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MACROCOSM

OPEC Eases (Or So It Claims)

Monday, June 25, 2018

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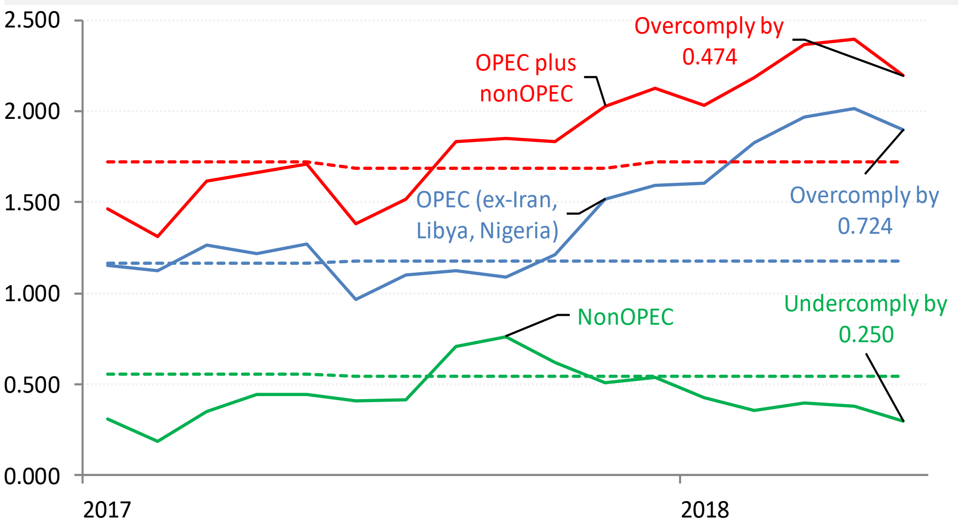
Saudi can't back up promises for 1 million new barrels/day. Crude markets will tighten.

OPEC is being about as clear about its plans as the Jerome Powell Fed – that is, not clear at all. *But reading through all the conflicting official statements and unofficial assurances, it looks like it's exactly what we predicted* (see "Saudi and Russia Change Their Tune" May 29, 2018)*:* *OPEC and its non-cartel fellow-travelers have agreed to taper production quotas and wind them up at year-end.*

- According to separate OPEC (Friday) and non-OPEC (Saturday) communiques, *the tapering will consist of no longer over-complying with the quotas. But this is somewhat nonsensical.*
- OPEC's over-compliance – producing now 724,000 barrels/day less than allowed (ignoring Iran, Libya and Nigeria – please see the chart below) – is more than half explained by Venezuela, whose collapsing economy simply cannot produce the additional 439,000 barrels/day allowed by its quota.
- If non-OPEC were to revert to compliance, that would entail a production *cut* – as it is presently *over*-producing its quotas by 250,000 barrels/day, led by Kazakhstan and Russia.

Compliance with production quotas Millions barrels/day, as of May 2018

— Actual - - - Target



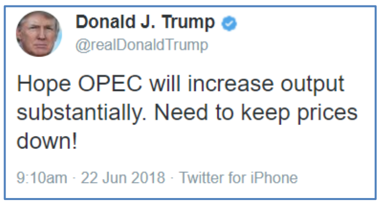
Source: Bloomberg, TrendMacro calculations

Update to strategic view

OIL: OPEC has officially announced what amounts to a tapering of its production quotas into year-end, to be achieved at first by the end of over-compliance with the quotas. Combined with non-OPEC partners, that means production should increase by 474,000 barrels/day – but dovish Saudi has said unofficially to expect 1 million, and even hawkish Iran has said 700,000. But more than all the over-compliance has come from the collapse of Venezuelan production, and no official announcement can bring that back. Saudi and Russia could probably quickly increase production by at least 500,000 barrels/day, but with the threat of US sanctions, Iranian production has nowhere to go but down. Production growth in the Permian will slow because of takeaway capacity constraints, which won't lift meaningfully until mid-2019. We reiterate our trading range for crude of $65 to $75, and expect upside overshoots.

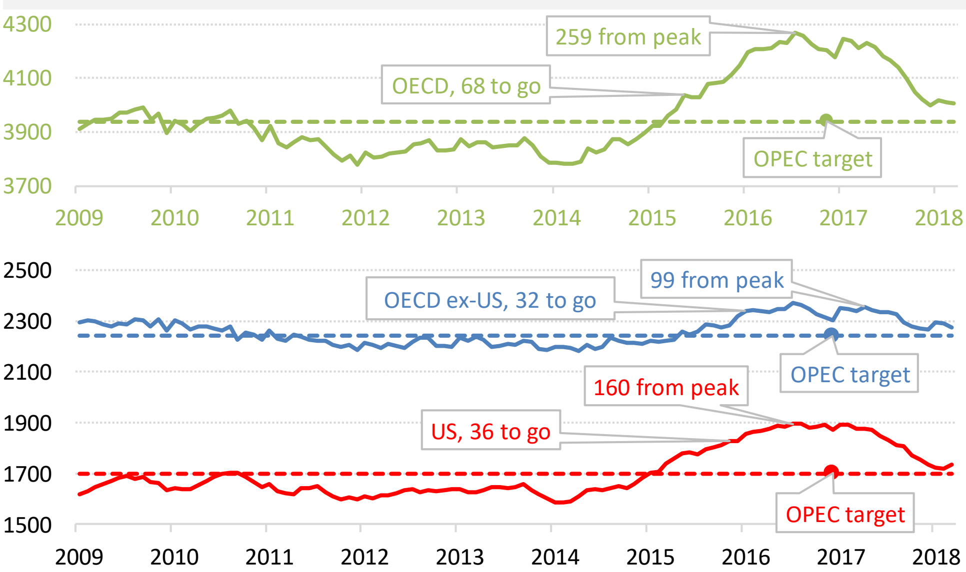
[Strategy dashboard]

