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MACROCOSM

If It's a V-Shaped Recovery, What About Oil Prices?

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Michael Warren and **Donald Luskin**

OPEC+ must optimize rebounding demand, huge inventories, and resilient US fracking.

World crude demand has recovered significantly, now down only 8% from year-end 2019. That's a 17% bounce-back from the demand-shock that started in January, when China, the buyer at the margin, started to lock down against Covid-19. At worst in April, global demand had fallen 21% (please see the charts below*). We're forecasting demand to work back to pre-crisis levels because we're expecting a V-shaped global economic recovery. It is difficult to map the exact road back for demand in the post-crisis world, and forecasting supply is even harder.*

- Demand forecasting is especially tricky because oil is primarily a

Update to strategic view

OIL: Crude demand is making a V-shaped recovery, as the global economy does. It's difficult to forecast ultimate demand for mobility fuel in a post-virus world, but …

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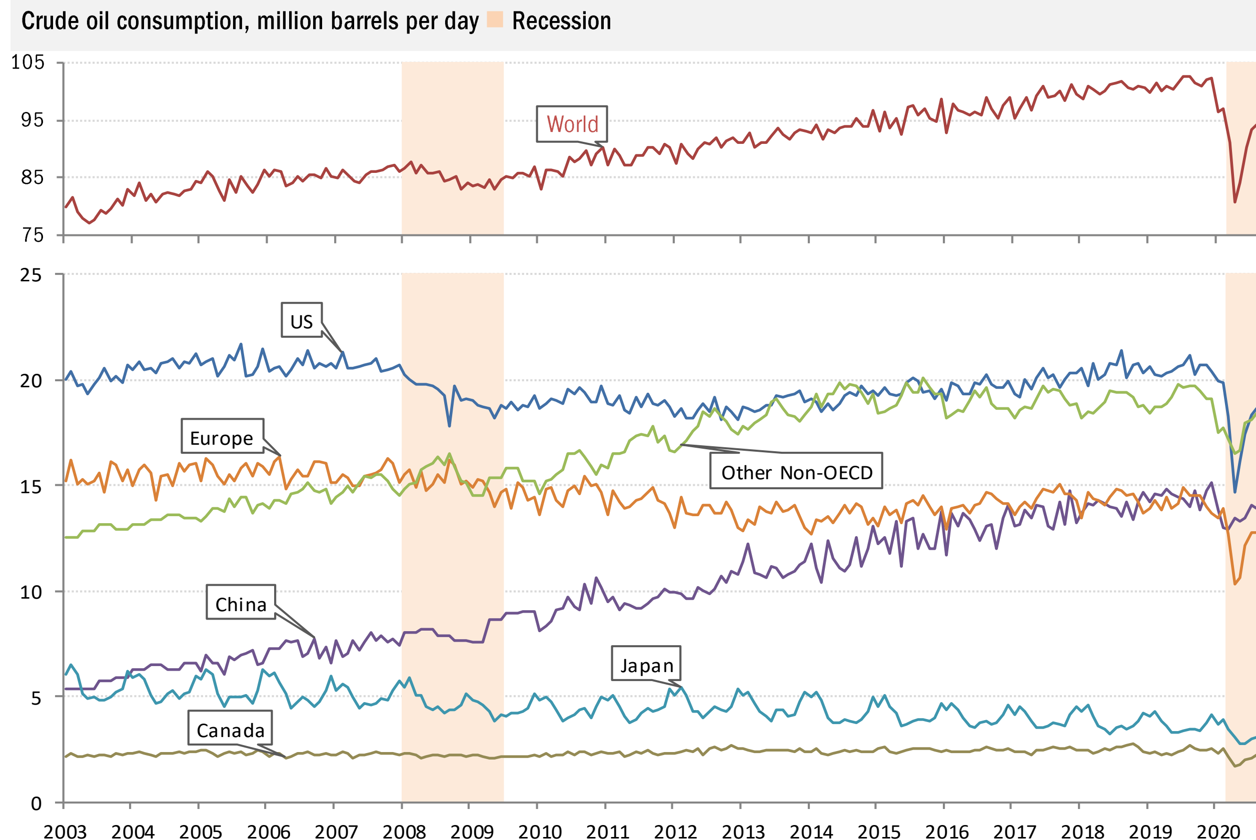
Crude oil consumption, million barrels per day



