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

MACROCOSM

Can Oil Survive Iran After All?

Friday, April 30, 2021

Michael Warren and **Donald Luskin**

An improbable rapprochement between Iran and Saudi could absorb a flood of new supply.

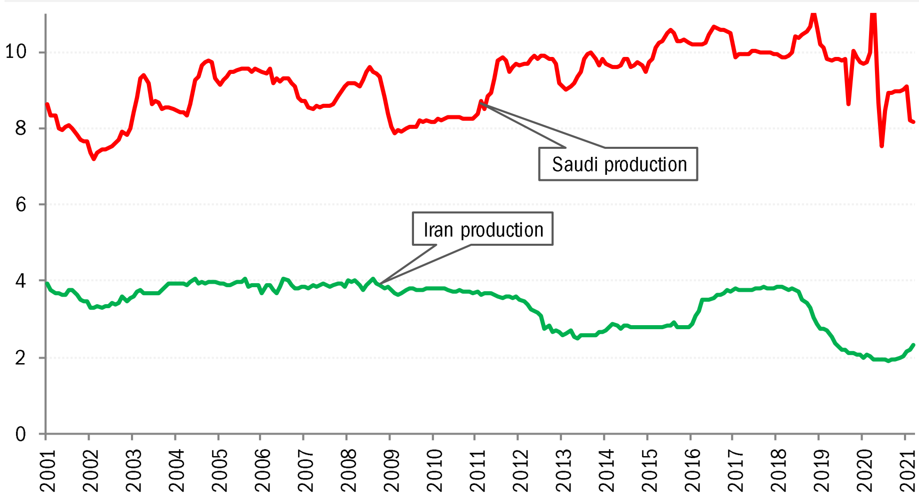
Why isn't the oil price crashing?

We've worried since Joseph R. Biden, Jr. was elected that he would return the US to the Obama-era Iran nuclear deal, lifting sanctions and flooding glut-prone oil markets with 2 million barrels per day of new Iranian production (see "How Will Biden Govern?" November 20, 2020). We worried that this was among the most salient threats that could bust our forecasted boom in 2021 (see "A Boom in 2021… But What Could Make It Bust?" January 4, 2021). When Biden formally opened negotiations with Iran in February, we issued a precautionary lowering of our price target to a range of from \$50 to \$60 (see "The Electric Future is Driven by Oil" February 19, 2021). Last week there came reports from negotiations in Vienna that a viable deal is in the works.

Why isn't the oil price crashing?

- *Maybe it's because oil markets don't believe a deal can really be done*. There are many dimensions of difficulty to it – political, geopolitical, legal – so it's not an insane thing for markets to think.

Oil production (million barrels per day)



Source: Bloomberg, TrendMacro calculations

Update to strategic view

OIL: The US and Iran are edging closer to a new nuclear deal that would lift sanctions and permit Iran's oil back into global markets, yet prices are not falling in anticipation. Perhaps a deal cannot really be done. Or perhaps markets are focusing on reports that Iran and Saudi are negotiating to settle their rivalry, which would open the door to Saudi restraining production to accommodate new Iranian supply, which would take more than a year to materialize. OPEC+ is demonstrating strong production discipline. US shale producers have already brought all shut-in wells online, and are now running off drilled uncompleted wells. New drilling has barely begun, and we anticipate US production won't be back to pre-pandemic levels until the end of 2022. We expect a boom year for the global economy, with crude demand coming back to pre-pandemic levels. This is an environment that could tolerate Iran's return, so we maintain our only slightly pessimistic price target of a range from \$50 to \$60.

