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MACROCOSM

Ukraine is One Risk, Saudi Another

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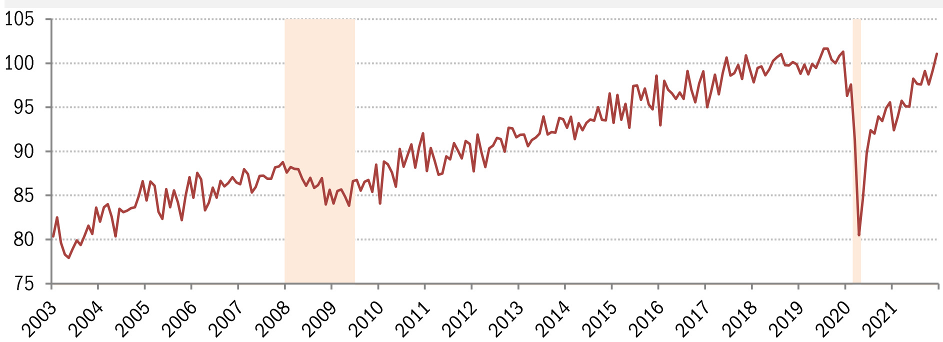
Prices imply a low probability of a Russia/Europe rupture. But Saudi could help, and isn't.

Elevated crude oil prices haven't changed our minds that we are not in a new commodities super-cycle (see, among others, "No, We Still Don't See $100 Oil" July 6, 2021). That said, there's no reason to expect prices much lower than we're seeing now. *A spike in crude to $100 or above is certainly possible if tensions between Russia and Europe over Ukraine lead to energy embargoes or boycotts* (see "War on Two Fronts: Ukraine and Inflation" January 24, 2022). We'll look at the Ukraine situation in a moment, after we review the baseline global picture.

- Restoration of global crude demand to pre-pandemic levels would not itself be the catalyst for higher prices, because it has already happened (please see the chart below).

Global crude oil consumption (barrels per day, millions)



Source: DOE EIA, TrendMacro calculations

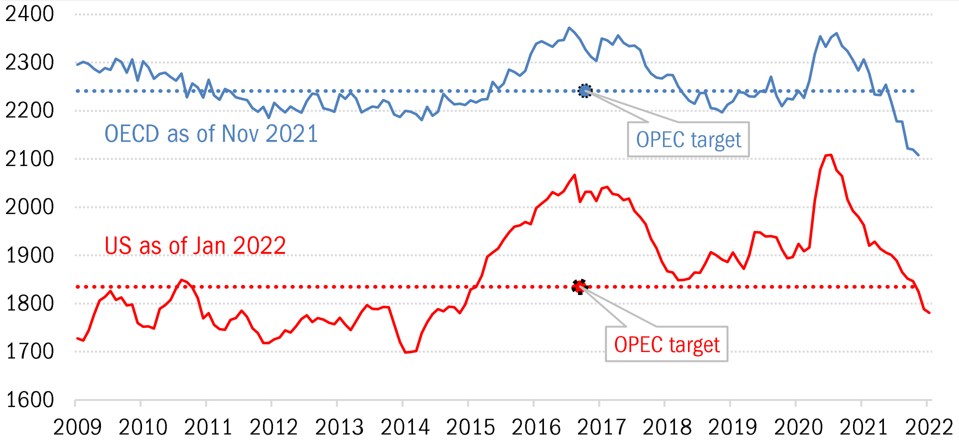
- But that restoration of demand has been uneven across countries and regions. *China is the only large country with crude consumption presently above pre-pandemic levels – the US is just back to where it started, and all the rest are still below. So much for China holding back its growth with its supposed "zero Covid" policy.* But that implies that as the rest of the world more fully reopens after the pandemic, *global demand will move to new highs, and it will have to be supplied*.
- It's not going to be supplied from inventories. The pandemic capacity crisis is more than over – at this point *US inventories are*

Update to strategic view

OIL, EUROPE MACRO, ASIA MACRO: Global oil consumption is back to pre-pandemic levels, led by China, implying its "zero Covid" policy is not holding back growth. OPEC has the capacity to accommodate a complete restoration of demand, but Saudi is sending a signal that it will now tolerate pricing in the 80s, as opposed to the 70s last year. Production risks beset many cartel producers, and Saudi has done nothing recently to make up for their quota shortfalls. US production is coming back slowly, but the drawdown of most DUCs means that further growth will require levels of CAPEX growth not seen in recent years. The industry faces both regulatory and capital-access headwinds. The risk of a bargaining failure between Russia and NATO raises the risk of embargoes and boycotts leading to a crude price spike, which would equilibrate over time. The modest premium in prices today implies a low probability of failure.

