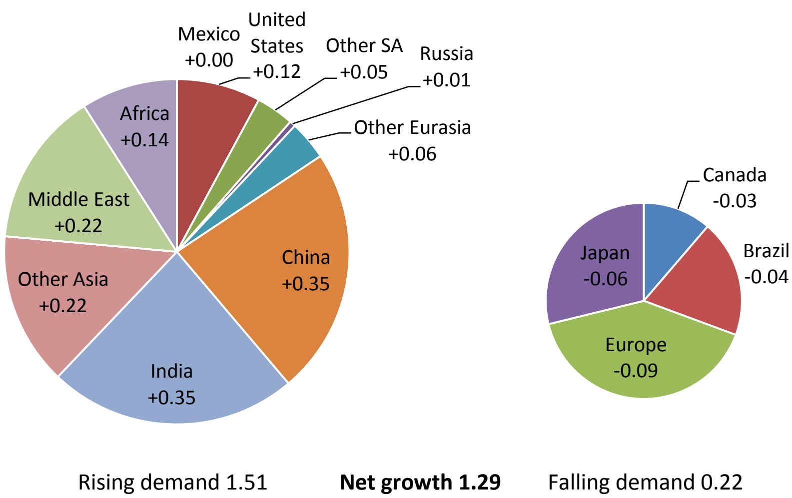
Michael Warren and Donald Luskin

Demand growth wasn't going to come from Europe. We still say oil is headed to $65.

Oil has been the weakest market post-Brexit. From pre-referendum, WTI is off 12% as of this writing. The only other Brexit victim at that level of damage is sterling.

- In fact, WTI peaked just below $52 on June 9, two weeks before the UK referendum, by which time it was already off 3.0%. From the peak, as of this writing, it's off 17.1%.
- This gets our respectful attention. We thought too-low oil prices threatened to cause a recession in the first quarter (see "The Recession Caused by Low Oil Prices" January 8, 2016). But crude's sharp recovery from its double-bottom in January and February made a mere mini-recession out of something that was shaping up to be the real thing (see "Have We Suffered Enough?" February 26, 2016).
- *Why is oil so weak? In one important sense, no explanation is really necessary.* After all, from the bottom on February 11, WTI rallied 98.3% in slightly less than four months. In that great bull move, there was already one substantial correction – 15.9% from late March to early April.
- *But instead, should we believe the often-heard narrative – from*

Crude demand 12 months forward Millions bbl/day, May/Jun/Jul average



Source: US DOE EIA, TrendMacro calculations

Update to strategic view

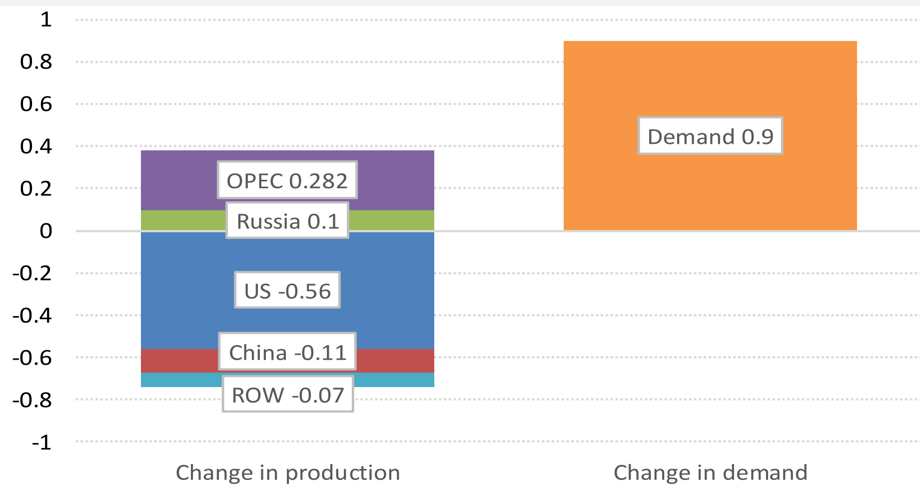
OIL: Oil has failed to recover post-Brexit as most other major markets have. This demands close monitoring, as too-low prices almost caused a recession in the first quarter. But we think the present slump is not a post-Brexit demand-shock, but only a well-deserved correction after a near-double from the bottom in February. Indeed, from a position of near-perfect supply/demand balance at mid-year, crude is about to enter into deficit of 1.27 million barrels per day by year-end, which will call forth sharply higher prices. We see no merit in the dominant narrative that stocks aren't being drawn down as rapidly as they should, as this ignores the sharp draw in OPEC stocks. We reiterate our forecast for oil at $65 by year-end.

[Strategy dashboard]

sources as seemingly authoritative as OPEC – that crude's present weakness reflects a demand shock arising from Brexit?

