

MACROCOSM

The Oil Glut Even Drones Couldn't Fix

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Not how we expected Saudi production to be curbed to accommodate a Permian surge.

Do you need any further proof of our thesis that the global oil market is in a glut, and that the only way to fix it is for Saudi Arabia to curtail production?

On Saturday attacks that [may be missiles](#) (or [may be drones](#)) [maybe by](#) the Houthi rebels in Yemen (or [maybe Iran](#)) hit Saudi's 1.5 million barrels per day Khurais oil field pipeline and its 7 million barrels oil processing center in Abqaiq (which processes oil from Saudi's two most important oil fields – Ghawar and Shaybah), taking out about 60% of Saudi production. *Yet WTI crude has barely broken the top of the \$50 to \$60 trading range we have been forecasting anyway* (see [“Despite the Gloom, Still a Shale Boom”](#) August 13, 2019). This is a [Black Swan](#) we've been warning about for years (see [“Oil: From Priced to Perfection, to Perfect Storm”](#) November 27, 2017). To be sure, it could get blacker. But unless it does, it now speaks less to sustained higher crude prices than it does to why we limited our downside forecast to only \$50.

- [Saudi Aramco's CEO Amin Nasser said initially](#) that the Kingdom will restore about one third of the 5.7 million barrels per day of production that was knocked out by today. Abqaiq has redundancies built into the facility, and part of it was constructed to withstand aerial attacks. But the remainder will take weeks to be brought back online, and [this morning Aramco is saying](#) that it could take longer than originally thought.

- The attacks temporarily knock out about 5% of global oil production. While Saudi storage is at the lowest level in at least a decade, global oil inventories and strategic reserves have 2.4 billion barrels in reserve to help bridge the gap between supply and demand. That's about 300

million barrels less than at its height in 4Q2016 to 1Q2017, but very ample. Indeed, President Donald J. Trump [committed yesterday afternoon](#) to tap the US Strategic Petroleum reserve “to keep markets well-supplied.”

- *The political imperative is clear enough: our quantitative election model estimates that, all else equal, Trump loses 3.7 electoral college vote in 2020 for each \$1 higher in oil prices* (see [“Inside Our 2020 Presidential Election Prediction Model”](#) March 18, 2019).

Update to strategic view

OIL, US MACRO, ASIA MACRO: An attack took out more than half of Saudi's oil production, yet WTI could barely get to the top of our forecasted trading range. Production will come back, and there is ample global storage. Trump will release SPR volumes, and encourage permitting of new pipelines – at a time when already-permitted ones in the Permian will enable increased production of 1 million barrels per day by year-end. Ultimately, Saudi will have to cut production – by conventional means – to support prices. The US and Saudi would like to use military force in Iran to take out production that US sanctions couldn't, with China still a major buyer. But China is backing Iran with a 25-year partnership including troops on the ground. That deal likely sets up a negotiating dynamic in the US-China trade talks, where China deals away the Iran partnership, committing to Texas instead in exchange for some other deal-point. An out-of-control military spiral, the only thing that could reverse the glut, is remote.

[\[Strategy dashboard\]](#)



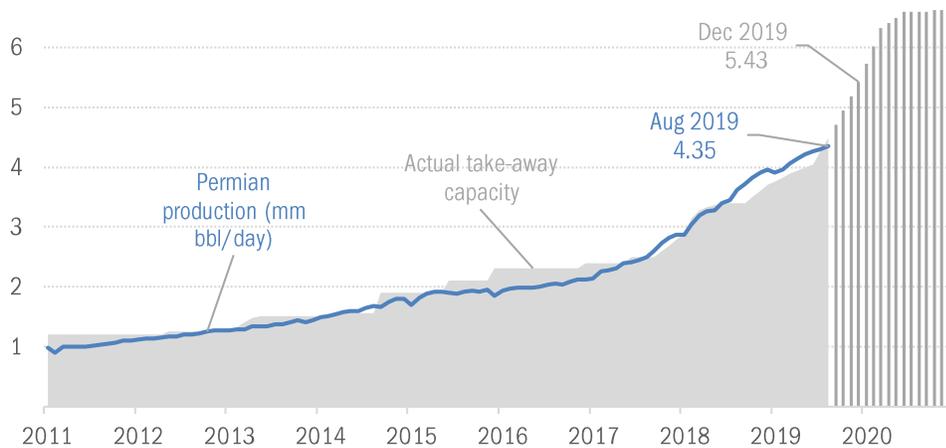
Donald J. Trump @realDonaldTrump... 6h
 Based on the attack on Saudi Arabia, which may have an impact on oil prices, I have authorized the release of oil from the Strategic Petroleum Reserve, if needed, in a to-be-determined amount...



Donald J. Trump @realDonaldTrump... 6h
 ...sufficient to keep the markets well-supplied. I have also informed all appropriate agencies to expedite approvals of the oil pipelines currently in the permitting process in Texas and various other States.