[Strategy dashboard]

- *But there may be other emerging reasons, too. Maybe Mr. Oil Market is telling us that we have been wrong to be afraid of what will happen to oil prices if Iranian crude comes back into production and export.*
- *Perhaps the most critical emerging reason is the surprising news that Iran is in negotiations with Saudi Arabia, brokered by Iraq*. Ostensibly the idea is to relieve regional tensions, potentially standing down the two rivals' proxy war in Yemen. But don't think for one minute that oil production levels haven't been discussed.
- *The only way to avoid a price collapse in the face of a flood of Iranian oil is for Saudi to cut production to make room for it*. If Saudi's modeling tells it that the loss of volume is less punishing than the drop in price, it is efficient to make the accommodation. But as we learned a year ago, the Kingdom's impulsive ruler Mohammed bin Salman doesn't always think this way (see "Just What We Didn't Need: An Oil Price War" March 8, 2020). *An accord with Iran on regional security would help the crown prince make room for Iran's oil and preserve pricing*.
- *The Biden administration likely shares the Saudi objective to keep oil prices from collapsing in the wake of an Iran deal, and may be working with the Kingdom toward that end.* As we have previously argued, the last thing a green-oriented president should want is for fossil fuel prices to be lower and therefore more competitive with subsidized green alternatives (see "Shale Survives, and May Soon Thrive" December 8, 2020).
- It's hard to tell, considering all the month-to-month noise in data as we come out of the pandemic depression, but it's possible that *Saudi is already acting to accommodate Iran's re-entry into the market*.
- Without much fanfare, Iran has already brought back 350,000 barrels per day of oil production since last year's presidential election (please see the chart on the previous page). Presumably, the customer is China, and presumably the Biden administration has been lax in US sanctions enforcement as a sweetener to get Iran to the negotiating table.
- Is it a coincidence that, as so much Iranian production began to reemerge against the backdrop of still-stagnant global demand, in early January Saudi voluntarily cut production by 1 million barrels per day beyond its agreed OPEC+ quota? As global demand presumably recovers, Saudi is planning to pull back these cuts only gradually, by 250,000 barrels in May, 350,000 in June and 400,000 in July.
- It is worth remembering that in 2015 as the original Obama-era deal was being negotiated and ultimately announced, oil was going through the second leg down in a steep bear market. Surely the over-supply risks associated with the deal made it worse. But when "implementation day" arrived in January 2016 and Iranian production started to grow, OPEC ended its era of quota-less free-for-all production designed to force the emergent US frackers out of business, and implemented production curbs. *So ironically, as it played out, the bear market ended and the recovery began when Iran's resurgent production hit the markets.*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
312 273 6766
don@trendmacro.com

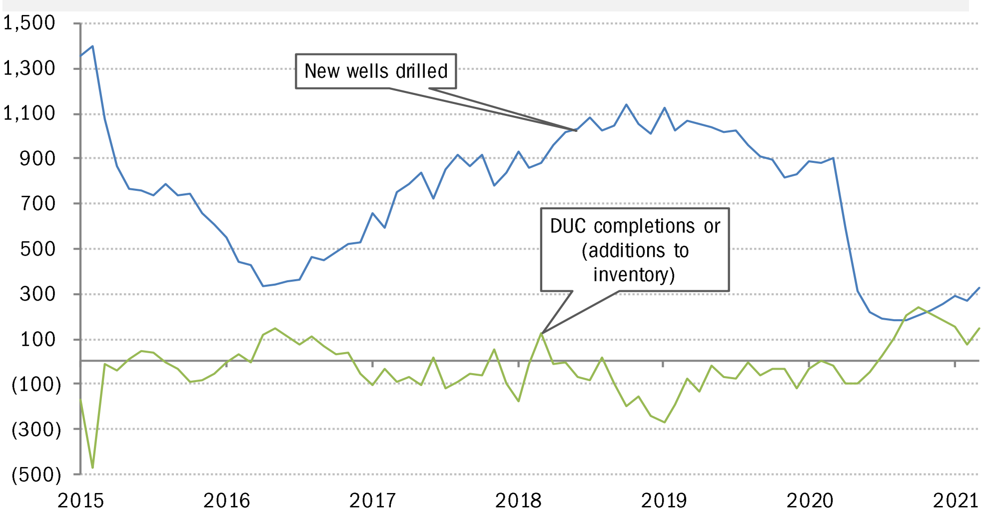
Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