[Strategy dashboard]

Crude oil stocks (millions of barrels)

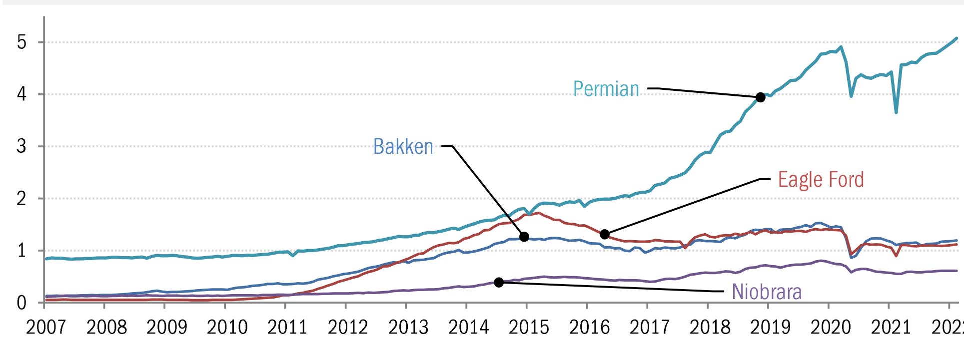


Source: JODI, DOE EIA, TrendMacro calculations

the tightest since 2015, and OECD ex-US are the tightest in the history of the data (please see the chart above).

- OPEC spare capacity is about 4 million barrels per day, according to the International Energy Agency, which is 1 million above its pre-pandemic levels (that does not include OPEC+ members such as Russia or Mexico). So it's not that a full restoration of demand world-wide couldn't be supplied.
- US production is coming back, but slowly. The Permian is the only shale region producing more now than before the pandemic (please see the chart below).

Crude oil production in US shale regions (barrels per day, millions)



Source: DOE IEA, TrendMacro calculations

- US production finished the year in 2021 with 11.6 million, down from a pre-pandemic peak of 12.9. We thought we'd get back to peak by year-end 2022, but in September we lowered our forecast to 12.5 million (see "The Mighty DUCs Are Gone" September 29, 2021). We have no reason at this time to change that now. As pessimistic as that is, in some sense – to not get back to the prior high even after three years of trying – it's actually more optimistic than the Department of Energy's official forecast of 12.1 million.
- Most of the restoration of US production so far has come from drawing down the "fracklog" of drilled but uncompleted wells (DUCs – again, see "The Mighty DUCs Are Gone"). *With DUCs all but*

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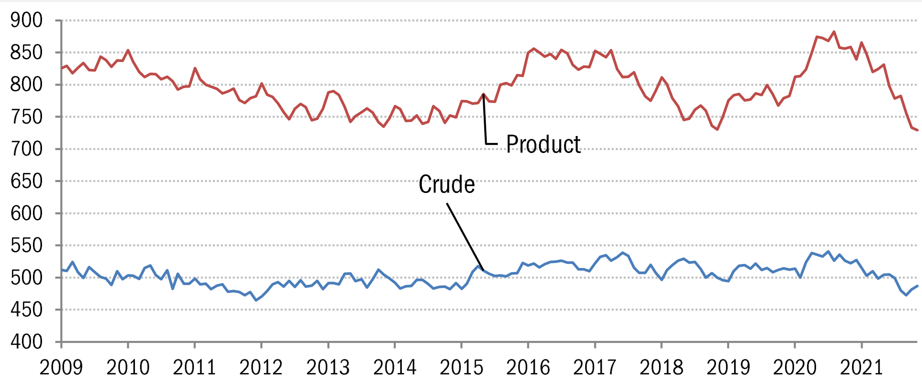
exhausted, there is no choice – if production is to be restored – but to increase CAPEX to fund the slow process of drilling and completing.

