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MACROCOSM

Saudi and Russia Change Their Tune

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Michael Warren and **Donald Luskin**

Bowing to Trump's tweet, or stabbing Iran in the back? Little change for global oil markets.

FIRST, A WORD ABOUT EUROPE The failure of the coalition government in Italy, which we predicted, is sharply driving up lower-quality sovereign yields across Europe, and safe haven demand in Germany and the US. *To understand the global systemic risk this implies, be sure to read our Friday report* "USD, Euro and the Risk of Italeave," which some clients may have missed ahead of the Memorial Day weekend.

NOW, ONWARD TO OIL Last week's sudden reversal in oil prices is a big change in the dominant narrative, but not outside what we were expecting. More than a month ago we nudged up our expected trading range for the year to $65-to-$70, and said to expect overshoots, which we quickly got (see "Oil's Bullish Bottlenecks" April 24, 2018). We also said the bull-case was overheated – and indeed, we've gone from widespread reports a month ago that Saudi Arabia was shooting for $100 crude, to reports now that Saudi and Russia are agreeing between themselves to end OPEC's production cuts at the upcoming June meeting in Vienna. *What a difference a month makes, at least in terms of the narrative. And there are some important new realities that have intervened. But as it all shakes out, nothing is causing us to tweak our expected range at this point.*

- One thing that has intervened is the US pulling out of the Iran nuclear deal (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018). It remains to be seen to what extent the threat of US sanctions against trading partners can cripple Iran's oil exports. But it should be no surprise to hear Iran's regional arch-rival Saudi Arabia talk about lifting production quotas to assure Iran's customers that there are ready alternatives.


Donald J. Trump
@realDonaldTrump
Looks like OPEC is at it again. With record amounts of Oil all over the place, including the fully loaded ships at sea, Oil prices are artificially Very High! No good and will not be accepted!
5:57am · 20 Apr 2018 · Twitter for iPhone

- What better way to thank President Donald J. Trump for pulling out of the deal, than to seem to respond – somewhat bow, to be sure – to his late-April tweet chiding OPEC for "artificially Very High" prices. Saudi's puppet, OPEC Secretary General Mohammad Barkindo said Friday, "I was prodded by his excellency [Saudi Oil Minister] Khalid Al-Falih that probably there was a need

Update to strategic view

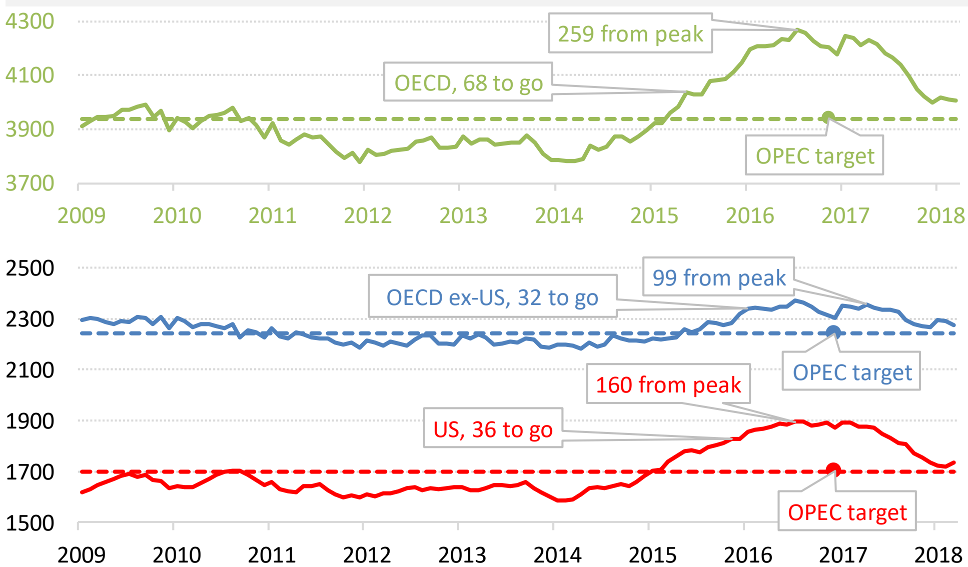
OIL: Saudi Arabia and Russia have reportedly agreed among themselves to end the OPEC production quotas at the upcoming June meeting. This has deflated the overheated bull-case, but it has not changed the supply-and-demand situation in the global oil market. Ending the quotas can make up for Iranian and/or Venezuelan exports lost to sanctions – giving Saudi and Russia a chance to muscle in on troubled competitors' business, and for Saudi to thank Trump for pulling out of the Iran nuclear deal. But depending on the impact of sanctions, that could take everything Saudi and Russia have got as swing producers. Global inventories are probably not fully back to OPEC's target, but their getting there, so it is time to announce a phase-out of quotas and it won't change the supply-and-demand dynamics. US export bottlenecks continue to point to shortages of light crude in the emerging markets, and a domestic glut. We do not change our expected range for $65 to $75.

