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Flash Note
06/06/2018

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Why has the price of oil fallen back in recent days? Outlook

Short-term view - The conjunctural factors are dragging down the price of oil and may continue to do so:

• (Price Negative) –US unofficially requested for OPEC to raise output to raise output by 1M bpd. The request was made unofficially to Saudi Arabia and other OPEC producers separately, not as a group. OPEC's answer was that any decision would have to be made collectively and taken after debate, adding that "the most important thing for OPEC is to keep the group together". The move came in a moment when OPEC countries pumped just 31.9M barrels a day last month, unchanged from April (the lowest output level in a year), In an attempt by the cartel to continue to strangle the energy market in order to defend a high price. Energy ministers from Saudi Arabia, UAE, Kuwait, Algeria, and Oman met over the weekend and emphasized that "cooperation is needed across producer countries to manage healthy market conditions".

• (Price Negative) – Total positioning in WTI across hedge funds and other large investors shrunk to its lowest level since last July. In the week ended 29-May, longs fell 10%, while shorts increased 29%, reducing the net-long position by 14%. That said, net positions in the derivatives market remain long oil (607k contracts, far above the 10-year average of +300k contracts), suggesting that there is still room for some (downward) normalization in the speculators' positions, which invites us to think of additional adjustments in the price of crude oil.

• (Price Negative) – Global demand could dip on expected slow down of Chinese imports: A slow down in Chinese demand could further pressure prices. Outlook for Chinese industrial and transport demand is shaky, as freight traffic and electricity production have fallen since Q3-2017 as a result of the significant supply-side reforms overtaken by Beijing (aimed at cutting excess capacity). If we add a slowdown in Europe, this could cause a decline in global demand for crude.

• (Price Negative) – Mexico's output could return to 2M bpd if next government pursues private investor auction plan: Mexico's Energy

Minister Pedro Joaquin Coldwell said that output could return to 2M bpd by 2022 if the next government pursues a plan to auction development blocks to private investors. Coldwell said Mexico would have to invest around $640B to stop the country's long-term output decline (production peaked at 3.4M in 2004, and was 1.9M in April).

Long-term view - The structural factors that we have been long considering have not changed, and point to cheaper energy prices

• Alternative energies picking up the baton: Producers must bear in mind that the value of their reserves is dictated by the amount of time they can pump before alternative energies render oil obsolete. In order to delay this deadline as long as possible, it is in producers' interests to keep oil prices low (keeping the opportunity cost of alternative energy sources as high as possible). The head of the latest consortium pursuing the large-scale production of cellulosic ethanol from farm waste says that the outlook looks promising again. "There are remaining process engineering problems to be fixed, but the technology can be competitive with oil at $70/ barrel"

• Growing environmental problems will gradually tighten legislation and production levels: The value of producers' reserves depends on the amount of time they can pump at current levels before tougher environment-inspired regulations come in. With growing environmental problems that will likely continue to put big pressure on the market for fossil fuels over the coming decades, Riyadh's most serious risk is of sitting on a big chunk of "stranded reserves" that it can no longer extract and sell. Producers therefore have a powerful incentive to monetize as much of their reserves as soon as possible.

• Are OPEC producers able to structurally fix prices? Back in the 1970s or the early 2000s, the exporters' cartel agreed to cut output and the approach worked well, as the principal competition was among oil producers (in particular between OPEC and non-OPEC producers). Today's biggest threat to any conventional oil producer comes from non-conventional producers and alternative energy sources. Energy cuts from conventional oil should easily be offset (in theory) by a quick increase in shale oil production. While it is true the agreement between the Saudis and Russia to strangle the global energy market has worked well, achieving a considerable increase in the price of oil, this has been at the cost of a loss of market share, meaning that OPEC producers are no longer able to fix prices without bearing costs.

- Shale producers to raise output considerably at $60 a barrel: The IEA has said that an oil price of $60 would be enough for many US shale companies to restart stalled production.

Why is it important to have a vision about the price of oil?

- The price of energy can increase or drain global liquidity, so that a shock of oil (towards US$ 100), would drain a lot of liquidity, what could lead to a disruption in the functioning of a market in which prices are increasingly set in the margin.

- In a market such as the corporate debt, which has dramatically changed its structure, it is essential that there is a good level of liquidity (and a low price of oil would help a lot).

  - In 2008, the market size of corporate debt was USD 2.8 trn, and the corporate bonds held by dealers offering liquidity was USD 260 bn (10% of the total).

  - In contrast today, the corporate debt market size is 5.3 trn USD, while the corporate bonds in the hands of dealers is 40 bn USD (~ 1% of the total)

- In a nutshell, we have a volume of corporate debt that is twice as much as 10 years ago, while the ability of dealers to offer liquidity has been reduced by more than 80%. That is why I emphasize the need to maintain a global liquidity in healthy levels, that improves the ability to make an agile clearing of the market in case the orders piles up.

- A shock in the price of crude oil would drain a lot of global liquidity and could endanger this entire market.