- We don't think so. The standard outlook for increased crude demand of 1.29 million barrels per day one year forward isn't counting on Europe. Indeed, declining demand is already expected there (please see the chart on the bottom of the first page).
- And we don't think the Brexit shock is going to spill over into the parts of the global economy where crude demand growth *is* expected (see, among many, "On the Brexit Referendum" June 24, 2016). *The focus of demand growth is the emerging economies. If we use stock market performance as a barometer, that's where Brexit both caused the least damage, and where we've seen the best recovery in Brexit's aftermath*.
- This is a reach, but if we had to implicate Brexit at all it would be on *the long-term supply* side. For the United Kingdom, freedom from European Union environmental *diktats* could mean rapid development of fracking. For that matter, fracking could be unleashed across the Continent, especially in shale-rich nations like Poland. But that's only a long-term consideration, and it would focus on natural gas in its initial phases anyway.
- *Be that as it may, if we're talking about demand shocks in the near future that are influencing spot prices now – it would take a massive demand shock indeed to prevent the crude market from going into substantial deficit starting right now*.
- *At mid-year, we calculate that the global crude market was pretty much perfectly in supply/demand balance. But it will be in a deficit of 1.27 million barrels per day by year-end, thanks to steadily growing demand, continued decline in US production baked in the cake at this point, and little likelihood that it can be quickly made up for by OPEC or Russia* (please see the chart below).

Crude oil at year-end 2016, changes from mid-year Mil bbl/day, final Q avg



Source: DOE EIA, JODI, TrendMacro calculations

- Crude prices will rise to levels sufficient to call forth new production, especially in the US, where fracking enables relatively rapid supply responses (see "Just-In-Time Energy" April 27, 2015).

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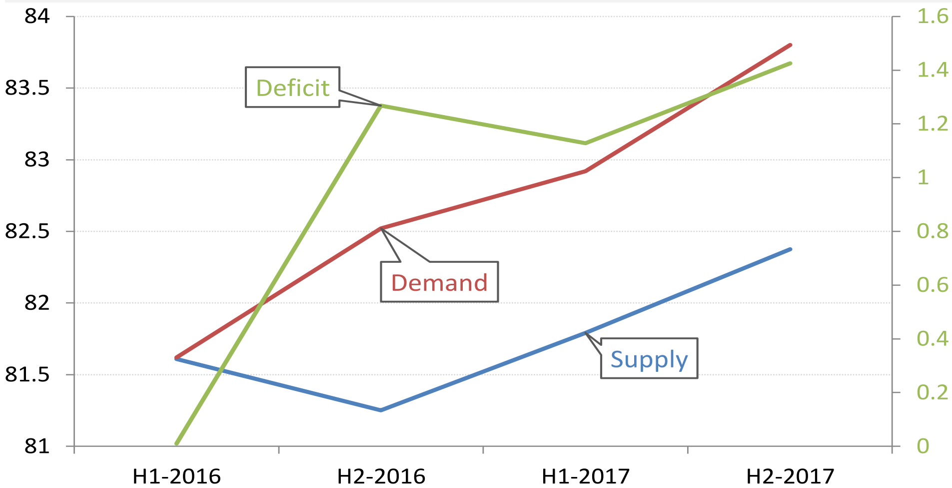
- *We still expect crude to trade as high as $65 this year* (see “How High Can Oil Go?” May 10, 2016).
- But even “just-in-time” takes *some* time, so we think deficits will persist and ultimately worsen through 2017 (please see the chart below).

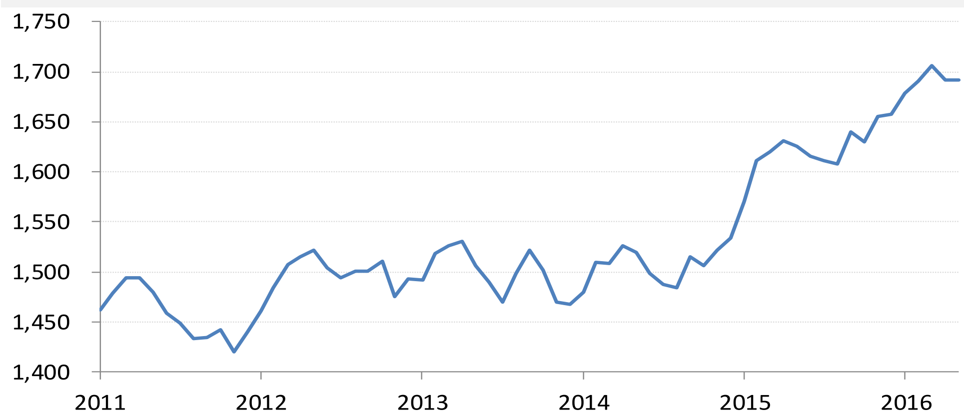
Global supply and demand for crude Millions bbl/da, final Q avg



Source: DOE EIA, JODI, TrendMacro calculations

- The safety valve, fortunately, is that crude inventories aren’t far off all-time highs (please see the chart below), and can be drawn down for many months before outright shortages materialize.