Source: DOE IEA, TrendMacro calculations

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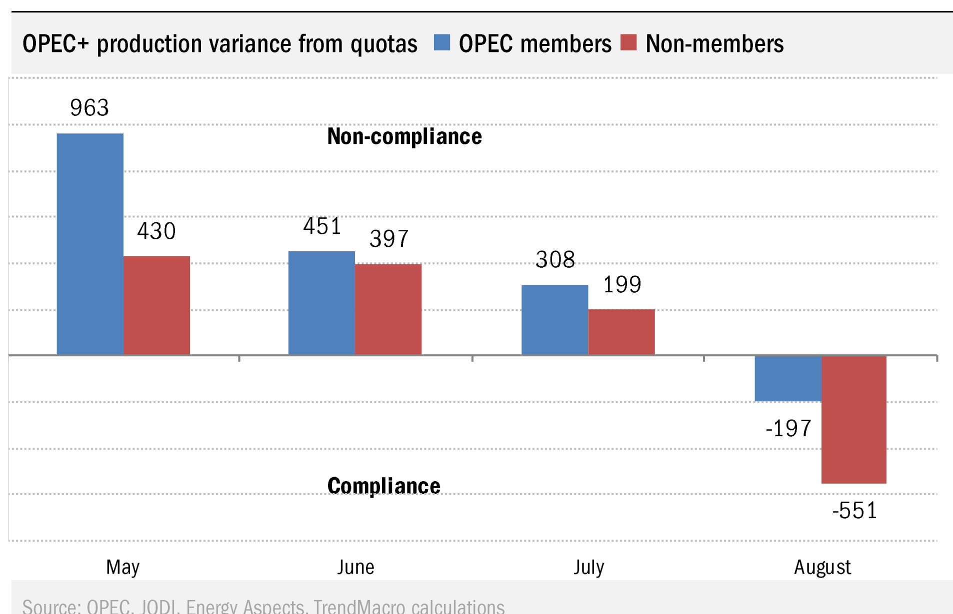
mobility fuel, and mobility is what gets crushed the worst in lockdowns against Covid-19. *Even as lockdowns end, extended work-from-home mandates cut against oil-fueled mobility*. When those mandates end, they may linger as preferences. That said, *the lockdown experience may have conditioned consumers against mass-transit and ride-sharing in favor of single-passenger vehicles*, which would drive higher per capita fuel consumption.

- The demand picture will evolve slowly, based on the behaviors of one consumer at a time. But *the supply picture is subject to both the gradual exigencies of making America frack again, but also sudden policy shocks from producing nations*. Remember, the oil price crash in the Covid-19 crisis was not just the result of a demand shock, but at the same time a supply shock when Saudi Arabia and Russia started a fratricidal price war at exactly the wrong moment (see "Just What We Didn't Need: An Oil Price War" March 8, 2020).
- They knew almost immediately it was a lethal error (see "Is the Oil Shock Over Already?" March 10, 2020), and the price war ended in weeks, with OPEC+ imposing production quotas (see "How Low Can Oil Go?" March 30, 2020). But now, *as demand comes back, there is ample reason to expect that the cartel will have a difficult time keeping production discipline. The evidence on that is moving from depressing to encouraging*.
- The September OPEC Monthly Oil Market Report indicates that participating members collectively produced less than their monthly quota by 197,000 barrels per day in August (please see the chart below). Initially, when the quotas began on May 1, compliance was poor – not entirely unexpected, coming immediately on the heels of the Saudi-Russia price war. Indeed, the *August data marks the first time in which compliance was fully achieved* – and more. Both member and non-member compliance are improving in tandem.
- To be sure, this was facilitated by the quotas themselves easing somewhat – but production discipline is the main explanatory variable.



