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MACROCOSM

Oil Under Trump: War and Peace, but Mostly Deregulation

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Michael Warren and **Donald Luskin**

Deregulation removes deadweight costs, promoting both lower prices and higher profits.

As we discuss Donald J. Trump's re-election with clients, we are constantly asked *what we think the black swans will be*. In other words, what known possibility that most people have written off as impossible might actually happen? Our number one nomination: *that Trump delivers on his most hyperbolic campaign promise: to "settle" the war between Russia and Ukraine before he even takes office*. Ronald Reagan effectively did it with the release of the US hostages in the Teheran embassy in 1980 at the moment of his inauguration, so such things are not impossible (now revisionist history in the mainstream media promotes a conspiracy theory that somehow the Reagan transition team managed to get the release delayed until that moment).

- For some reason the administration of President Joseph R. Biden, Jr. sees the Ukraine situation as not subject to negotiation, only ever-escalating US financial and military support – including the newly announced US permission for Ukraine to use ATACMS to strike inside Russia. Russia responded by revising its nuclear weapons deployment doctrine, calling for nuclear retaliation against large-scale attacks by non-nuclear powers with non-nuclear weapons supplied by nuclear powers. That, by the way, is the only purpose of nuclear weapons: to threaten to use them. Nevertheless, quite the drama to have been triggered by a lame duck US president on his way out the door.
- This followed on last week's announcement by Russia that it has "temporarily" halted exports of enriched uranium to the US. *All this would seem to set up ideal preconditions for negotiation.*
- We know what a Trump-brokered peace looks like, because it's the only possible solution, because Ukraine was never going to win. Russia gets Donetsk, Luhansk and Zaporizhzhia, completing a land-bridge to Crimea. NATO freezes its membership, excluding what's left of Ukraine. Europe ends its ban on Russian energy products. Russia ends its embargo on uranium. This is a not a deal Biden could make, because it would look like failure for him – but this is not Trump's war, so he can make it.
- Already Russian president Vladimir Putin has spoken with German Chancellor Olaf Scholz, the first Western leader to do so for two years. Scholz's fellow leaders have universally condemned him for having the conversation, with the exception of Canadian prime

Update to strategic view

OIL: In anticipation of a deregulatory regime under Trump that will increase both demand and supply for fuels, and remove deadweight costs, we are lowering our projected trading range for Brent to $60 to $80, while at the same time turning positive on the lagging US energy sector. Wright for Energy secretary is the perfect pro-growth choice. CAFE standards will be revised down, effectively ending the electric vehicle mandate. A black swan is that Trump will "settle" the Ukraine conflict rapidly, and Russia can rejoin world energy markets, but with little effect on prices. A widening conflict in the Middle East as Trump gives Israel broader permissions to defeat Iranian terror is more of a threat. Trump will enforce existing sanctions on Iran, sharply reducing their crude exports, but this will easily be compensated by production increases by other OPEC members, especially Saudi and UAE.

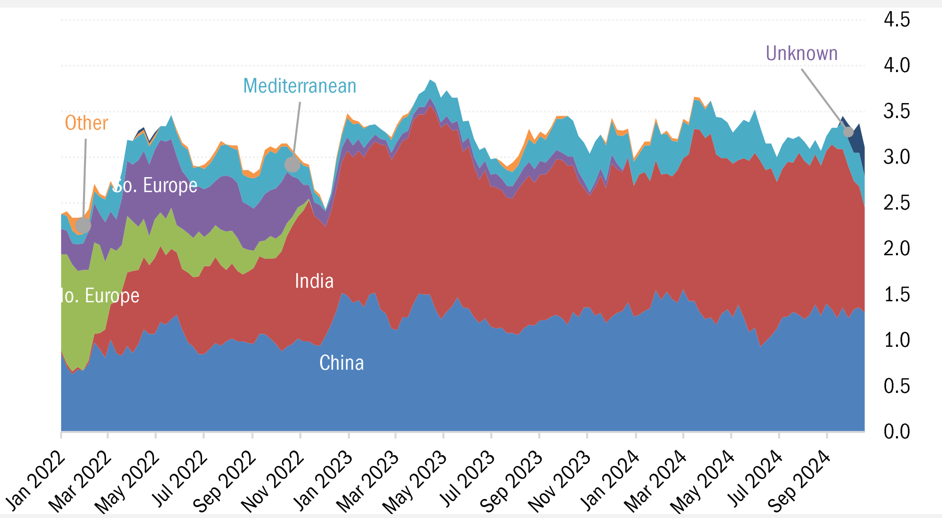
[Strategy dashboard]

minister Justin Trudeau. It would seem that the more unpopular an incumbent Western leader is, the more he is willing to support negotiating an end to a war that the West is obviously not winning.