- *With Iran working with Saudi, that could play out again. Furthermore, if a deal is done and sanctions are lifted, we would expect Iranian production to build up only gradually, as it did in 2016* (as we forecasted – see "Iran: The New New World Oil Order, Volume I" July 20, 2015).
- After "implementation day" in January 2016 production grew from a low of 2.8 million barrels per day to a peak of 3.8 million in 14 months. This time around, sanctions enforcement was more rigorous, so Iran is starting from last year's low of 1.9 million barrels per day – but it has already stealthily come back to 2.3 million. The bad news for over-supply is that Iran could, theoretically add 1.5 million more from here to return to the 3.8 million peak level, more than it added in 2016. The good news is that theoretically it would take longer to do so.
- Indeed, it may take a very long time for Iran to bring production back because years of on-again-off-again sanctions and political instability have kept foreign firms from investing in Iranian infrastructure, leaving Iran without state-of-the-art approaches for maintaining or optimizing production.
- Just as last time Iran re-emerged from sanctions in 2015, it took time for them to find customers for their crude, as some contracts last for six months or a year. And when a refinery switches to a different crude blend, it has to recalibrate the towers to process it. This costs money and time, and given Iran's past decade of on-again-off-again supply customers may come back to Iran only cautiously.
- *What about US production?* President Donald J. Trump's withdrawal of the US from the nuclear deal suppressed Iran's production by about 2 million barrels per day, making room for US production to grow by about that much without over-supplying the market. Then from a pre-pandemic record high at 12.9 million barrels per day, US production fell to 10.0 million at the worst of the pandemic lockdowns, and has rebounded so far only to 10.8 million. *Will a 2.1 million barrel drive back to the prior peak in US*

