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Sustainable Jump in Oil Prices What Next?

The global energy world seems to have completely changed in recent weeks, but in reality what has changed is only a very tiny part of it, although market participants have exploited the confusion to build strong positions (driven by a lack of opportunities in a historically thin market), and thus magnifying the effects.

Saudi Arabia's 32-year-old crown prince Mohammed bin Salman, acting as the head of the newly-established anti corruption commission, lead to a dramatic shakeup in Saudi Arabia by ordering the arrest of dozens of princes, billionaires, ministers, and former top officials in what is being billed as an anti-corruption drive. The actions have been presented as a part of the crown price drive to modernize the economy, but the move has deeply unsettled the oil market. Clearly, a change is needed if the Saudi regime is to survive in a post-oil world. Yet, our sources warn us that by openly challenging such powerful interests within the political elite, the crown prince risks fracturing the fragile consensus that for decades has held the Saudi state together. The risk is that by alienating the key constituencies (business, political and religious elite) he could have overplayed his hand.

The dramatic shakeup in Saudi Arabia domestic politics has deeply unsettled the oil market

The low oil prices have strained the state's ability to finance the current patronage networks (the 2016 fiscal deficit exceeded 17% of GDP). Having asked about why now, my sources answered that it is possible that Mohammed bin Salman was emboldened by the renewed strength of his regime ties to the US administration. It would be ironic that Trump could end up being the culprit of the shift towards a more liberal regime in a country that paralyzed its social reforms in the 70s due to the pressures of the extremists.

The reaction of the market, by boosting oil prices, seems pretty normal at first glance. The renewed strength of ties between Saudi and the US means an escalation in the antagonism between Riyadh and Tehran (due to the recent deterioration of relations between Washington and Tehran). Indeed, a big portion of the recent jump in oil price seems to have been driven by fears of political conflict in the Middle East than any improvement in the sector fundamentals. In particular, Yemeni rebels (Iran's clients) launched a failed ballistic missile attack on Riyadh's international airport on Saturday (Saudi Arabia has been fighting Houthi rebels in Yemen since March 2015). Well, Riyadh regarded the attack on Saturday as an act of war by Iran. You can imagine the rest of the "caresses" that were thrown all over the weekend and the influence that this has had on the speculators. Hedge funds go all-in on oil and built near-record bullish positions in almost all parts of the petroleum complex. They have amassed a net bullish position in crude and refined products amounting to more than 1B barrels, with net long position in the five major contracts surging by almost 720M barrels and being now just 3M below the record of 1.02B set in February.

Saudi Arabia and Iran (OPEC's first and third largest oil producers) are long-term adversaries but talk of war is an intensification of this rivalry. Indeed much of Saudi Arabia's oil export infrastructure is located on its east coast close to Iran and about 17m bpd of oil flows through the Straits of Hormuz, which Tehran has previously threatened to block. Nevertheless, for now though, it seems that Saudi Arabia and Iran will continue to fight proxy wars rather than resorting to direct conflict.

Having said all that, and considering that the sector fundamentals have not changed, as concerns about geopolitical tensions and the shakeup in domestic Saudi politics fade, oil prices are likely to surrender their gains.

Best regards