- *<u>So together, return to compliance by OPEC and non-OPEC would mean a production increase of 474,000 barrels/day.</u>*
- Yet for all this, Saudi Arabia has [repeatedly told the press] post-meeting that the agreement will raise production by 1 million barrels/day – specifically assuring consumers that "their energy supplies are available, are being stewarded by a responsible group of producers." Iran and Iraq are [telling the press] the production increases will be more like 700,000 barrels/day, close to the number it would take to erase OPEC's *over*-compliance – seemingly without taking into account non-OPEC's *under*-compliance.



- It's not hard to see where the economic and geopolitical battle lines are drawn. Dovish Saudi wants to be cooperative with President Donald J. Trump's [repeated calls for relief] from high gasoline prices, if for no other reason than to thank him for putting the screws to the Kingdom's regional rival, Iran, by withdrawing from the nuclear deal and re-imposing sanctions. Hawkish Iran, for its part, sees US sanctions diminishing its export volumes – so why not press for quotas on other producers that will keep unit-prices high? And if that thwarts Trump, so much the better.
- *<u>Rhetorical and geopolitical conflicts aside, things are quite clear directionally: the quotas are being tapered away through the rest of the year. But this does not necessarily change the basic supply-and-demand equilibrium in the global oil market.</u>*
- Remember, the whole point of the production quotas was to tighten the market, by causing excessive global crude and product stocks to be drawn down to historically normal levels (see ["150 Million Barrels To Go"] January 22, 2018). They aren't there quite yet (please see the chart below), but they will likely be in a couple

Stocks of crude oil and petroleum products Millions of barrels, as of April



Source: JODI, TrendMacro calculations

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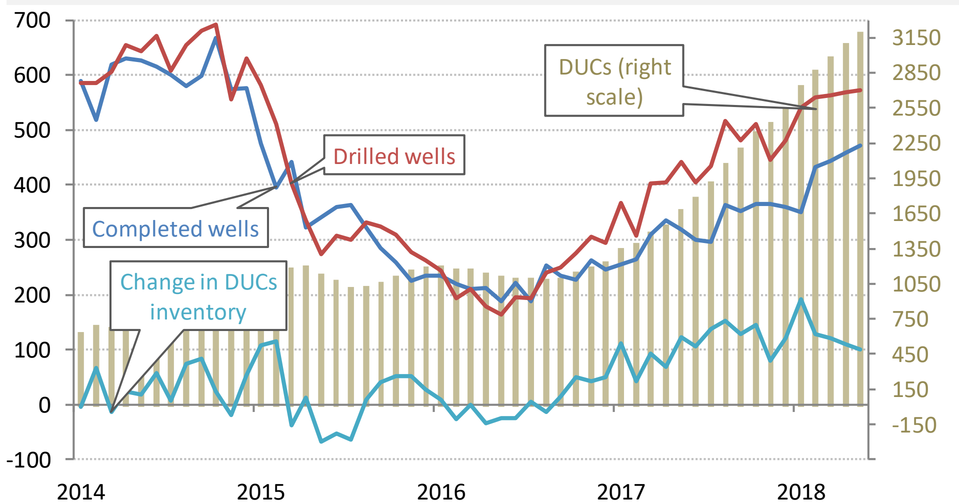
months, and certainly by year-end. So the *loosening* of supply will come at the same time as a *tightening* of stocks – so no net change in the equilibrium (again, see “Saudi and Russia Change Their Tune”).

- *What’s less clear is: how exactly will OPEC loosen production?*
- *We think only Saudi has the excess capacity to make a decisive difference – say 500,000 barrels/day. Russia may have some as well. The big difference-maker in terms of the effectiveness of the production cuts all along has been Venezuela, and again, that’s been only an accident, and it is presently helpless to increase production. At the same time, again, Iranian production probably has nowhere to go but down, as the threat of US sanctions on non-US consumers of Iranian oil start to bite* (see “Iran Deal: More Fire, More Fury, Pure Trump” May 9, 2018).
- The US has a great deal of scope to increase light-tight oil production, especially in the Permian. There are more than 3,200 drilled but uncompleted wells (DUCs) in the Permian, an all-time record, and twice as many as twelve months ago (please see the chart below).

