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

MACROCOSM

How Low Can Oil Go?

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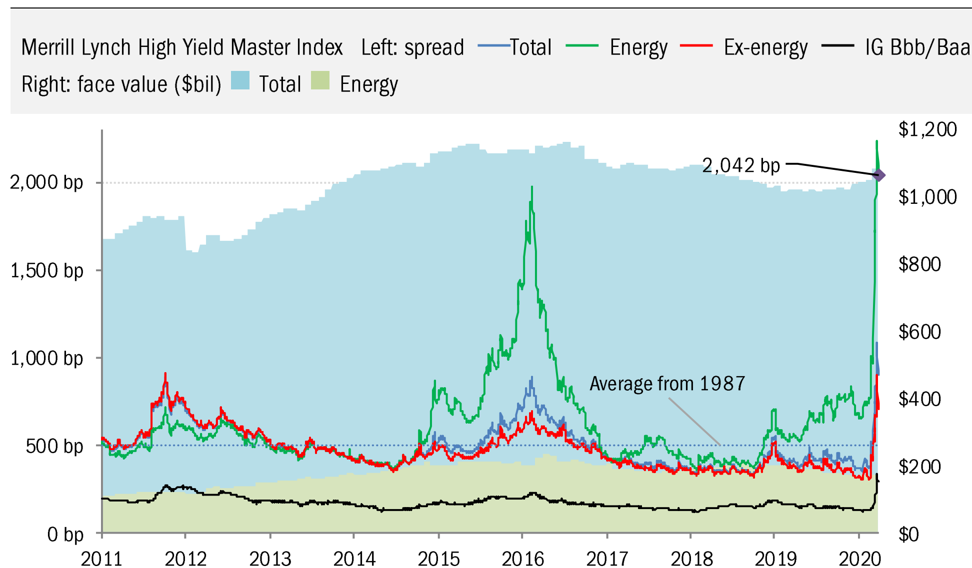
Michael Warren and **Donald Luskin**

Oil is caught in a storage and finance squeeze, but the world can't be supplied at $20.

The Saudi Arabia-led oil price war would be destabilizing to US and global financial markets in the best of times, as it was in 2015-2016 (see "The Recession Caused by Low Oil Prices" January 8, 2016). But these are not the best of times, with the price war adding a supply shock in oil markets on top of the demand shock in place already, thanks to the global lockdown to fight the spread of Covid-2019 (see "Just What We Didn't Need: An Oil Price War" March 8, 2020). *This malignant intersection of shocks has infected an already-vulnerable patient zero in the blow-out in US credit spreads: the outsized energy sector of the non-investment grade bond market* (please see the chart below). *It's not clear how the Fed's lender-of-last resort initiatives can help these borrowers, at least directly. And very regrettably, President Donald J. Trump's absolutely correct policy initiative to support oil prices by filling the US Strategic Petroleum Reserve was not funded in the so-called "stimulus bill" passed last week.*



Source: ICE, Moody's, TrendMacro calculations

- *Prices at $20 WTI or below are not sustainable as a global equilibrium even at severely impaired levels of demand. They are the very real but temporary consequence of an incipient storage squeeze, which will only intensify the industry's financial squeeze.* As a rough-and-ready estimate, it looks like the US is about 80

Update to strategic view

OIL, US STOCKS, US MACRO: Oil is testing the lows at WTI $20, as refilling the SPR got left out of last week's "stimulus bill." This would be destabilizing to the US financial system even in normal times, as it was in 2015-2016. It's not clear how the Fed's new programs can directly help the non-investment grade issuers in the energy sector. There's a storage squeeze building, and anything could happen to prices in the short-term. But even today's impaired global demand cannot be supplied with $20 oil. Saudi may break even there, but it is throwing away revenues by overproducing, when a production cut could sharply raise prices. No one else breaks even, including Russia, whose median breakeven is higher than US shale. Trump has the option to tariff Saudi oil, and to use diplomacy to get Saudi to do the right thing for the world economy. At $20, we have to bet on the upside, and take a timid bite at the long-suffering energy sector.

[Strategy dashboard]

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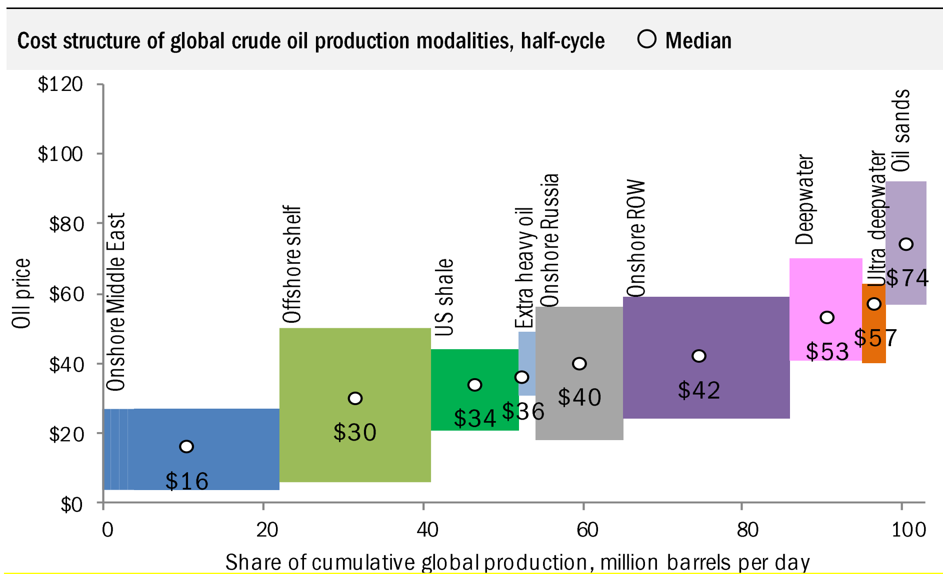
million barrels from the peak storage seen in 2017, and that excess capacity could get taken up in weeks unless the economy comes back to life.