Update to strategic view

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… preference for single-passenger transit could offset preference for working from home. OPEC+ appears to have learned a lesson from its March price war, turning now to disciplined compliance with production quotas. Petroleum stocks are even higher than in the 2016 crisis, and the cartel understands they must be drawn down to restore pricing power. US fracking is coming back, with wells that had been capped in the crisis more productive than before. Official forecasts show little production growth, but at the pace so far, recovery could be complete by the end of 2021. If OPEC+ is serious about maintaining production discipline, the path of least resistance for oil prices is higher.

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- Looking forward, long-time free-riders like Iraq, the United Arab Emirates and other underperforming members pledged to make up for previously-missed monthly production cuts by year-end at last week's Monitoring Committee meeting. They got a royal chewing out at the meeting by Saudi Energy Minister Prince Abdulaziz bin Salman, who said his goal was to make short-sellers "jumpy" (he invited speculators to "make my day").
- A data source other than OPEC through which we confirm compliance is the International Energy Forum's JODI numbers coming out of Riyadh. The IEF is underappreciated in the oil analytic community as both a source of data and of moral authority in shaping policy when OPEC needs assistance in matching supply with demand. Minister bin Salman helped found the IEF – he's the same petro-diplomat who was instrumental in recruiting many of the non-OPEC partners in OPEC+.
- We shouldn't underestimate the importance of American Joe McMonigle being seated as IEF's new Secretary General. McMonigle previously had spent four years as Chief of Staff of the US Department of Energy, so his new position speaks volumes about the potential for cooperation between the Trump administration and Saudi Arabia.
- OPEC+ has seen this movie before. Prior to this episode the last time production quotas were imposed was late 2016, in the wake of OPEC's campaign to drive US frackers out of business by lowering the world oil price below the Americans' breakevens. It didn't work, but it glutted the world oil market with then-record levels of petroleum stocks, which OPEC ultimately addressed by imposing production quotas (see the chart below, and "While the World Cuts, the US Pumps" December 12, 2016).
- The cartel's failure to cut production immediately when Chinese demand started to slide in January – exacerbated by the Saudi-Russia price war in March – has led to global petroleum stock levels even higher than during the 2016 episode. It took about two

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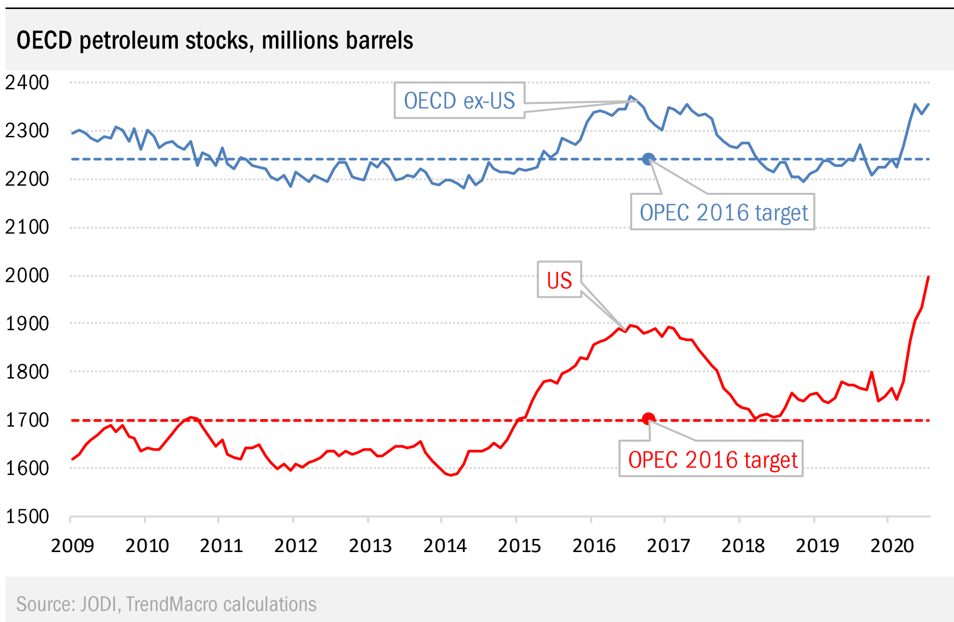
[About us]

