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Flash note
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We raise the target price of oil. The implications for the rest of assets

Most of the developments in the energy industry this month have been (counterintuitively) favorable for the future price of crude oil. We raise the target price for oil (West Texas) from the current range of 35-45, to 40-50, without ruling out new price increases in the coming months. As such, oil becomes a BUY recommendation. What follows is a brief synthesis of the arguments for our decision.

(Price Positive) – Two big oil donating to Democrats: CVX and XOM, the two largest US energy firms, have increased their campaign donations to Democratic candidates, in contrast to the ~85% of all oil and gas donations that have flowed to Republicans this election cycle. This has come as Democratic presidential candidate Joe Biden--who has called for a renewable-energy transformation and an end to new fracking permits on federal land--has been surging in the polls. Biden had pledged to not accept donations over $200 from the fossil-fuel industry, but has taken nearly $900K from individuals and PACs linked to oil and gas. This information installs me in the idea that a Democratic victory could represent a severe setback for unconventional energy activity, and a considerable reduction in global supply, which would push crude prices considerably higher.

(Price Positive) – OPEC joint ministerial meeting committee acknowledges a slowdown in oil market recovery, and delays the easing of output restrictions: Saudi energy minister Prince Abdulaziz bin Salman said the group will do what is necessary in the interest of all, while Russia's Novak said the oil market has seen a material slowing of demand recovery as many countries re-impose lockdowns to contain COVID-19. Novak also highlighted many uncertainties around the path to return to pre-pandemic levels. Analysts expect the group to postpone the planned production increase in early 2021 by a few months, citing Novak's comments on demand trends as well as elevated global stockpiles. Officials including OPEC Secretary General Barkindo have recently said the demand outlook is still looking anemic, while the group still expects a persistent supply overhang to continue into 2021 in the event of a prolonged and severe COVID-19 second wave. However, global oil demand recovery to 94% of pre-pandemic levels and stronger consumption trends in China and India could also play a part in the December decision.

(Price Positive) – Russian oil majors signal lower drilling in 2021: Bloomberg reports that Russia's crude producers are looking to reduce drilling volumes in 2021 as the pandemic continues to threaten demand and price recoveries. The article quotes analyst projections that oilfield spending in Russia and the former Soviet Union may drop by 31% in 2020, making the region the third hardest-hit by the virus, behind North America and Africa. It adds that oil producers have signaled some confidence that they can ramp up production quickly after the end of the year in accordance with the OPEC+ agreement, but lower drilling may delay capacity growth at projects Russia sees as the drivers of future output growth.

(Price Positive) – China's next five-year plan to call for increases to crude reserve: China's next five-year plan beginning in 2021 will call for increases to its state reserves of crude in an effort to withstand supply disruptions following deteriorating relations with the US and its allies. The plan is expected to be rolled out in October. The country has already begun to prepare and build some of the storage capacity needed to boost reserves. In April the government set a reserve target of 90 days of net imports, but could eventually be expanded to 180 days when commercial reserves are included

(Price Positive) – CTFC votes to institute position limits: The WSJ reports that the US Commodities Futures Trading Commission (CTFC) voted 3-2 to institute position limits on 16 agricultural, metal, and energy commodities, with the goal of preventing speculators from causing price swings that don't reflect underlying supply and demand. The limits were authorized by the Dodd-Frank Act but have proved to be thorny to implement, with four previous attempts having failed amid industry opposition or court challenges. This decision can avoid episodes like the one seen in June.

(Price Negative) – Libyan output moves toward 500K bpd: In the wake of a truce in Libya's civil war, that country's oil production has risen to almost 500K bpd, with a large contribution from ramping production at the large Sharara oilfield (which can top out at ~300K bpd). The article notes Libya's exports averaged 385K bpd for the first two weeks of the month, against 213K bpd for all of September. It adds, however, that many of these shipments have thus far been from storage tanks at the country's port facilities rather than freshly pumped crude.

The implications for the rest of assets

The effects of a gradual (and constant) rise in oil prices could be felt in the form of an increase in the slope of the yield curve. We are thus cautious in long dated bonds.

In the equity market, small-mid caps should do well in this environment of a more pronounced slope, overperforming big caps. Small companies are financed at a floating rate, while large companies are financed at a fixed rate and for longer terms, assuming greater refinancing risk, which can eventually impact negatively on margins.