- *Who knows how low prices could go under such pressure? But even at $20, you've got to bet on the upside. The time may have come to take a timid bite at the long-suffering US energy sector.*
- *Remember, we have been consistent and strident oil bears* (see, among many, "I Have Seen the Future, and It Fracks" February 24, 2015). We've always argued that oil prices need to revert to their long-term equilibrium after a long period of unusually high prices – to their century-and-a-half mean of about $38 in today's dollars. *Present prices are an overshoot – again, due to the confluence of a demand shock and a supply shock, both of which are temporary.*
- Price recovery requires visibility on when the *demand* shock will end as the Covid-2019 crisis abates. And it requires the *supply* shock to end with some combination of Saudi Arabia coming to its senses economically and submitting to diplomatic demands of its key ally, the United States. Timing is tricky, but when either of these happens the effect will be immediate and electrifying.
- *All that said, $20 oil simply does not meet global demand, even at today's impaired levels* (please see the chart below).



Cost structure of global crude oil production modalities, half-cycle

Source: Various, TrendMacro calculations

- *To be clear, Saudi can produce profitably at these levels, but even at full capacity it can't begin to supply the market. The marginal price simply has to get set by less efficient producers at the margin.*
- Russia cannot produce profitably at today's prices. So if this price war is about punishing them for their attempt at free-riding at the last OPEC-Plus emergency meeting (again, see "Just What We Didn't Need: An Oil Price War" March 8, 2020), it will indeed hurt. It hurts just about everybody, but for what it's worth it hurts US frackers less than it hurts Russia. The median US shale half-cycle breakeven is $34, while for Russia it is $40.

- This price war even hurts Saudi, the world's low-cost producer. The arithmetic is simple. If Saudi's vengeful production increase of, say, 10% has crashed the price by, say, 50%, they just can't "make it up in volume." Better to have done nothing and collect $1, rather than to have started this price war and collect 55 cents. And that's *revenues*. In terms of *profits*, it's even more self-destructive for Saudi.
- *Does Saudi never learn?* It made this mistake – of increasing production into the face of weak pricing resulting from new competing supply – in both 1985 and 2015. But this time it's a double-mistake: *this time there's a collapse in demand at the same time*.
- It's useful to consult the 2016 memoir of Saudi's legendary oil minister Ali Al-Naimi, *Out of the Desert*. He wrote of the failed price war of the mid-1980s:

  There was a closed session at OPEC when the ministers agreed to flood the market, get the price down and see the producers from Alaska and the North Sea come begging to OPEC. But they never showed up. One minister [Abdullah Al Attiya of Qatar) said: "All we have to do is wait and they will come with tears in their eyes." Well, in a few months, we were the ones with tears in our eyes.

- This time there's some talk of the Texas Railroad Commission negotiating with OPEC to cut production in the Permian as part of a global deal. To be sure, there are a couple high-profile producers agitating for it, but it's hardly an industry groundswell. For our money, there's one thing that would have to happen before Texas would ever go back to "prorationing" – specifically, hell would have to freeze over.
- *So we're quite sure that this, too, will end in tears for OPEC. But in the meantime, US producers and the bondholders who finance them are crying too, and its adding unwelcome pressure to credit markets.*
- President Trump has said, "At the appropriate time I'll get involved." In the meantime, he's sent Secretary of State Michael Pompeo to tell the mercurial Saudi crown prince Mohammad Bin Salman that he should "rise to the occasion" – especially as Riyadh currently holds the presidency of the G20. As the host of last Thursday's conference call of G20 leaders, MBS had the opportunity to do the right thing then and he didn't take it.
- *What can Trump do? Remember, he's in a strange position of not wanting to be seen overtly as having done anything to raise prices at the pump on American consumers.* Buying for the SPR was the perfect finesse in that regard. Trump was thwarted by Congress on that, but we think he may finagle a way to use the Defense Production Act of 1950 (or any number of other "emergency powers" statutes on the books) as a work-around.
- Far less ideal, the US could tariff Saudi oil on some pretext (Continental Resources CEO Harold Hamm has a point when he accuses Saudi of "dumping"). It's only about 7% of US imports, but it would move the needle.

- And Trump can remind Saudi that it was US defensive equipment that on Saturday shot down a ballistic missile over Riyadh, launched from Yemen – or, for that matter, that his administration has put billons in Saudi's coffers by pulling the US out of the Obama-era Iran nuclear deal. Such benefits are for friends. We are quite certain that such points have already been made – more than once.
- It seems to us that the supply/demand logic, the revenue-maximizing logic, and the diplomatic logic all point to Saudi doing the right thing and supporting higher prices. It's not a question of if. It's a question of when. We fully appreciate that at this moment, when is almost every bit as important as if.

Bottom line

Oil is testing the lows at WTI $20, as refilling the SPR got left out of last week's "stimulus bill." This would be destabilizing to the US financial system even in normal times, as it was in 2015-2016. It's not clear how the Fed's new programs can directly help the non-investment grade issuers in the energy sector. There's a storage squeeze building, and anything could happen to prices in the short-term. But even today's impaired global demand cannot be supplied with $20 oil. Saudi may break even there, but it is throwing away revenues by overproducing, when a production cut could sharply raise prices. No one else breaks even, including Russia, whose median breakeven is higher than US shale. Trump has the option to tariff Saudi oil, and to use diplomacy to get Saudi to do the right thing for the world economy. At $20, we have to bet on the upside, and take a timid bite at the long-suffering energy sector.