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MACROCOSM

$100 Oil?

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For the moment Saudi dictates prices, and they say "it's my job" to stop a "super-cycle."

With world crude benchmarks in the $70's – especially while many other commodities are in sharp corrections since their mid-May tops – we have to admit we've been too pessimistic on oil prices (see "Can Oil Survive Iran After All?" April 30, 2021). But we're far from ready to capitulate to chatter about a new "super-cycle" that will take crude to $100 per barrel.

The most important baseline reality in oil markets is that global consumption at 96.2 million barrels per day remains 6 million, or 5.8%, from the pre-pandemic peak at 102.2. The pandemic lockdowns were primarily exercises in human immobilization, and oil is primarily a mobility fuel. Mobility-intensive activities such as business air-travel and daily office commuting will be the last to come back as things get back to normal. Indeed, they may never come back – at least not as a share of global output – if it turns out that economic actors have learned they need, and prefer, less mobility to operate productively.

OPEC spare capacity of about 8.9 million barrels per day is more than enough to meet a complete restoration of demand to the pre-pandemic peak level. Much of that is swing capacity that can be brought on-line quickly, as needed. Production in the US is coming back, and we think it will continue to do so faster than expected (more on that later in this report). But shale can't provide true swing capacity – existing wells face steep decline curves, and it takes time to drill and complete enough new wells to more than make up for the exhaustion of old ones. *So we are in an unusual moment in oil markets in which the OPEC cartel, especially Saudi Arabia, can effectively dictate prices to the extent that it accommodates or fails to accommodate changes in recovering demand.*

- *So we could see $100 oil if that's what Saudi wants.*
- Presumably Saudi is profit-maximizing, which means (to oversimplify) it would like the highest prices possible that don't crash the global economy or incentivize competitive innovation, including green alternatives. *At the moment though, with global economic recovery surging ahead because of both deferred consumption and government subsidies, it's a tricky matter to guess what oil price would start to be demand-inhibiting.*
- *Making things harder to predict, the present Saudi regime – the mercurial Crown Prince Mohammed bin Salman and his brother,*

Update to strategic view

OIL: We're all but ruling out $100 oil, despite increasing chatter about a "super-cycle." With OPEC spare capacity enough to accommodate a complete return to pre-pandemic levels of consumption, and with US production growing back to pre-pandemic gradually over the coming 18 months, Saudi is enjoying a moment in which it can dictate prices. The current regime has no experience with high prices, so there is no history to go on. But the oil minister has said "it's my job" to prevent a super-cycle. We'll learn more by seeing whether and by how much OPEC eases production quotas this week. An Iran nuclear deal is still a possibility, though perhaps less so than before. While US recovery will be gradual, it is aggressively underway, led by record activity levels in the Permian. Putting it all together, at this time we see buffers against large price moves in crude in either direction.

[Strategy dashboard]

newly appointed [oil minister Abdulaziz bin Salman] – have no experience with high oil prices. Indeed, their formative on-the-job experience has been with low oil prices – last year, prices so low they were negative (see "On the WTI Crash" April 20, 2020).

- One clue is that Abdulaziz said, at a conference 10 days ago, that he sees risk of a super-cycle due to "lack of investing." But *he added, "I think it's my job, and others' jobs, to make sure this super-cycle doesn't happen."*
- We'll get another clue at OPEC's meeting this week, where the word is that the cartel will agree to loosen production quotas in light of recovering demand. The whisper-number is 500,000 barrels per day, and we think that's about right. Any significant deviation from it would be new information.
- *Further complicating predictions is the potential for the US to rejoin the Obama-era Iran nuclear deal*, lifting US secondary sanctions that would allow Iran to bring its supply of crude back to global markets.
- *We had originally been very concerned about the downward price-risk of up to 2 million barrels per day of renewed Iranian supply* (see, among others, "A Boom in 2021… But What Could Make It Bust?" January 4, 2021). We moderated our concern by observing that, since the inauguration of President Joseph Biden, Jr., 500,000 barrels per day of Iranian supply have already come back to market, with the US apparently having done nothing to sanction the buyer (or even identify him). That's already at least a quarter of the capacity Iran could restore over any feasible time-frame, and yet it has done nothing to spook markets. *So presumably Saudi, who reportedly has been in talks with regional arch-rival Iran brokered by Iraq, has decided to adjust its production to accommodate this new supply and support prices at the expense of market-share* prices (again, see "Can Oil Survive Iran After All?").
- At the same time, talks in Vienna between the US and Iran – which two months ago were being advertised as on the verge of breakthrough – have gone nowhere. Since then, a new Iranian president, hardliner cleric Ebrahim Raisi, has been elected. His predecessor Hassan Rouhani was seen as more of a secular figure and more of a moderate – so his replacement with a hardliner, in a presumably sham election, likely reflects the preferences of Supreme Leader Ali Khamenei to take a tougher stance in the negotiations. Immediately upon his election, Raisi said Iran's missile program and its support of regional militias – two elements the US had hoped to include in a restart of the nuclear deal – were "non-negotiable" in the nuclear deal talks.
- *A tough stance by Iran doesn't mean a deal won't happen.* It just means Iran thinks it is in its interest to act tough, perhaps because it believes any subsequent compromise will be more favorable for having started with bigger demands, and/or because it possibly sees the Biden administration as weak, desperate for a deal, just to show it can accomplish something in a US political environment in which other initiatives – that have to pass through a balky and divided Congress – have little, if any, chance (see "Video: What

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you're not hearing about the death of Biden's corporate tax hikes" June 21, 2021).

