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

MACROCOSM

Venezuela: A Trump Oil Shock?

Tuesday, August 8, 2017

Michael Warren and **Donald Luskin**

Oil is priced for geopolitical perfection. Venezuela is far from perfect, and getting worse.

The two actions that have brought the Trump administration near-universal praise have been April's targeted attack on Syria in punishment for use of chemical weapons, and Saturday's unanimous United Nations decision to impose sanctions against North Korea in punishment for its missile tests. Eager to put more wins on the scoreboard, it is possible that the administration could impose new sanctions to punish the regime of Nicolás Maduro in Venezuela, if it makes further moves toward dictatorship. *If limited sanctions already in place against Maduro and other officials are ramped up to target Venezuela's oil industry, it would be a hard break in the present blissful sentiment in the global crude market, which seems to have geopolitical threats in Venezuela, Libya and Nigeria priced to perfection* (see "Is Oil Priced to Perfection Again?" May 9, 2017).

- Speculation has focused on a potential US ban on Venezuelan crude imports, which currently run about 700,000 barrels per day.
- The US has alternative suppliers of the sludgy heavy crude that Venezuela exports – especially Canada, although it would be expensive because, given present pipeline capacity, it would have to be shipped by rail.
- Most likely the US would draw from the 428 million barrels of heavy crude in the Strategic Petroleum Reserve, and from additional volumes in the Louisiana Offshore Oil Port. With no other sourcing substitution, these alone could replace Venezuelan imports for almost two years.
- *So an import ban would not drive physical shortages in the US market. But it would create supply chain dislocations and uncertainty – and draw down inventories – so it would likely push crude prices higher.*
- *A countervailing force against an extreme price shock that might otherwise result would be the ever-present possibility that somewhat higher prices and reduced US inventories would prompt OPEC to prematurely end its production cuts.*
- Another countervailing force is that Venezuela would have to try to place volumes not sold to the US with other global customers. Much of the rest of the world doesn't have the US's complex refineries optimized for Venezuela's sludgy heavy crude. Venezuela would have to muscle into existing supply chains by discounting prices. *But this is only a first-order analysis.*

Update to strategic view

OIL, EMERGING MARKETS MACRO: US sanctions on crude oil and product imports or exports would push Venezuela into collapse, taking up to 2 million barrels a day off-line. Though strategic and LOOP reserves would buffer the impact in the US, Trump would not likely want to be responsible for a global oil shock. Venezuela is already in a deep inflationary depression and near civil war, so may collapse anyway. It's an embedded call option in oil that is far underpriced.

[Strategy dashboard]

- *A more profound upward crude price shock would come if Venezuela were to completely lapse into chaos*, reducing crude production now at about 1.9 million barrels per day to, say, only 500,000 – as happened in 2002 during the Hugo Chávez coup.
- At that level of production, Venezuela could not meet its own consumption needs of about 600,000 barrels per day. *Exports would cease, and Venezuela would have to become an importer.*
- Actually, thanks to Venezuela's inability to keep its refineries in good repair, it *already* imports 16% of its gasoline and 19% of its diesel, both mostly from the US. In addition, Venezuela imports 23% of its refinery feedstocks – blending components, naphtha, oxygenates and so on – also from the US.
- These imports from the US come primarily through Venezuelan-controlled CITGO, using barter arrangements that don't deplete scarce dollar reserves. Without dollars, Venezuela would be hard-pressed to replace US supply. *So a ban on crude imports by the US would have the second-order effect of being a ban on product and feedstock exports from the US, which would create an intense energy supply shock in Venezuela.*
- *The Trump administration could impose this shock directly by banning exports to Venezuela, even if it doesn't ban imports from it.*

Venezuela is very close to collapse anyway. The full extent of its inflationary depression is not generally appreciated.

- Venezuela's GDP is down 35% from 2013 levels in aggregate, and 40% in *per capita* terms, the worst economic shock in its history.
- The cause isn't just inefficient socialism or long-standing political chaos. Not to forgive any of those things, but it's also the drop in global oil prices. Oil exports are off by $2,200 per capita over the last five years, of which $1,500 is due to falling prices. With Venezuelan per capita income at less than $4,000 to begin with, that's a drop in national income of more than half.
- Inflation is rampant. The minimum wage – which in Venezuela is also the median wage – has declined by 75% over five years in real terms. It's worse measured in black-market US dollars.
- Venezuela has very little financial resiliency with which to deal with this. It is already the world's most indebted nation, measured by either external debt as a share of GDP or of exports.
- Maduro's bid for dictatorial power is only a logical next step in such an environment.
- One of us – Michael Warren – has worked in Latin America and studied it for decades. Based on experience and local knowledge, we see the *next* next step being former military and some current National Guard members arming themselves for confrontation after the seating of the "Constituent Assembly" that will likely soon legitimatize Maduro's dictatorial powers.

The Trump administration may not want to put its fingerprints on oil sanctions – imports, exports or both – and be blamed both for a Venezuelan collapse that would happen anyway, and an enormous global

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]

Recommended Reading

Why the Trump dynasty will last sixteen years
Edward N. Luttwak
The Times Literary Supplement
July 25, 2017

The Mystery of L.A. Billboard Diva Angelyne's Real Identity Is Finally Solved
Gary Baum
Hollywood Reporter
August 2, 2017

[Reading home]

crude price spike that would result. But the risks of both – collapse, and an oil shock – are tangible, and underappreciated. That means there's an embedded long call option in crude, and it's far underpriced.

Bottom line

US sanctions on crude oil and product imports or exports would push Venezuela into collapse, taking up to 2 million barrels a day off-line. Though strategic and LOOP reserves would buffer the impact in the US, Trump would not likely want to be responsible for a global oil shock. Venezuela is already in a deep inflationary depression and near civil war, so may collapse anyway. It's an embedded call option in oil that is far underpriced.