But this report is supposed to be about oil, so…

- Well, actually, it doesn't matter.
- Immediately after the invasion of Ukraine by Russia, Brent crude soared to $140. The narrative was that Europe would have to ban imports of Russian oil – which it did – which would strand 3 million barrels per day of Russian crude, effectively reducing global supply. But we argued, correctly, that it would be a depressant to oil prices – and it was, with crude roughly half that price now (see "The Bear/Bull Case in the Russian Oil Ban" March 16, 2022). We knew that Russia would continue to produce oil, but it would have to sell it to new non-Western customers and incentivize them with steeply discounted prices that would drag down pricing across the whole global market for crude.
- Now, more than two and a half years later, global oil markets are entirely reconfigured with Russia exporting to India all that it had previously exported to Europe (please see the chart below). The "Urals discount" persists, but has narrowed to insignificance.

Russian seaborne crude exports (millions barrels per day)



Source: Bloomberg, TrendMacro calculations

- So if peace breaks out in Ukraine and Russia is able to rejoin to world oil markets with no restrictions, what difference, at this point, does it make? The only difference is that Russia will have repositioned its export trade away from Europe, where fuel demand is shrinking, to Asia where it is rising. *Well played*.

Now let us turn to the other geopolitical hotspot potentially affecting oil markets: Israel.

- Under the Biden administration, Israel is the opposite of Ukraine –

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and hardly in a way that reflects the fact that Israel is a long-time staunch US ally, and Ukraine is not.

- The Biden administration has only grudgingly supported Israel in its struggle against regional terrorism, while constantly and conspicuously promoting a negotiated peace (see "Video: TrendMacro conversation with Haviv Gur on rising anti-Semitism and Israel's strategic realities after Trump's election" November 14, 2024).
- Biden will not negotiate with dictators. Only terrorists. Trump, on the other hand, will negotiate with anyone. And in the meantime, he is telling Israel "do what you have to do."

There is more relevance to oil markets here than there is in Ukraine.

- Trump will surely resume enforcement of existing sanctions against Iran that the Biden administration had allowed to lapse, in Biden's vain hope of obtaining a new "nuclear deal."
- After Trump abrogated the nuclear deal during his first term, Iranian production fell from 3.8 million barrels per day to 2 million from May 2018 to December 2020 – because Trump enforced the sanctions that snapped back into place with the lapsing of the deal.
- Under Biden, Iran's crude oil production rose to 3.3 million as of this September.
- *So renewed enforcement under Trump can be expected to reduce Iran's oil exports by 1.3 million barrels per day. But this apparent supply restriction would not lead to higher oil prices, because OPEC's draconian production cuts have been, in part, to offset Iran's increasing production – and those cuts can easily be rescinded. Saudi Arabia and the United Arab Emirates, alone, have spare capacity to replace lost Iranian exports three times over.*
- *So we would expect no change in oil prices as Iran is forced out of global markets – only a redirection of oil revenues away from a nation that funds regional terrorism to nations that don't.*
- The black swan here is that Israel won't be patient enough for that, and would move against Iran's oil assets – acting here and now on Trump's permission to "do what you have to do." An even blacker swan would be if Israel moved against Iran's nuclear capacity – taking it out before Iran achieves the "breakout" that would make it unassailable.
- Iran is already an isolated and wounded beast, with no powerful friends in the region. Blows like these could move it to self-destructive acts of desperation and vengeance, such as attacking oil production and transport facilities in the region (see "Don't Panic Over the Saudi Attack and the Oil Supply" September 18, 2019). It is not clear that these assets could be defended as effectively as Tel Aviv has been.
- Even with diminished forces, Iran could disrupt key transportation choke points in the region such as the Strait of Hormuz (with its 20 million barrels per day throughput) and the Bab el-Mandeb (with its 8 million).

- Of course blocking the Strait of Hormuz would be uniquely destructive to Iran itself, as it is its one and only shipping point. Saudi Arabia, on the other hand, can use the SUMED pipeline in the Suez Canal. That said, a desperate Iran could take out that pipeline.
- A wise client told us recently, "For markets, there are no geopolitical crises. Only oil crises." In that spirit, *Ukraine doesn't matter. Israel maybe does*.

Very much less in the realm of black swans, let us turn to things we know for sure will move oil markets.

- *The incoming Trump administration is sure to reduce regulation on domestic energy exploration, production, transport and export.*
- Trump's nomination of Chris Wright for secretary of the Department of Energy fits right in.
- Wright is CEO of fracking company Liberty Energy, and a board member of OKLO, a firm focused on developing next-generation nuclear power generating capacity. He is a pro-growth energy visionary whose 2024 research paper "Bettering Human Lives" calls, first, for recognizing that "Energy is essential to life and the world needs more of it" and ultimately that "Zero Energy Poverty by 2050 is a superior goal compared to Net Zero 2050."