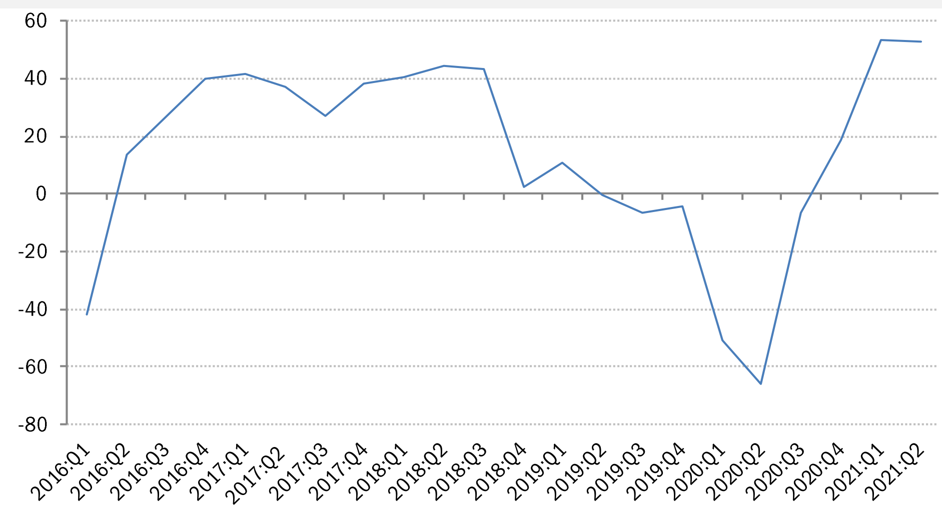
- Iran may be misreading Biden. We don't doubt the administration would love to get a deal – almost any deal. At the same time, a deal that would result in millions of barrels per day of new oil supply to come on the market, which all else equal is sure to lower oil prices, is exactly what the environmental/climate wing of the Democratic party doesn't want. It wants oil to be left in the ground, and expensive. They're already lambasting Biden for having done less than they wish to curtail oil and gas production domestically.
- This is all just tea-leaf reading, but for what it's worth our sense is that a deal is still very possible, but less likely than at any time since Biden's inauguration.

Turning to US production, our forecast for the restoration of oil production is far rosier than the Department of Energy's. From current production at 11 million barrels per day, the Energy Information Administration expects 11.5 by year-end, while we expect 11.7. *The EIA expects 12.2 by year-end 2022, while we expect 12.9. That's just 100,000 barrels per day below the pre-pandemic peak at 13 million*.

Our forecast relies on:

- …the Permian Basin compensating for lower production from other shale plays that do not return to peak production levels. Production in the Permian is already within 200,000 barrels per day of reaching its pre-pandemic levels (see "Data Insights: Oil" June 14, 2021). In the Dallas Fed's quarterly Energy Survey, the Business Activity Index has put up the highest readings – by far – in its five-year history (please see the chart below).

Dallas Fed Energy Survey Business Activity Index



Source: Dallas Fed, TrendMacro calculations

- …the Gulf of Mexico adding between 100,000 to 200,000 barrels per day.

- …the resolution of legal uncertainty over the Dakota Access Pipeline. This has caused Bakken producers to lower drilling and completion activity over concern that the pipeline, currently in operation, will be shut down. Despite attack from the administration, we expect the Army Corps of Engineers to favorably recomplete its environmental review to allow DAPL to operate and producers to re-invest in the play by 2Q-2022.

More on the Permian Basin:

- According to Sourcewater, new dirt work suggests that operators added 849 new well pads in May, twice April's additions. Three of the five top operators creating new well pads are private companies, not publicly traded, not directly answerable to Wall Street – which hasn't quite gotten the message that today's prices make exploration and production in the Permian very profitable.
- In the 15-month period prior to the pandemic, operators added to the "fracklog" of drilled but uncompleted wells by completing only about 90% of new wells drilled. Since August last year, 25% of all wells completed have come from the DUC inventory. There are still 2,616 DUCs in the Permian awaiting completion.
- Salt water disposal well permits have been surging, suggesting that more completion activity is in the cards.
- The Permian needs 300 completions per month to increase production. For the last three months completions have been over 300 and rising each month sequentially to 373 in May 2021.
- Much infrastructure investment –such as pipelines – has already been completed, and tariffs have fallen, in some cases by half, making US crude more competitive in global markets.

Bottom line

We're all but ruling out $100 oil, despite increasing chatter about a "super-cycle." With OPEC spare capacity enough to accommodate a complete return to pre-pandemic levels of consumption, and with US production growing back to pre-pandemic levels gradually over the coming 18 months, Saudi is enjoying a moment in which it can dictate prices. The current regime has no experience with high prices, so there is no history to go on. But the oil minister has said "it's my job" to prevent a super-cycle. We'll learn more by seeing whether and by how much OPEC eases production quotas this week. An Iran nuclear deal is still a possibility, though perhaps less so than before. While US recovery will be gradual, it is aggressively underway, led by record activity levels in the Permian. Putting it all together, at this time we see buffers against large price moves in crude in either direction.