BearBull
Global Investments Group

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New Crude price War: The forward structure predicts a rebound

The Covid-19 shocks the crude market. Saudi Arabia overturns the chessboard. New crude price war. American producers in turmoil. The forward structure predicts a rebound.

Key Points

- Covid-19 causes first temporary demand shock
- Covid-19 and Saudi Arabia cause panic in a second step
- Saudi Arabia wants to take the initiative and gain market share
- US shale oil producers in the eye of the storm
- Massive fall in CAPEX, decrease in the production of "US shale oil"
- A first semester characterized by an increase in inventories
- A resumption of activity and demand in the second half
- Crude prices could rise again before the end of the year, average price of $ 50 in 2020

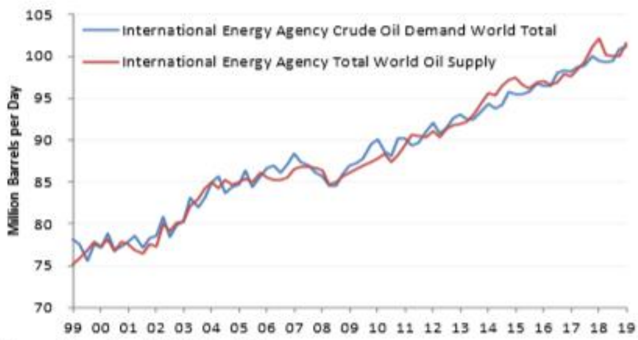
Covid-19 causes first temporary demand shock

From the start of the Coronavirus crisis in China and well before February 21, 2020, the oil market began to anticipate a fall in global crude demand caused by a likely massive decline in Chinese imports in the 1st quarter. A first correction in prices from $ 60 to $ 50 a barrel in January testified to the change in demand expectations at the start of the year. The world's largest consumer and importer of oil was then in an unprecedented health crisis and was undertaking an uncompromising fight against the evolution of the epidemic by quarantining a city, then a province, and then establishing a global strategy at the country level.

This policy quickly resulted in a collapse in Chinese demand for raw materials and logically impacted crude prices.

The year 2020 started however on excellent auspices, world demand was then estimated to increase by around 1 million barrels per day on average according to the various energy agencies, while the supply seemed to be able to be stabilized by production declines in OPEC countries and a limited increase in the US supply of unconventional oil.

<u>Crude oil supply and demand</u>



Sources: Bloomberg, BBGI Group SA

The Covid-19 thus caused a temporary shock, in our view, to Chinese demand in January and February, which should recover quickly when the Chinese economy resumes a notable pace of activity. The situation is not yet ready to normalize, but the epidemic seems to have been controlled according to statistics released recently in China. Since February 21, it seems clear that the fall in Chinese demand may be accompanied by a fall in demand in the countries newly affected by Covid-19 and which are taking very strict measures to combat it. the spread of the virus.

Undoubtedly, travel restrictions and the fall in international trade will have a negative impact on oil demand as well at first.

If WHO considers today that the epidemic is now a pandemic, it also notes that it is controllable. In other words, if the oil market is currently disrupted by a temporary demand shock linked to Covid-19, the latter should probably start again in the 2nd quarter when the effects of the pandemic diminish.

Covid-19 and Saudi Arabia cause panic in a second step

On February 21, crude oil prices resumed a downward trend, prompted by a new awareness by investors that a transmission of the Covid-19 was possible outside the borders of China with considerable potential effects on world populations. Gradually, the world also realized without being able to protect themselves that Western economies were weakened by a now extreme interdependence between them and the Chinese economy. The collapse of Chinese activity, which initially had little impact on the financial markets, has now emerged as a major threat that can affect supply and production chains in a very large number of industrial sectors in particular. The air, maritime and transport sectors in general have suffered massive effects which are sure to cause bankruptcy risks without government support in the coming weeks. At the same time, the risks of a cyclical slowdown thus appeared more serious, pushing interest rates, equity markets and commodity prices down.

Against this backdrop of panic on the financial markets, the fall in crude oil prices was again significant (-14%), but it was then exacerbated also by the shock caused by Saudi Arabia on the oil market. March 6.

This handful of digital stocks (5 out of 500) has very much dragged the index as a whole upwards this year, maybe especially so in October. It is estimated that nearly two thirds of the index's growth is down to key technology stocks.

By decreeing a drop in its crude prices to its customers following the absence of an agreement on the reduction of quotas within OPEC +, Saudi Arabia was unintentionally throwing fuel on the fire and caused a further drop of -40% in WTI prices in two days. WTI prices then plummeted overall by -55% in six weeks.

