ANDBANK Private Bankers

Flash Note
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The Fed? Inflation expectations? What really matters is oil price.

We begin the year and, for some strange reason, among all the factors to be considered, the most decisive again, as in January 2016, is oil. Yes, crude oil is the factor that we all must monitor more closely in the next weeks. Why? All assets, with no exception, are dancing today along with the outlook on the Fed, which in turn will vary depending on the evolution of prices, which are finally surprising to the upside but it looks like it's all about oil prices. While this recent bout of positive inflation surprises should repress deflationary fears in many parts of the world, the bad news is that it looks like it is all related to oil prices (according to banking sources). Therefore, what matters today is to know whether the oil price will continue to rise, fueling new upward expectations for inflation, the Fed, bond yields, the dollar, etc., or if on the contrary the rally of oil has come to an end.

Without being an expert on the subject (in fact, the word expert does not exist in my dictionary), I would dare to say that crude oil should not go up much more driven by fundamental reasons. According to all the daily information that I have gathered concerning the oil market, I see more reasons to think of a stabilization of the price of oil first, and a moderation afterwards. Let me share with you this relevant information that invites me to think of flat oil prices.

All assets are dancing today along with the outlook on the Fed…

1. More wells and output is coming: US shale production may break a three-month slide in February, with production expected to post a m/m increase for the first time since October. The EIA report showed that producers drilled 712 wells and completed 545 in the largest shale basins in December after the recent increase in oil prices, leaving total drilled but uncompleted (DUC) wells at their highest level since April. As a result, IEA Executive Director Fatih Birol sees a significant increase in US shale output as OPEC tries to rein in supply: "shale-oil production will definitely react strongly".
2. Job postings in the US are returning to the oil patch following the recent recovery in oil price. In the five states where the crude industries carries the highest impact on the labor market, the number of oilfield listings as a share of total work posts climbed 52.1% from August through October.

If oil prices don't continue to climb higher I expect Fed expectations (and pressure on debt markets) to ease significantly.

3. Cut in marginal costs for drillers points to more output at each oil price level: The US shale drillers have recently halved their cost base thanks in part to standardization of drilling equipment, resulting in a cut of nearly a third from their exploration and development costs. However, this could be offset by rising costs to hire experienced crew and outsourcing critical oil-services firms.
4. Saudis say cuts may end in June: Saudi energy minister Khalid al-Falih said yesterday that OPEC and Russia will not need to prolong output cuts beyond June because the agreed reductions will have already ended the oversupply in world crude markets.
5. Oil futures curve raises doubts over OPEC rally: Oil futures contracts for delivery late are not reacting quite as enthusiastically to OPEC's deal. Brent for next month delivery has risen 15%, but the contract for December 2018 is up only 6%. The weakening of the market's *contango* structure (the six-month *contango* has decreased from $4.50/barrel to ~$2.60) and has the potential effect to make flood back into the market more than 100M barrels currently stored on tankers at sea and undermine recent stronger prices.
6. Trump administration will be friendly toward the fossil fuel industry and could boost output: Rick Perry (Dept. Industry), Cathy Mc.Morrys (Dept. Interior), and Rex Tillerson (Secretary of State) are all advocating for expanding oil development.
7. Libya Sharara field pipeline blockade is lifted. Libya's National Oil Corporation has confirmed that has reopened two of its biggest fields (the Sharara and El Feel), which will help boost Libya's oil production by ~175K bpd within a month and 270K bpd within three months. It notes that the country's current production of 600K bpd is less than half the 1.6M bpd it was pumping before the 2011 uprising.
8. Norway, which has declined to participate in OPEC's plan, will still benefit from higher prices, which could then spark more investment in the offshore industry. Norway said its oil and gas output will be higher than previously expected in 2017 and 2018 following above-forecast output last year.

If oil prices don't continue to climb higher, as this information suggest, I expect to see the inflation surprise index fall back once again, although not immediately. If true, then the Fed expectations (and pressure on debt markets) will ease. The dollar will stop having the explicit support of a more hawkish Fed, but it will be the euro and its unresolved existential problems what will set the tone for the €/$.