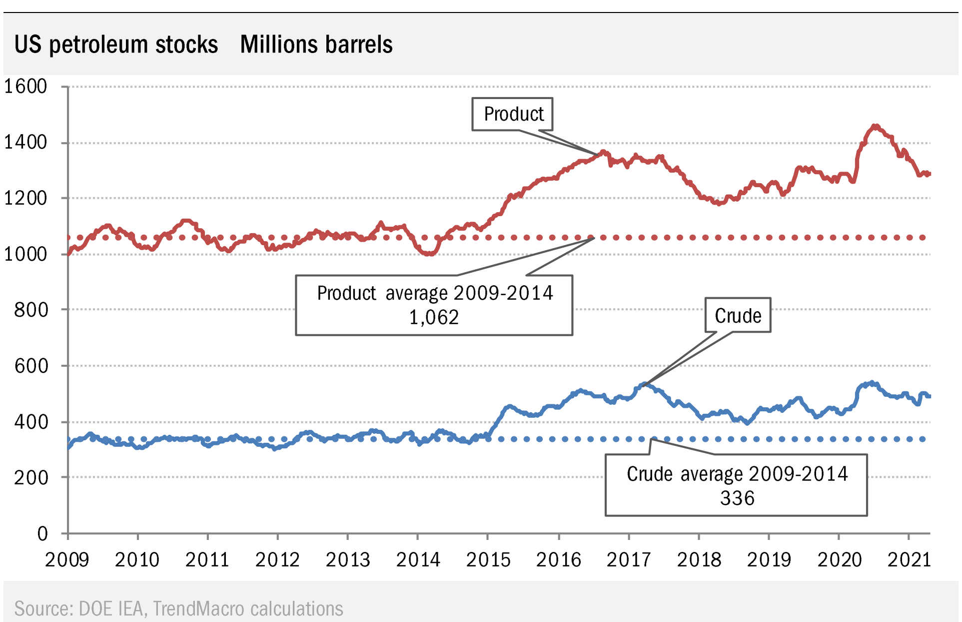
Monthly US oil production dynamics



Source: TrendMacro calculations

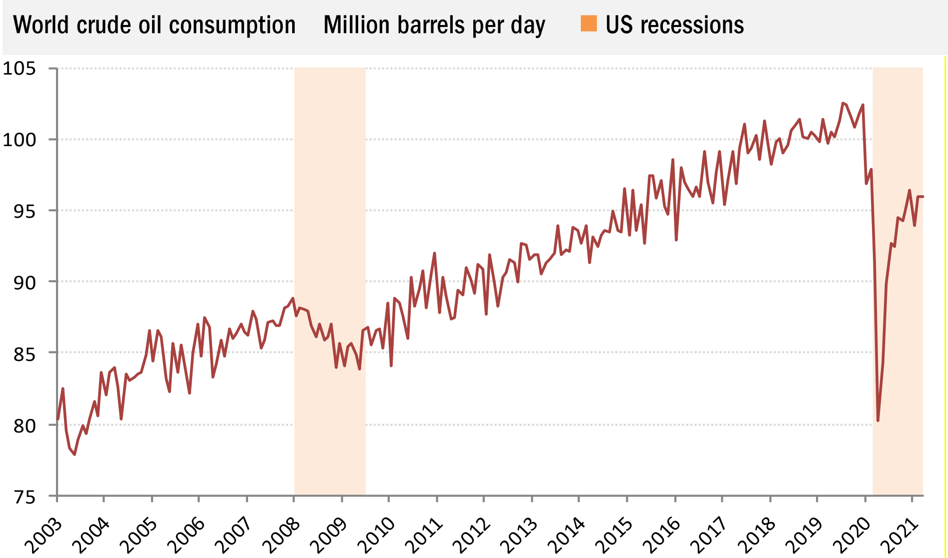
production have to compete with Iranian oil coming back online?

- *Potentially yes, if a deal is done. But US production – dominated now by shale – will not come back cheaply or easily*. Shale wells have sharp decline-curves, with production running off substantially within the first two years of a well's life, necessitating the constant drilling and completing of new wells to even maintain production.
- The vast inventory of shale wells that had been shut-in during the pandemic lockdown emergency (see "How Low Can Oil Go?" March 30, 2020) has now been pretty much entirely brought back into production. *So that source of easily and cheaply accessible supply is an accomplished fact, not an overhang. And now that these wells are producing again, their production is naturally declining*.
- The next-cheapest alternative for producers is to complete wells that have been drilled but not completed (DUCs). While new drilling is at its lowest level in the history of the data, the reduction of the "fracklog" of DUC inventory – implying the DUCs are getting completed – is at its greatest level (please see the chart on the previous page). There are still over 5,000 DUCs in inventory. Producers will complete the best ones first, and some may not be worth completing at all. *But this second-best source of cheaply accessible new supply is still something of an overhang that will surely add to production over the coming year.*
- The newly completed DUCs were drilled with previous years' CAPEX, which will add significant 2021 volumes with less capital expended. Considered together with bringing shut-in wells online, producers are doing little more than "taking oil out of underground storage."
- Speaking of storage, US petroleum stocks remain gorged. Following a pandemic storage squeeze that briefly sent crude prices to negative levels (see "On the WTI Crash" April 20, 2020), product stocks have pulled back to near pre-pandemic levels,



while crude stocks have made less progress (please see the chart on the previous page). Both remain well above their 2009-to-2014 average, which OPEC has been known to use as a benchmark of oil market balance. *This remains on the one hand a source of supply overhang and slack in the market, but on the other hand it is a key signal that has worked in the past to trigger OPEC production discipline.*

- *So while storage – in the ground and above it – is dominating US supply today, the long, hard and expensive work of drilling and completing new wells has scarcely begun*. The US Energy Information Administration has dramatically hiked its 2022 year-end US crude oil production forecast. From today's production of 10.8 million barrels per day, it has raised guidance from 11.8 million in January's Short-Term Energy Outlook to 12.3 million in April's. But even though that's the better part of two years out, it's almost 600,000 barrels short of pre-pandemic levels.
- We're more optimistic. Yes, US shale players issued guidance that marginally increases CAPEX this year to slightly raise production. But if the history of guidance versus reality is any guide, 2022 CAPEX will be significantly higher and have US production all the way back to the pre-pandemic peak by year-end 2022.
- *At the same time, global demand remains 6.5 million barrels per day from its pre-pandemic levels* – which means that there is a lot of remaining absorption capacity for supply coming back into the market (please see the chart below).



