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Oil: From Priced for Perfection, to Perfect Storm

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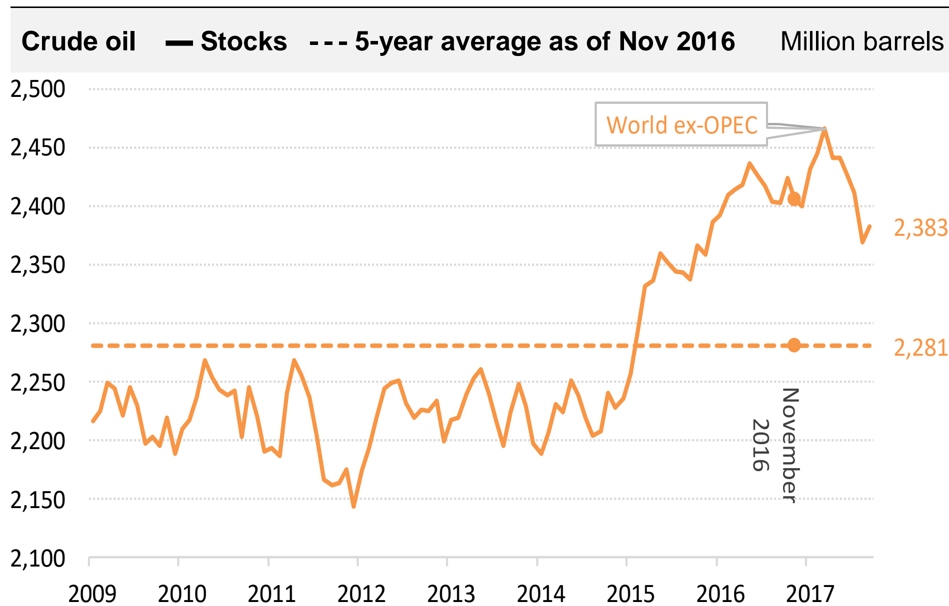
Michael Warren and **Donald Luskin**

OPEC will squeeze another 100 million barrels out of global stocks. US producers win.

At last! Crude oil is being driven to the our long-standing price target of $65, at the top of the $45 to $65 trading range we established a year and a half ago (see "How High Can Oil Go?" May 10, 2016). In fact, the Brent benchmark got as high as $64.65 earlier this month (missed it by that much). It's been a perfect storm of all the risk-factors we pointed to in June, when we called the bottom at WTI $42, saying oil was priced for perfection, in denial of those factors (see "The Crude Stocks Conundrum" June 28, 2017).

- **GLOBAL STOCKS AND OPEC** In June, it seemed that OPEC's production cuts were failing to bring down bloated global inventories. After they were announced in November 2016, they had the perverse effect of encouraging hoarding, making inventories rise. But now world ex-OPEC stocks, which had risen by as much as 60 million barrels, are down 83 million from there, for a net draw of 23 million from the November 2016 starting point (please see the chart below).
- 22 million may seem like a small prize after a year. *But OPEC and*

Crude oil — Stocks - - - 5-year average as of Nov 2016 Million barrels



Source: JODI, TrendMacro calculations

Update to strategic view

OIL, US RESOURCE STOCKS: Oil is headed to $65, and will likely overshoot our price target, as it undershot below $45 in June. It's a perfect storm. Domestic production has stalled out, global inventories have come down and have further to fall, OPEC will likely extend its production cuts through 2018 at this week's meeting, and the Middle East faces black swan risk as the Saudi/Iran rivalry heats up just as Saudi undertakes a dangerous modernization agenda. The US energy sector will thrive in a coming year of higher prices, having been the second-worst performing sector in 2017.