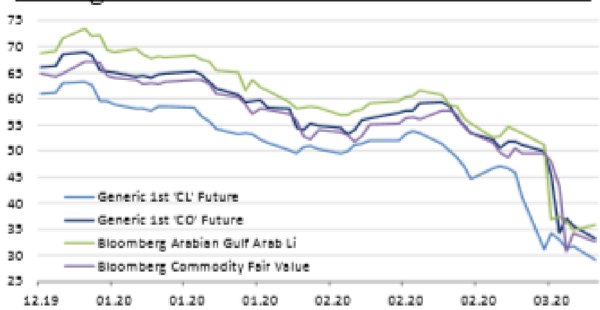
Saudi Arabia has cut the official price of its deliveries of Arab Light for its Asian customers from $ 6 to $ 8 on average, while announcing its desire to increase its production and its supply of crude by 9.7 million barrels. per day (February) to 12.3 million barrels per day in April.

This delivery target exceeds the maximum level of production estimated at 12 million barrels per day, the Saudi Minister of Finance therefore addressed the company Aramco asking to push the maximum level of production to 13 million barrels per day.

This new strategy from Saudi Arabia largely surprised observers for whom the kingdom was attached to follow a policy of supply control by limiting production if necessary, and in particular in the context of the Covid-19 crisis.

This complete flip-flop completely overturned the oil market, but also contributed to the development of global panic in the financial markets in the days following this decision.

Arab light – Ural - Brent – West Texas Intermediate



Sources: Bloomberg, BBGI Group SA

Saudi Arabia's move lowered Arab light prices, but other crude oil prices (North Sea Brent, Ural Crude, and US WTI) also had to adjust very quickly.

Existing premiums contracted, especially those prevailing on the Arab light. The gap between Saudi crude and American crude (WTI) prices narrowed drastically from over $ 10 at the start of the year to around $ 3 in mid-March.

Saudi Arabia wants to take the initiative and gain market share

If Saudi Arabia has radically changed its strategy, it is probably due to the attitude of Russia. The lack of Russian support in OPEC's effort to respond to the drop in demand caused by Covid-19 has left only one option for Saudi Arabia: " to further increase the global supply, to temporarily drop prices and bring back to the negotiating table potentially those who did not feel sufficiently concerned by the management of the supply in the tense context of the 1st quarter. Meanwhile, the increase in Saudi supply at particularly competitive prices will allow it to increase its market share and perhaps keep it when the crisis is over.

Saudi Arabia's logic, particularly in the context of the colossal costs and financing needs of the major reforms wanted by Prince MBS, would be that it seeks to maintain higher crude prices instead. The previous production cuts accepted by the Kingdom were effectively aimed at reducing supply. Its latest proposal to reduce OPEC quotas by 1.5 million barrels a day was a step in the right direction, but Russia's negative reaction pushed Saudi Arabia into action, clearly it could not cut production unilaterally.

The impact of the Saudi decision on other crude producers will be major and constitutes a revival of the price war already observed in 2014-2015.

All prices of other crude oil exporters have adjusted quickly, and exporters with higher production costs are likely to be the hardest hit in this new environment, notably exports of crude oil from Ural and American shale oil.

US shale oil producers in the eye of the storm

The fall in the price of a barrel of Saudi crude is obviously not without consequences for Brent or WTI, which naturally fell in concert. Saudi Arabia thus also declares war on American shale oil and it is of an obvious and rational logic if we consider that the balance of the oil market is in fact always driven by OPEC and by the most important producers. efficient and at the lowest production costs.

The reduction in global crude supply has been driven since the emergence of unconventional US crude production exclusively by OPEC.

From a strictly economic point of view, logic would on the contrary want producers with the highest and least efficient production costs to be the first to suffer from a fall in demand and prices.

It is normally ineffective to reduce the production of cheap oil because the production of American shale oil increases.

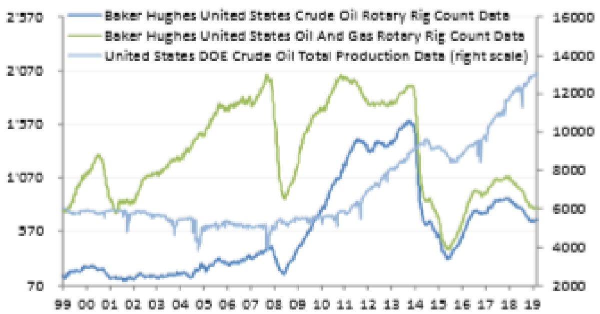
The return to an average price of $ 30-35 a barrel has already caused significant effects on American

companies which have announced drastic cuts in their CAPEX and their dividends. Their production will certainly also be reduced, but the need to maintain sufficient cash flow to meet the demands of their creditors will partially limit the decline.

It is already estimated that nearly $ 500 billion in potential cash flow will fall for all shale oil producers if crude oil prices stabilize at $ 30 a barrel.