OECD petroleum stocks, millions barrels



Source: JODI, TrendMacro calculations

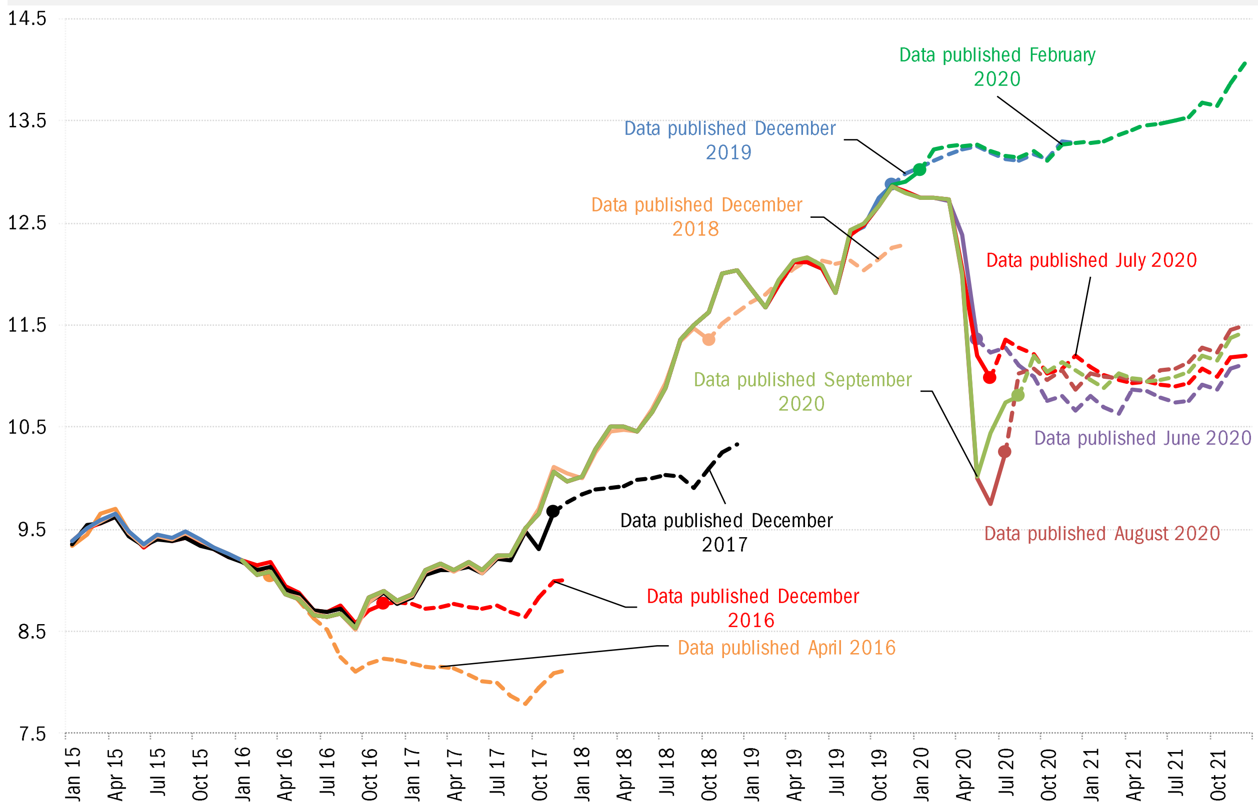
years of cartel discipline then to bring stocks back to normal levels, and thus restore the cartel's marginal pricing power – and sustainable prices, as well (again, please see the chart on the previous page, and "150 Million Barrels To Go" January 22, 2018).