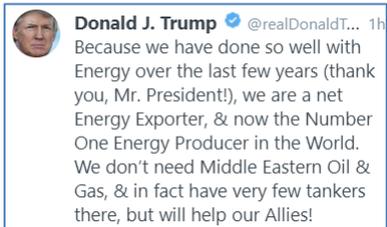
- Trump [also tweeted yesterday](#) that he asked “all appropriate agencies to expedite approvals of the oil pipelines currently in the permitting process in Texas and various other states.” *This is somewhat gilding the lily. It goes directly to the issue at the heart of what we believe is a global glut: the arrival of new pipeline capacity by year-end in the Permian alone will likely enable an unprecedented production increase of as much as 1 million barrels per day* (please see the chart below).

Production and takeaway capacity in the Permian



Source: DOE EIA, TrendMacro calculations

- Trump is bragging in [a new tweet](#) this morning when he takes credit – “thank you, Mr. President!” – for America’s new oil abundance.



We know some people in Texas who had more to do with it than he did. But Trump is directionally correct. America’s new oil abundance is driving a seismic shift in producers’ global market shares.

- *We’ve been saying that when this new oil comes onto world markets, OPEC – mostly Saudi – will have no choice but to curtail production to accommodate it, to prevent an outright price*

collapse (again, see [“Despite the Gloom, Still a Shale Boom”](#)). *To be sure, Saturday’s attack wasn’t what we had in mind, but it will do for the time being until OPEC-plus can meet in Vienna in December and make it official.*

- *This morning OPEC is making it obvious that they see this attack as a useful if unexpected expedient for getting prices up – there will be no emergency production provided by other members, and no emergency meeting ahead of Vienna.*

- *The deep question going forward is what the Saudi (or joint Saudi-US) military response will be.*



• Trump [tweeted yesterday](#) that the US is “locked and loaded” and will be consulting with Saudi as to “under what terms we would proceed.” If military action – and counter-action and counter-counter action, and so on – takes out more supplies in the Middle East or closes its

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seaborne routes to global refining centers, then the short-term upside market response is only the beginning.

- Yet in the long-term, military action against Iran would not be without purpose and promise for the US and Saudi – at least theoretically. If Iran’s oil exports could be throttled further, Saudi would have to cut back less itself to accommodate new Permian oil.
- And here, as now seems always the case in most matters, the US-China rivalry comes to the fore.
- US sanctions have succeeded in completely blocking imports of Iranian oil by just about every nation except China, which flouts the sanctions [and still imports about 600,000 barrels per day](#) (that we know of).
- Indeed, China has just welcomed Iran into its Belt and Road initiative with [a 25-year strategic commitment](#) aimed at helping Iran develop its oil resources, with China as its key customer.
- The deal has China supplying a front-loaded \$280 billion capital investment over the next five years for oil and gas development. The China National Petroleum Corporation will significantly increase investment in the South Pars gas/condensate fields, having already purchased Total’s 50.1% share (after the French oil company sold out when Trump re-imposed sanctions last year). CNPC and SinoPec will participate in increasing production at the West Karoun oil fields by 500,000 barrels per day.
- China will be able to buy Iran’s production at a 12% discount to world prices, and pay for it over time and in non-dollar currencies.
- 5,000 Chinese security personnel will be on the ground around oil and gas development and transport projects.
- It seems to us their major purpose is to act as human shields. By that we mean that when they are in place, an attack on Iran would be an attack on both Chinese interests and Chinese people.
- So if the US and Saudi are going to do anything militarily in Iran, they’d better hurry: Iran is on the way to becoming untouchable.
- Our best guess is that, instead, China’s relationship with Iran will likely be folded into US-China trade negotiations. It was smart of China to do this deal with Iran, so that it can un-do it as part of a trade deal, agreeing to buy Texan oil instead of Iranian, in exchange for Trump’s forbearance on some other deal-point.
- So the probability of anything more than a proportionate tit-for-tat US/Saudi military response – with all its destabilizing potential repercussions – is likely fairly slim. Already, with Trump’s “lock and load” tweet, and [the Houthis this morning warning](#) of more attacks, the situation appears to be worsening. Actually, it is likely stabilizing into the mutual trash-talking that typically brings equilibrium to [“frozen conflicts.”](#)
- That keeps remote the one thing that could reverse the global oil glut – an out-of-control military spiral in the Middle East.

Bottom line

An attack took out more than half of Saudi’s oil production, yet WTI could barely get to the top of our forecasted trading range. Production will come

back, and there is ample global storage. Trump will release SPR volumes, and encourage permitting of new pipelines – at a time when already-permitted ones in the Permian will enable increased production of 1 million barrels per day by year-end. Ultimately, Saudi will have to cut production – by conventional means – to support prices. The US and Saudi would like to use military force in Iran to take out production that US sanctions couldn't, with China still a major buyer. But China is backing Iran with a 25-year partnership including troops on the ground. That deal likely sets up a negotiating dynamic in the US-China trade talks, where China deals away the Iran partnership, committing to Texas instead in exchange for some other deal-point. An out-of-control military spiral, the only thing that could reverse the glut, is remote. ▶