[Strategy dashboard]

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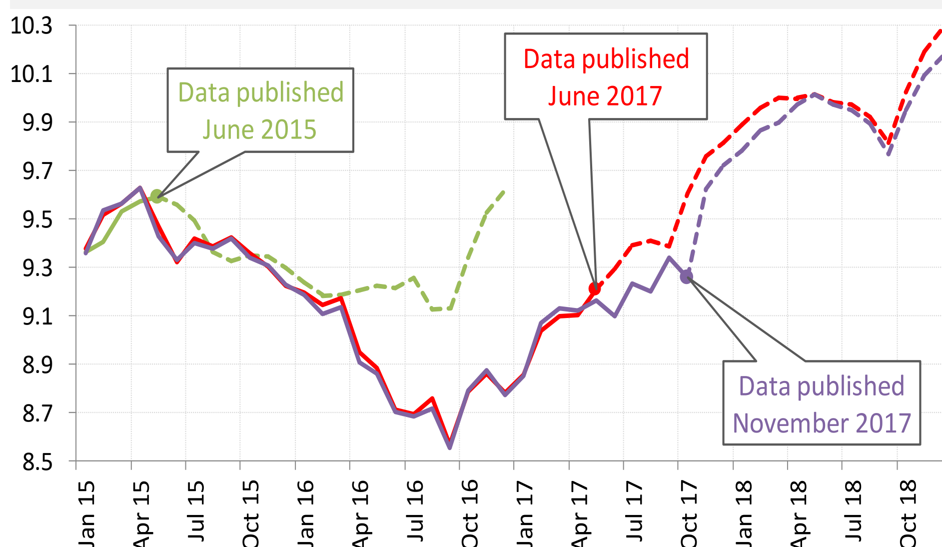
its non-member collaborators have every reason to extend the cuts this week at the Vienna meeting – both because they have now visibly worked, and because there is still so much work left for them to do. To hit the cartel's target of the 5-year average, world ex-OPEC stocks must still fall 102 million barrels (again, please see the chart on the previous page).

- Some analysts we respect believe there is an iron-clad inverse relationship between inventory levels and price. We just don't see it in the long-term data. Nevertheless, we think in this case, *from such historically high inventory levels, it's likely that an extension of OPEC's quotas would have the effect of both lowering inventories and raising prices in the intermediate term.*
- From the cartel's perspective, what amounts to about a 5% cut in production only has to raise the oil price by 5% to be worthwhile. And for all the attention being paid to Vladimir Putin as the man driving the deal – as much as anything, we think, mostly just a story that keeps Russia in the US news as a hidden hand manipulating world affairs – Saudi Arabia's needs predominate. The young Crown Prince Mohammad bin Salman (MBS) continues to make an IPO of Saudi Aramco a cornerstone of his reform regime, and higher prices are pretty much a necessity to pull that off. Iran, for its part, has admitted that it doesn't have much upside potential for new volumes – so nothing is lost by going along with regional rival Saudi – it's a free option to try to boost cash flow with higher prices.
- *So it's a no-brainer for OPEC to announce an extension this week.*
- **US PRODUCTION** There was a time, not so very long ago, when we were a lonely voice in a skeptical world forecasting a productivity revolution in extracting oil from shale (see "I Have Seen the Future, and It Fracks" February 24, 2015; and, our earliest, "The Stench of CrISIS" June 25, 2014). By this mid-year, the consensus had adopted a premature form of our long-term vision, going so far as to declare that Tesla had made oil obsolete,

US crude oil production **— Actual** **--- Forecast** Million barrels per day



Source: DOE EIA STEO, TrendMacro calculations

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Recommended Reading

US tight oil and gas and its global impact
Anas Alhajji
The Journal of World Energy Law & Business
October 27, 2017

French Companies Boost Hiring as Business Confidence Improves
Piotr Skolimowski and Mark Deen
Bloomberg
November 23, 2017

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just as shale allowed us to pump an infinitude of it (see “The Peak Oil Myth is Back (But This Time It’s Demand)” July 12, 2017).