- *So we're pretty sure that OPEC+ has learned the necessary lessons here, and that there will be discipline brought to bear in the task of reducing inventories and restoring higher prices.*
- *In the meantime, it's a reality that the entire universe of producers has to compete against all that stored oil, which effectively has a production breakeven cost of zero. The restoration of sustainable prices – say, $50 or above – will happen, but it won't be as rapid a recovery as it was a crash.*

What does this mean for the US frackers?

- In the 2016 episode, US frackers restored production under the competitive umbrella afforded by the OPEC production quotas. *They will do the same thing this time.*
- Shale production fell from an April 2015 peak of 9.7 million barrels per day to a trough of 8.5 million 17 months later (please see the chart below). It took another 13 months, to October 2017, to get back to the prior peak – basically a V-shaped recovery.
- That restoration of production was a complete surprise to the

US shale production, million barrels per day — Actual - - - Forecast



Source: DOE IEA, TrendMacro calculations

forecasting gurus at the Department of Energy who, at the trough, were predicting virtually no recovery at all.

- They are pretty much making the same kind of grim forecast again (again, please see the chart on the previous page).
- *We'll take the over on that one*. We strongly doubt that US production will only increase a mere 460,000 barrels per day from today's 11.05 million level through the end of 2021, as the DOE is forecasting.
- For one thing, we know what shale production is capable of. It was only 8 months ago that the frackers were producing 12.8 million barrels per day.
- That said, we are undertaking something of an experiment here. Fracking crude is little more than a decade-old technology, and during that time *we have never before had the experience of having to cap fracked wells and then restart them*. In the slump of 2015 and 2016, producers didn't cap wells to reduce production, they just let them exhaust themselves – which shale wells do fairly quickly. But this time the need to reduce production was more urgent, so wells were capped.
- The initial indications bode well for rapid production restoration. *US production from shut-in wells in April and May reported an increase in production from prior levels when brought back on line*. EOG Resources, for example, explains the increase as the result of pressure built during the two months their Permian wells were shut-in. Not only did most wells demonstrate higher production, but the gas-oil ratio yielded more oil than previously as built-up pressure pushed more liquids through the wellbore.
- We expect US production to increase from 10 million barrels per day in May to over 11 million by year-end. This puts us only 130,000 above the DOE's forecast. But if a gain of 1 million barrels per day can be achieved in just seven months, why shouldn't gains of 1.7 million be achieved in the next twelve months? That would get us close to the November 2019 peak of 12.9 million.
- Without a V-shaped global *economic* recovery, sufficient demand won't have been restored to sustain prices that would make such a US *production* recovery possible. So increased US production is not itself a threat to prices – rather, prices and US production co-exist in an equilibrium.
- Finally, another wild card is that Libyan production could increase by hundreds of thousands of barrels per day by year-end. A tenuous truce between the Russian-backed General Khalifa Haftar of the eastern provinces and the second-in-command of the UN-backed Government of National Accord in Tripoli might allow for oil exports to flow.
- OPEC+ will consider all of this when it revisits its production quotas at its Monitoring Committee meeting in mid-October. *We think OPEC+ has learned many lessons in the Covid-19 crisis, and is likely to sensibly modulate production to facilitate drawdown of swollen inventories at the same time as US production builds back.*
- It will be a multiyear process, with many uncertainties. But altogether we think the path of least resistance for prices is higher.

Bottom line

Crude demand is making a V-shaped recovery, as the global economy does. It's difficult to forecast ultimate demand for mobility fuel in a post-virus world, but preference for single-passenger transit could offset preference for working from home. OPEC+ appears to have learned a lesson from its March price war, turning now to disciplined compliance with production quotas. Petroleum stocks are even higher than in the 2016 crisis, and the cartel understands they must be drawn down to restore pricing power. US fracking is coming back, with wells that had been capped in the crisis more productive than before. Official forecasts show little production growth, but at the pace so far, recovery could be complete by the end of 2021. If OPEC+ is serious about maintaining production discipline, the path of least resistance for oil prices is higher.