[Strategy dashboard]

for us to respond… We in OPEC always pride ourselves as friends of the United States."

- At the same time, following the sham re-election of Venezuelan President Nicolás Maduro, the US has imposed new financial sanctions, and the European Union is preparing to do the same. These are short of the kill-shot the US could administer by halting US exports of refined petroleum products and feedstocks to Venezuela via the present barter arrangements managed by Citgo (see "Venezuela: A Trump Oil Shock?" August 8, 2017). We can't rule out the Saudi's new willingness to supply the global market is a result of a pre-negotiation with Trump that would enable such actions, which would effectively shut down the Venezuelan economy and take its oil exports entirely off the market for a period.
- *Atmospherics aside, the simple supply-and-demand reality is that if higher exports from Saudi and Russia – the only major participants in the quotas capable of acting as significant swing-producers at this point – simply make up for lower exports from Iran and/or Venezuela, nothing on net has changed in global oil markets. Indeed, making up for lost Iranian exports will take just about everything Saudi and Russia have got.*
- At the same time, as the month has gone by, global consumption has continued to grow and global inventories have likely edged lower, which was the intention of OPEC's production quotas all along. The International Energy Agency is just wrong when it claims that OPEC's inventory-reduction goals have already been more-than-completely accomplished as of the most recent data, which is for March (please see the chart below). But we don't doubt that by the time OPEC meets in late June, it could be close enough to allow the cartel to announce a schedule for ending the quotas. For that matter they were never planned to go beyond year-end 2018 anyway (see "150 Million Barrels To Go" January 22, 2018),

Stocks of crude oil and petroleum products Millions of barrels



Source: JODI, TrendMacro calculations

so this next semi-annual meeting was always the logical time to announce their phase-out – it's just a question of timing details.

- *But assuming that the phase-out is in line with inventory-reduction goals, then the equilibrium between production-flows and inventory-stocks will be unchanged. Here too, nothing will have changed in the supply-and-demand dynamics of the global oil market.*
- That market will still be beset by strange dynamics driven by the over-supply of light-tight oil in the United States – crude for which domestic demand is satiated, and yet for which export facilities are in short supply. If relaxation of quotas by OPEC-plus-Russia ends up getting absorbed mostly to replace sanctions-crippled Iranian exports, *there may well be a crude shortage overseas, especially in the emerging economies, and a simultaneous glut in the US. Such dynamics are likely to lead to strange spread-relationships, but not lower global prices overall.*

Bottom line

Saudi Arabia and Russia have reportedly agreed among themselves to end the OPEC production quotas at the upcoming June meeting. This has deflated the overheated bull-case, but it has not changed the supply-and-demand situation in the global oil market. Ending the quotas can make up for Iranian and/or Venezuelan exports lost to sanctions – giving Saudi and Russia a chance to muscle in on troubled competitors' business, and for Saudi to thank Trump for pulling out of the Iran nuclear deal. But depending on the impact of sanctions, that could take everything Saudi and Russia have got as swing producers. Global inventories are probably not fully back to OPEC's target, but their getting there, so it is time to announce a phase-out of quotas and it won't change the supply-and-demand dynamics. US export bottlenecks continue to point to shortages of light crude in the emerging markets, and a domestic glut. We do not change our expected range for $65 to $75.

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