- But at mid-year 2017, US production was 410,000 barrels per day lower that what had been forecasted two years before for year-end 2016. And today’s production is only 52,000 barrels per day higher than at mid-year, which is 350,000 barrels less than forecasted at mid-year (please see the chart on the previous page).
- *The reality is that crude prices have been too soft to justify a lot of fracking anywhere but the Permian. And there, production is constrained by pipeline take-away capacity, which has maxed out until the first quarter of next year.*
- **GEOPOLITICAL RISK** Until recently, crude markets have been oblivious to the ever-present risk of social and political instability in major oil producing countries. Those risks have become more salient recently, and they’ve contributed to some extent to the rally in crude prices as a third explanatory factor alongside OPEC production cuts, and disappointing US production.
- We think recent flare-ups in the Middle East should not be seen as one-off sporadic events, but a building crescendo of mishaps affecting the changing balance of power dynamics that will take years to play out.
- When President Barak Obama tilted the regional balance of power (see "Oil and the Obama Doctrine" April 10, 2015) with a one-sided nuclear deal with Iran (see "Iran: The New New World Oil Order, Volume I" July 20, 2015), he abdicated the US role as the regional power-broker, and provided Iran with the economic wherewithal to more effectively destabilize the region. The most pressing issue is an economically empowered Iran, building a ballistic missile system and carrying out acts of aggression against regional rivals and innocent bystander nations, through its proxies from Hezbollah to the Houthis.
- The Saudis, and especially MBS, the ambitious but unseasoned crown prince, are especially sensitive to the threat to what was, until recently, their unquestioned supremacy in the region.
- Imagine Saudi’s consternation at Iran and Iraq signing two new energy deals, pumping Iraqi oil through Iranian ports and Iranian gas to the Iraqi grid. Combined, Iran and Iraq produce almost as much as oil as Saudi. And the gas deal is astounding in that Iraq already has plenty of associated natural gas to source its own grid.
- The Saudis boosted security operations after intercepting a missile fired from Iran-backed Houthi rebels in Yemen – which the Kingdom called an act of war – and the disruption of the crude oil pipeline that pumps feedstock to Bahrain for refining and export operations.
- Saudi’s rift with Qatar, in our estimation, is a warning to regional neighbors not to take Iran’s side in the intensifying rivalry.
- Who knows what to make of the bizarre drama of the Lebanese prime minister resigning while visiting Saudi Arabia (under Saudi pressure, according to Hezbollah, to destabilize the influence of Iran’s proxy) – and now just as suddenly returning home?
- At the same time, MBS is courting all manner of unknown unknowns with an aggressive modernization and reform agenda, of

which his beloved Aramco IPO is a part. The recent crackdown on wealthy princes in the name of anti-corruption risks a potentially destabilizing internal dynamic within the Saudi ruling elite. And his program to modernize and make more West-friendly Saudi's harsh and insular form of Islam risks a split with a powerful clerisy that has been the royal family's partner in power for many decades. *A collapse and chaotic realignment of that power could be the biggest black swan to hit the oil market since the Iranian revolution of the 1970s.*

- There are other rifts forming in the Middle East as well. The Kurds and the Iraqi central government almost came to blows over the Kirkuk oil fields that flow through the Kurdistan Regional Government (KRG) in the pipeline to Ceyhan, Turkey. While bloodshed was avoided, Iraq has emphasized the rebuilding of the northern pipeline that bypasses the KRG, after the Kurds voted for independence and started questioning Iraqi crude oil "transit payments" that go through its pipelines. Even Turkey – for whom Kurdish independence is anathema – could get into the fray, shutting down the Ceyhan pipeline.
- And on the other side of the world, Venezuela moves closer to complete collapse. The arrest of eight American CITGO executives brings closer the possibility of US-imposed sanctions, which could easily shut down not only Venezuela's oil export capacity, but would have the effect of depriving it of critical gasoline and diesel (see "Venezuela: A Trump Oil Shock?" August 8, 2017).