Saudi Arabia is fully aware that crude prices below $ 40 or $ 35 have already had a significant impact on the number of active wells in the United States in the past. It hopes that despite efforts to rationalize the sector since 2015, its decision will act as a brutal brake on the development of the sector.

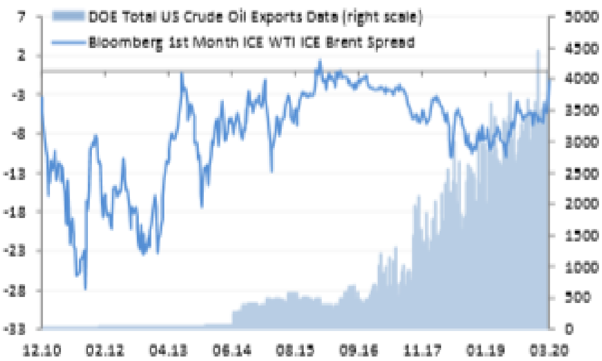
<u>Number of active and producing wells (US)</u>



Sources: Bloomberg, BBGI Group SA

Since 2015, the CAPEX of the oil sector had already largely decreased, this new episode will only increase the risks of a future reduction in production capacity in the United States.

<u>WTI-Brent differential and US crude exports</u>

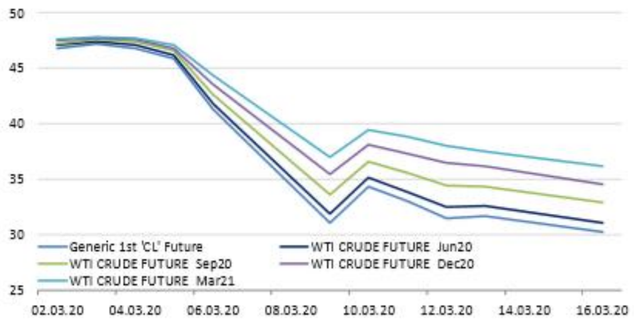


Sources: Bloomberg, BBGI Group SA

Crude prices rise again before the end of the year, average price of $ 50 in 2020

The structure of oil futures prices clearly suggests that oil prices will soon rise significantly.

Evolution of the WTI futures price structure



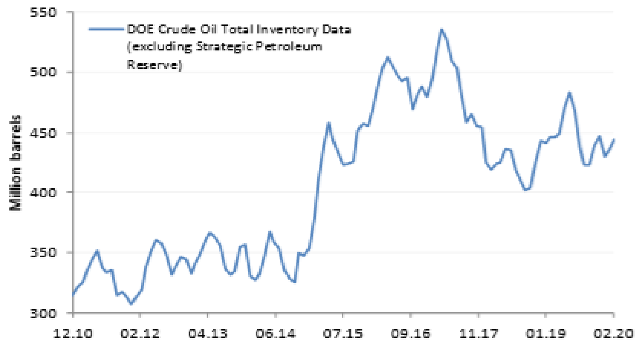
Sources: Bloomberg, BBGI Group SA

Indeed, the brent futures market already presents an exceptional situation of "contango".

The current spread between "spot" prices and the price of a barrel of oil in six and twelve months is again the highest since 2014 and stands between $ 6 and $ 7. The market therefore expects a temporary increase in inventories, which will be followed by a recovery in demand and a significant rise in prices of almost + 20%.

Our global scenario for the year 2020 favors an evolution of the market in two phases. The first phase is underway and is characterized by a decrease in demand linked to the Covid-19 crisis (between 0.5 and 1 million barrels per day) and an increase in supply driven by the strategy of winning shares of Saudi Arabia's markets of around 1.5 million barrels per day.

US crude stock



Sources: Bloomberg, BBGI Group SA

A likely decline in US production, an agreement on new OPEC + quotas including Russia and a subsequent recovery in demand (+1 million barrels per day) after the Covid-19 crisis should characterize the second half. These market conditions should make it possible to reach an average price of $ 50 in the year 2020.

In summary, the fall in recent weeks is therefore similar to that observed in 2015, which hit $ 26 a barrel before rebounding above $ 50 and then stabilizing for four years between $ 50 and $ 60. Saudi Arabia's initial strategy to cut OPEC production to keep supply and demand balanced against the backdrop of a weaker economic outlook for Covid-19 was not followed by the Russia. Saudi Arabia has temporarily lowered prices, which we believe will gradually rise above $ 50.

Although it is not excluded that the effects of Covid-19 on world demand for crude oil may be more lasting than expected, we consider that at the current level of $ 25-30 per barrel, WTI prices offer particularly attractive investment opportunities with a nine-month investment horizon. In addition, diversified oil companies with lower production costs and more competitive than those of American producers of unconventional oil will be favored by a high dividend and a price recovery following the rise in crude prices.

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