What specifically should we expect on the regulatory front?

- *Trump will revise the Environmental Protection Agency's Corporate Average Fuel Economy (CAFE) requirements that currently mandate fleetwide 50.4 mpg by 2031*.
- *This is urgently important because it is through these requirements that the Biden administration has effectively created an electric vehicle production mandate for the US auto industry*. There are no actual rules for the share of US production that must be EVs – but the CAFE requirements can only be met by diluting internal combustion engine vehicle production with zero-MPG EV production. These requirements can be revised at the whim of the EPA, and the EPA is controlled by the executive branch, and the executive branch is about to be controlled by Trump.
- Trump lacks such unilateral power to rescind the EV consumer subsidies embodied in the so-called Inflation Reduction Act, but could move to do so through legislation. But so far it seems that even with the subsidies consumers do not consider EVs to be an attractive value proposition. *So without the CAFE requirements forcing US-made EVs into the showrooms and into consumers' garages, we can be sure that this will effectively increase gasoline demand versus what had previously been expected.*
- Trump will pull the US out of the United Nations Paris Agreement on climate change for the second time.
- Trump will allow drilling in Alaska on all leased acres in the Alaskan National Petroleum Reserve – now, under Biden, it is just on 400,000 acres in the Arctic National Wildlife Refuge. Trump will

increase federal land leasing both on-shore and off-shore, which dropped to the lowest level on record this year.

- Trump will nix the DOE's Liquefied Natural Gas Export Study, being rushed out in Biden's final days, which would have been used to stop the build-out of liquefaction facilities. New natural gas export facilities could increase the total gas market by 14 billion cubic feet per day for US operators drilling in shale plays from Appalachia, Texas, and Louisiana – an overall volume roughly equivalent to the entire current Haynesville production.
- Trump will approve pipelines that have been sidelined under the Biden administration. The on-again off-again Keystone XL pipeline would allow up to 890,000 barrels per day of Canadian heavy crude flows into the Gulf's refinery complex.
- Trump will remove the regulatory hurdles in the way of several oil export pipelines/hubs to help the US increase crude oil exports by 3 to 5 million barrels per day.
  - Bluewater Texas Terminal near Corpus Christi was denied permits under the Biden administration that had been granted previously under Trump's first term. The 384 million annual capacity crude export facility is close to newly constructed oil pipelines from the Permian Basin and Eagle Ford Shale plays.
  - Blue Marlin Offshore Port in Louisiana is another deep-water port with capacity of almost 2 million barrels per day, connected to the existing Stingray pipeline. It is a brownfield natural gas export facility that could be easily converted.
  - Inglewood Energy Center needs permits passed to significantly expand existing infrastructure. The facility could simultaneously load one Suezmax and two VLCC oil tankers at a rate of 160,000 barrels per hour.
  - The Biden administration has approved two large export terminals – Sea Oil Port Terminal (2022) and Texas Gulf Terminal (2024). We will get higher oil exports under Trump as these two terminals are about to come on-line.

So what does this mean for oil prices, and for US oil industry profits?

- Trump uses the simplistic but compelling slogan "drill, baby, drill" to capture his vision of US energy abundance and the lower consumer prices that would flow from it. But it's way more complex than that. If it were not, it would be a sure path to collapsing profits for the oil industry.
- *Regulation is a tax. As such it entails a deadweight loss to the oil market. Its elimination creates a dividend that can be shared by consumers and producers.*
- *Producers can preserve unit margins at lower prices. Lower prices mean consumers will want more units. Producers will enjoy greater dollar profits, thanks to higher unit volumes at preserved margins. Consumption of more oil will lead to more economic growth that will increase unit demand. More unit demand means more production, which in turn means a faster journey up the learning curve, which*

<u>produces another dividend that can be shared by consumers and producers. And so on...</u>

So if we can just avoid a nuclear war…

We will find ourselves in a world in which oil prices are lower, and yet oil industry profits are higher. So…

- We are lowering our expected trading range for Brent crude to $60 to $80, down from $75 to $90.
- At the same time, we are turning positive on the lagging energy sector.

Bottom line

In anticipation of a deregulatory regime under Trump that will increase both demand and supply for fuels, and remove deadweight costs, we are lowering our projected trading range for Brent to $60 to $80, while at the same time turning positive on the lagging US energy sector. Wright for Energy secretary is the perfect pro-growth choice. CAFE standards will be revised down, effectively ending the electric vehicle mandate. A black swan is that Trump will "settle" the Ukraine conflict rapidly, and Russia can rejoin world energy markets, but with little effect on prices. A widening conflict in the Middle East as Trump gives Israel broader permissions to defeat Iranian terror is more of a threat. Trump will enforce existing sanctions on Iran, sharply reducing their crude exports, but this will easily be compensated by production increases by other OPEC members, especially Saudi and UAE.