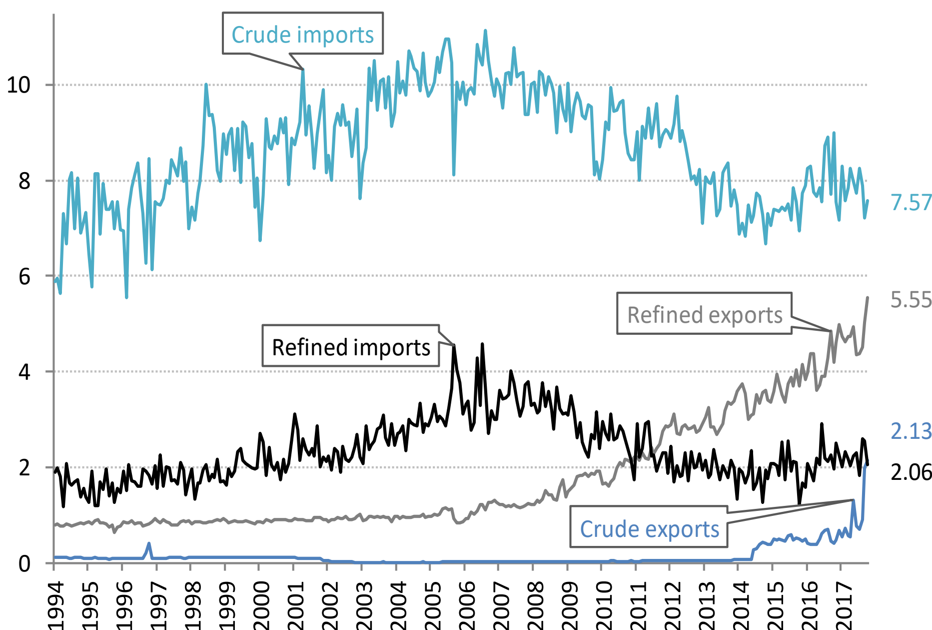
Barring the eventuation of one of the geopolitical risk events – which now have at least commanded some degree of risk premium – we are by no means calling for oil to return to the bad old days of triple-digit prices.

But for all these reasons, we think crude will work higher, hit our $65 price target, and likely overshoot it somewhat (as it did our $45 downside target), and then live for the intermediate term at the higher end of the trading range.

- A major factor capping the upside for crude is pent-up potential in the Permian. Production is forecasted to hit 2.68 million barrels per day by year-end and – what do you know! – we had estimated pipeline takeaway capacity at 2.65 million (again, see "The Crude Stocks Conundrum"). Two new Permian oil pipelines with a combined 900,000 barrels per day capacity will come online between Q2-2018 and Q1- 2019. Given the near-doubling of drilled uncompleted wells this year – to 2,533 – there is little doubt that the 460,000 barrel Midland to Sealy pipeline, the first to open next year, will be filled to capacity immediately.
- There will be more pipelines, too. With the Trump administration's easier regulatory policies, the Dakota Access is already flowing, and the Keystone XL pipeline marches step by step to approval. Typical analyses of crude prices that focus only on end-demand and drilling costs ignore the key role of the cost and availability of transport (see "Keystone is Key to Low Oil Prices" February 2, 2015).