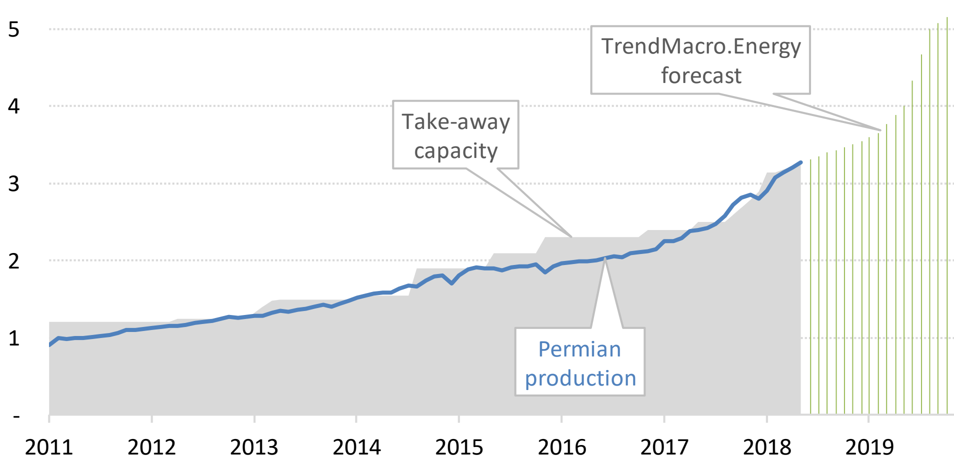
Permian drilling activity Number of wells



Source: DOE EIA, TrendMacro calculations

- But while it is easier, cheaper and faster to complete a drilled well than to start from scratch, this enormous number of DUCs is not swing-capacity that can be clicked into place instantly.
- Even if it could be, production will be constrained – indeed, already *is* constrained (please see the chart on the following page) – by scarce takeaway capacity, the lack of sufficient pipelines to take Permian crude from the well to market, or even just to storage (see “Oil’s Bullish Bottlenecks” April 24, 2018).
- Pipeline capacity will only increase by 280,000 barrels/day by year-end – so, of necessity, that is a cap on how much more production growth can be expected from the Permian above the 354,000 seen already year-to-date through May. That’s about a halving of the monthly growth-rate.

Permian crude production and pipeline capacity Millions of barrels/day



Source: DOE EIA, TrendMacro calculations

- *Takeaway capacity for the Permian should see a sharp leg up in mid-2019, based on already-announced construction plans. Production growth, even if based only on the DUCs already in place, will easily fill that capacity.*
- But pipes aren't the only problem. Once Permian crude reaches the Texas Gulf coast, it faces scarce overseas shipping capacity for which it has to compete with high-margin refined product. Considering that the domestic refiner market for light-tight oil is already sated, that's a hard constraint.
- The Brent/WTI spread, having widened out to about $10 as the OPEC quotas have put the cartel's crude in relative scarcity to American crude, eases the problem somewhat by underwriting the use of less efficient smaller tankers that can dock in Texas's shallow ports.
- At the same time, the spread begins to make shipping crude by rail from the Bakken to US east coast refineries economically feasible. As the spread begins to underwrite the cost and efficiency differentials, so we're beginning to see a renaissance of rail shipments from the Midwest to the east coast – which had fallen to near-zero. It will take a bigger and a longer-lived spread to get rail shipments from the Bakken to the east coast back to their much higher levels back in the glory days before the 2014-2016 crude crash – the spread was as wide as $25 in 2011, after Libya's export capacity was taken offline, and that triggered the whole Bakken boom – but even at a spread of $10 the direction is encouraging.
- *If demand continues to steadily grow, global stocks continue to shrink, sanctions start taking Iranian oil out of the market, Venezuela continues to bleed and OPEC and non-OPEC producers can't bring swing-production on-line to fulfill Saudi's big promises of a million more barrels/day by year-end, we could see a significant tightening in the global oil market until new takeaway capacity in the Permian comes online in mid-2019.*

- We're going to leave in place our expectation for a high trading range for crude, between $65 and $75. We continue to expect to see upside overshoots.

Bottom line

OPEC has officially announced what amounts to a tapering of its production quotas into year-end, to be achieved at first by the end of over-compliance with the quotas. Combined with non-OPEC partners, that means production should increase by 474,000 barrels/day – but dovish Saudi has said unofficially to expect 1 million, and even hawkish Iran has said 700,000. But more than all the over-compliance has come from the collapse of Venezuelan production, and no official announcement can bring that back. Saudi and Russia could probably quickly increase production by at least 500,000 barrels/day, but with the threat of US sanctions, Iranian production has nowhere to go but down. Production growth in the Permian will slow because of takeaway capacity constraints, which won't lift meaningfully until mid-2019. We reiterate our trading range for crude of $65 to $75, and expect upside overshoots.