- Rig count is up from the pandemic lows, but it is still 270 below pre-pandemic levels. Spuds are 409 below pre-pandemic levels. Rig intensity (the number of spuds a rig drills on a monthly basis) is also still lower than pre-pandemic levels.
- Prices should be attractive to producers, and even the steeply backwardized futures curve offers hedging opportunities. But producers face situational headwinds as they consider CAPEX. The ESG movement closes the door to some traditional sources of capital. A fossil fuel-hostile administration makes transport and regulatory costs unpredictable.
- And many on Wall Street continue to insist on "capital discipline," despite the reality that cruel shale decline curves command constant reinvestment in order to keep the oil – and the cash, free or otherwise – flowing. We are encouraged that EOG Resources and ConocoPhillips both announced CAPEX increases to spur 2022 crude production without incurring the investor wrath we've come to expect in such situations. But it will take the mobilization of the entire industry to increase production quickly.
- *With the US only slowly headed back to its status as global producer at the margin, which it enjoyed before the pandemic, reliance on OPEC+ is greater than ever.*
- OPEC+ has gradually increased its production quotas as consumption has returned. But it feels like there is a tone-change. Back in June 2021 Abdulaziz bin Salman, Saudi Arabia's Oil Minister (and brother of the Crown Price), said "I think it's my job, and others' jobs, to make sure this super-cycle doesn't happen" (see "$100 Oil" May 28, 2021). Yet, earlier this month he said that Saudi will not produce above quota to compensate for lower production from other OPEC+ members – "We have an OPEC+ agreement, and I have to honor my colleagues and my friends."
- *This suggests that Saudi – and by extension, OPEC+ – is willing to permit higher oil prices now, say in the low-to-mid 80s, than mid last year, when it seemed they were targeting mid-70s.*
- Nearly all OPEC members were undercutting their quotas – which isn't normal – during the fourth quarter of 2021. For the higher January 2022 quota, OPEC members would have to raise production by 883,000 barrels per day.
- Many offshore projects are starting to come online in Angola, so it might be able to produce 250,000 more barrels to meet their quota next year – but definitely not in January.
- Iraq had to cut production in 2021 to make up for overproduction back in 2020. But it's an easy target for insurgents to target oil export infrastructure. We see it as a wildcard.
- Nigeria is a real problem due to aging infrastructure and vandalism. We doubt that they will reach their quota in 2022.
- The United Arab Emirates could easily raise production by 600,000 barrels if they wanted to. A new risk, though, is that Houthi rebels have attacked UAE oil infrastructure and military bases hosting US personnel.

- Kazakhstan, not an OPEC member but nevertheless a substantial producer with 1.6 million barrels per day, is in a near civil war.
- In better news, Libya is back on-line. And Iran – although still saddled with sanctions – has seen production rise by almost a half million barrels per day over the past year while the Biden administration looks the other way, presumably to lubricate the wheels of diplomacy in pursuit of a new nuclear deal.
- *And, of course, the biggest risk to oil prices at the moment is Ukraine* (which, by the way, has the largest shale reserves in continental Europe, which are entirely unexploited).
- *Russia and Europe are energy interdependent.*
- *As we discussed in our report yesterday, failure to negotiate a diplomatic solution between Russia and NATO could result in Russian embargoes and/or European boycotts of both oil and natural gas, which would have chaotic effects on global energy markets* (again, see "War on Two Fronts: Ukraine and Inflation").
- Europe sources 27% of its crude oil demand, 7% of its refined product and 41% of its natural gas from Russia.
- Russia sends 57% of its crude oil exports to Europe, 59% of its product exports and 72% of its natural gas exports.
- *For crude and refined product, the first result of a bargaining failure would be sharply higher prices as Europe scrambles for supply at a time when inventories are historically low* (please see the chart below).

European petroleum stocks (millions of barrels, as of November 2021)



Source: JODI, TrendMacro calculations

- Europe would be more desperate to find replacement imports than Russia would be to find replacement exports, because Russia has the option to store unexported oil. Eventually, though, Russia would need replacement export markets – China, most likely – and would have to offer discount pricing to displace existing suppliers. Russian barrels imported by China, say, would displace imports from some other supplier, who would then be free to sell to Europe. *So the market would find a price equilibrium over time, after an initial upward shock.*
- We believe that today's somewhat elevated crude prices – about 3% above last year's October highs – reflect some probability of that shock. But considering the potential magnitude of the shock,

the implied probability of it occurring must be fairly modest. *As a rough-and-ready estimate, if we assume that a Ukraine shock would drive oil 50% higher, then prices just 3% higher implies an event-probability of just 6%.*

- This is in line with our expectations that a diplomatic solution, likely involving non-public concessions to Russia, will be found (again, see “War on Two Fronts: Ukraine and Inflation”).

Bottom line

Global oil consumption is back to pre-pandemic levels, led by China, implying its “zero Covid” policy is not holding back growth. OPEC has the capacity to accommodate a complete restoration of demand, but Saudi is sending a signal that it will now tolerate pricing in the 80s, as opposed to the 70s last year. Production risks beset many cartel producers, and Saudi has done nothing recently to make up for their quota shortfalls. US production is coming back slowly, but the drawdown of most DUCs means that further growth will require levels of CAPEX growth not seen in recent years. The industry faces both regulatory and capital-access headwinds. The risk of a bargaining failure between Russia and NATO raises the risk of embargoes and boycotts leading to a crude price spike, which would equilibrate over time. The modest premium in prices today implies a low probability of failure.