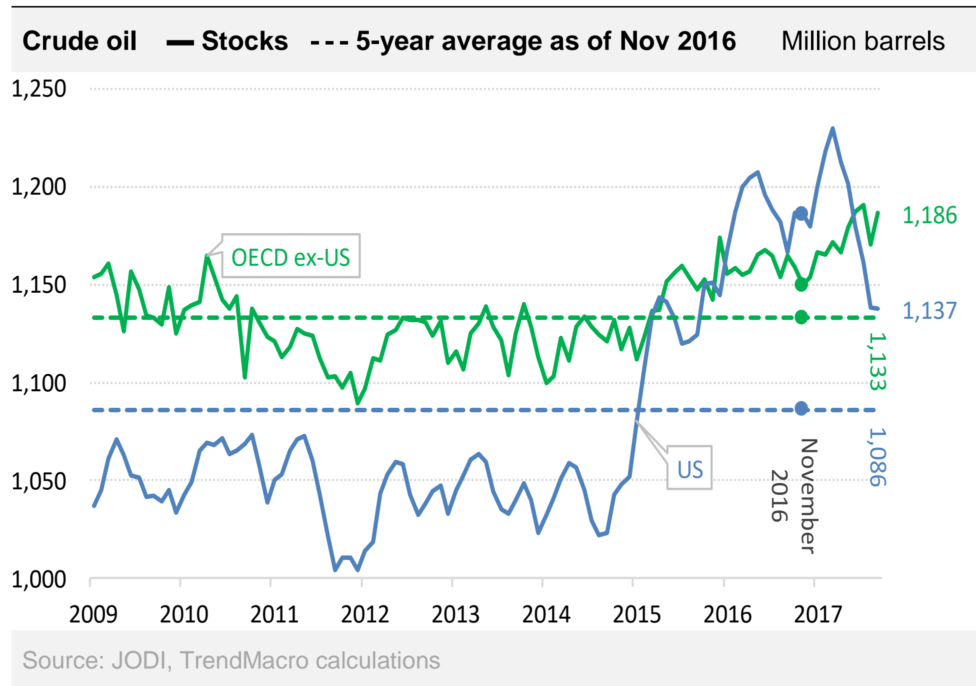
- And in the mid-$60's, fracking gets interesting again in shale plays other than the Permian.
- *As OPEC considers its options this week, it's just a reality that its production quotas facilitate development, profits and gains in market share by American frackers. But OPEC learned in the crash of 2014 to 2016 that it can't spend market-share (nor, as it turns out, knock out American frackers).*
- An oil-producing nation needs dollars, not market share, to meet its voracious social-spending budget (see "Market Share for Cannibals" June 8, 2015). *That means you need higher prices, and production cuts from the cartel that is still the global swing-producer are the only way to even try to do it.*
- We doubt OPEC has all that much spare capacity anyway. Oil producing nations need dollars to reinvest in the infrastructure that will keep the oil (and the dollars) flowing in the future. Thanks to its misadventure in quest of market share, there's been too little reinvestment. The US DOE estimates that OPEC spare capacity has increased by 1.1 million barrels per day from when production cuts of 1.2 million were announced a year ago. *That implies OPEC spare capacity has fallen, on net, by 100,000 barrels.*
- Meanwhile, global demand for US-sourced light oil – as well as distillates and petroleum products – has soared. Relentlessly falling natural gas prices have made the US the world's low-cost producer of refined product. At the same time, we don't have a sufficient market for all the diesel produced domestically as a gasoline by-product – so it goes to Europe and emerging markets, where diesel demand is insatiable. All in all, the US has been a net exporter of refined products since mid-2011 (please see the chart below, and "Data Insights: Oil" November 13, 2017).

US petroleum trade flow Millions barrels per day



Source: DOE IEA, TrendMacro calculations

- And since 2015 when, as a happy spillover of the Iran nuclear deal, domestic producers were liberated to export crude for the first time in decades, exports have grown to more than 2 million barrels per day (again, please see the chart on the previous page), making the US the world's seventh largest crude *exporter* at the same time as it is the world's second largest crude *importer!*
- The US isn't ready to be the global swing producer yet. But its rise as a major *exporter* has changed global inventory dynamics. Remembering that world ex-OPEC crude stocks are down 23 million barrels since the OPEC production cut was announced in November 2016, more than all of that is explained by the US, whose stocks are down 48 million. In fact, OECD-ex US stocks are *higher* by 37 million (please see the chart below; the missing draw of 12 million, to net to 23 million, is non-OECD non-OPEC stocks).



- *Based on the target 5-year average level as of November 2016, US crude stocks have 52 million barrels still to fall.*
- *A year of prices between $55 and $65 – after a year between $45 and $55 – will be a game-changer for the beleaguered US energy sector, which has been the second-worst performing of the year.*

Bottom line

Oil is headed to $65, and will likely overshoot our price target, as it undershot below $45 in June. It's a perfect storm. Domestic production has stalled out, global inventories have come down and have further to fall, OPEC will likely extend its production cuts through 2018 at this week's meeting, and the Middle East faces black swan risk as the Saudi/Iran rivalry heats up just as Saudi undertakes a dangerous modernization agenda. The US energy sector will thrive in a coming year of higher prices, having been the second-worst performing sector in 2017.