Source: DOE IEA, TrendMacro calculations

So with all these dynamics in play, what's our current best guess for what happens to oil prices if there is a new Iran deal?

- Though past is prologue in markets, there are many important differences between now and 2015, when the original Iran nuclear deal affected oil prices so negatively.

- First, in 2015, there was already a high-momentum bear market in oil going on, starting from the June 2014 peaks above $100. *Now oil is in a bull market. For WTI, the recovery – the price increase – from the pandemic lows last year at negative $40 are as many dollars as the entire oil price in 2014.*
- Second, the US fracking revolution was just getting up to speed, bringing supply onto the market that very few old-school oil-watchers had expected, or expected could be maintained (we did – see, among many "Oilmageddon" December 16, 2014). *Now a better developed but more capital-cautious fracking industry is bringing production online gingerly.*
- Third, in 2015, there were no OPEC production quotas in place to provide a pre-existing institutional framework for handling exogenous shocks to supply and support prices. Indeed, it was OPEC's clear intention to bankrupt the US frackers with prices below their relatively high breakevens. *This time an expanded OPEC+ has had the experience, after an admittedly rocky start in March last year, of expertly managing production through the pandemic recession and its aftermath*.
- Fourth, Iran and Saudi weren't making nice in 2015. Their proxy war in Yemen had just started, and the Saudi embassy in Iran was burned. *Now Saudi and Iran are meeting to seek rapprochement and, again, we believe Saudi has already made a good-will gesture to its rival by accommodating a 350,000 barrels per day production increase*.
- Fifth, in 2015 we were in the midst of a tepid economic recovery – the decade of "secular stagnation." Oil demand was rising only gently, with its rate of increase gradually decelerating. *Today the global economy is in a post-pandemic boom, rolling from country to country as lockdowns end and consumers and firms get back to business and express pent-up demand for products and services. Oil demand is rising at rates of change literally never before seen in history*.
- *Maybe a deal simply can't be done. In that case none of this matters, and that may very well be the way it turns out*. But if it is done, Mr. Oil Market seems to be saying it won't be the catastrophe for prices we have feared, and we think we understand why. That salutary outcome is dependent on demand coming back as we expect, on OPEC+ maintaining discipline as we expect, on Saudi in particular making room in the markets for Iran, on US frackers restoring production cautiously, and – oh yes – on there actually being a global post-pandemic boom.
- We are going to retain our target price level for oil as a range between $50 and $60. We are aware it is trading above that range as of this writing. If a new Iran deal gets done, we expect some negative reaction. After all, at that point any chance that it would *not* get done would have to come out of the market, forcing it to confront the reality of a supply increase at the margin, and risks that the mitigating factors we have laid out might not hold. But for now we are going to change our view to anticipate that, providing the factors we have laid out do stay in place, prices don't need to fall any further than our range suggests.

Bottom line

The US and Iran are edging closer to a new nuclear deal that would lift sanctions and permit Iran's oil back into global markets, yet prices are not falling in anticipation. Perhaps a deal cannot really be done. Or perhaps markets are focusing on reports that Iran and Saudi are negotiating to settle their rivalry, which would open the door to Saudi restraining production to accommodate new Iranian supply, which would take more than a year to materialize. OPEC+ is demonstrating strong production discipline. US shale producers have already brought all shut-in wells online, and are now running off drilled uncompleted wells. New drilling has barely begun, and we anticipate US production won't be back to pre-pandemic levels until the end of 2022. We expect a boom year for the global economy, with crude demand coming back to pre-pandemic levels. This is an environment that could tolerate Iran's return, so we maintain our only slightly pessimistic price target of a range from $50 to $60.