OECD crude inventories Millions of barrels, estimated for June 2016

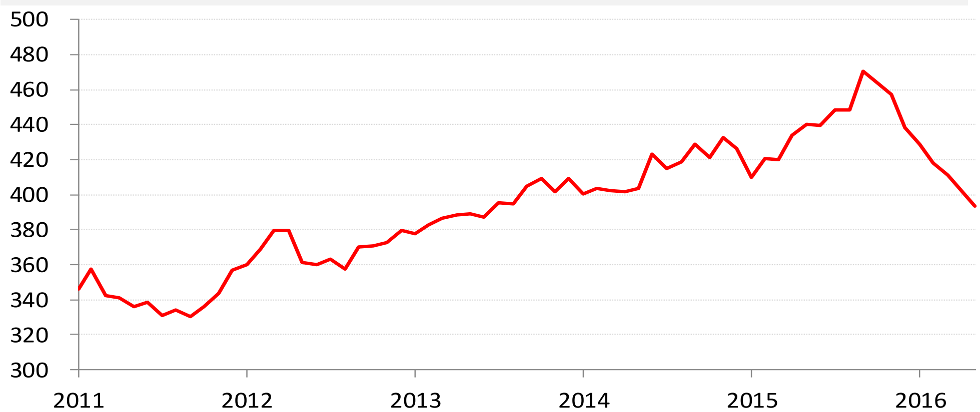


Source: JODI, TrendMacro calculations

Inventories are at the center of another often-heard narrative that would seem to contradict our expectations, and to offer an explanation for the recent weakness in crude. According to that narrative, the recent decline in OECD stocks is disappointingly small, given that we are at the peak of the driving season. Supposedly this implies a sudden shortfall in end-demand that isn’t being picked up in other measurements.

- The stocks narrative focuses on refined products. Global motor fuels and distillates remain about 100 million to 150 million barrels above normal, according to JODI data. But most of the overhang is in distillates due to the exceptionally warm winter.
- And the recent focus on US gasoline stockpiles – as some kind of canary in the mineshaft for post-Brexit demand – is downright perplexing. Global gasoline stockpiles only make up about 40% of the combined gasoline and distillate inventories, and have been dropping steadily since January 2016.
- The obsessive focus on stocks – using them as a tool to infer supply/demand imbalances – requires us to believe that global stocks numbers are sufficient and correct, while measures that show falling contemporaneous global production and rising contemporaneous global demand are all wrong.
- Stocks estimates are no more correct than the others. Indeed, right now, we are hearing that there is a very large discrepancy arising from a failure to accurately account for large Canadian drawdowns during the recent outages caused by wildfires.
- *If we must focus on stocks, let's look at a component in the overall picture which for some reason has been scarcely reported at all – the fact that OPEC crude stocks have been falling extremely sharply, relentlessly, month after month* (please see the chart below).

OPEC crude inventories Millions of barrels, estimated for June 2016



Source: JODI, TrendMacro calculations

- Since, October 2015, they've already declined for seven months in a row, cumulatively by 70 million barrels (for those members who report it), according to data from the International Energy Forum's Joint Data Initiative (JODI). During this decade, the longest consecutive drawdown was only three months, cumulatively 27 million barrels.
- With OPEC stocks falling sharply while OECD stocks have fallen only a little, one interpretation would be that this represents only a forward-deployment down the supply-chain, aggressively putting goods closer to the end-user as a tactic in OPEC's internecine war for market-share (see "Market Share for Cannibals" June 8, 2015).

- Or it might be connected to Iran's production after sanctions were lifted in January. Having surged now by as much as 700,000 barrels per day, and with little storage capacity within its own borders, Iran's output has to be stored somewhere.
- Be all that as it may, there remains the question of why OPEC would let stocks pretty much complete a round-trip back to historically normal levels, especially with Saudi Arabia (which represents about 70% of OPEC stocks) having brought on-line the huge new Jubail and Yanbu refineries since 2014, which ought to command significant new inventories.
- <u>*For us, it begs the question of whether OPEC is running out of production capacity in the near-term.*</u>
- Even in today's energy environment of abundance – when nobody speaks of "peak oil" anymore, and the tacit assumption is that there will always be as much more on tap as might be desired – it is nevertheless a fact that OPEC hit all-time high production last December – and is now 190,000 barrels per day below that high, and that thanks only to Iran's surge this year once sanctions were lifted.
- Far be it from us to talk about "peak oil." *Never!* But at today's still-low prices, we have to at least think about diminishing returns, especially after Iran's one-time surge. To coax more oil out of the earth, whether in OPEC or in Texas, it's going to take higher prices. They are on the way.

Bottom line

Oil has failed to recover post-Brexit as most other major markets have. This demands close monitoring, as too-low prices almost caused a recession in the first quarter. But we think the present slump is not a post-Brexit demand-shock, but only a well-deserved correction after a near-double from the bottom in February. Indeed, from a position of near-perfect supply/demand balance at mid-year, crude is about to enter into deficit of 1.27 million barrels per day by year-end, which will call forth sharply higher prices. We see no merit in the dominant narrative that stocks aren't being drawn down as rapidly as they should, as this ignores the sharp draw in OPEC stocks. We reiterate our forecast for oil at $65 by year-end.