

Are Oil Prices headed towards \$100/barrel?

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On 1st June 2021, Jeremy Schwartz, Global Head of Research at WisdomTree and regular host of the Behind the Markets Podcast was joined by Mobeen Tahir, Associate Director of Research at WisdomTree to host Erik Gilje, Professor of Finance at University of Pennsylvania's Wharton School of Business. The topic was oil and the focus was on Erik's bullish view on the commodity stemming from structural supply issues in the US amid an improving demand outlook.

The Professor outlined that over the last decade, almost all new supply of oil has come from North America, i.e., either Canada or the US while the Organisation of the Petroleum Exporting Countries and its partners (OPEC+) have lost market share. The group was forced by the Covid-19 pandemic to remove 9.7m barrels in what can be characterised as dramatic and unprecedented policy coordination.

But OPEC+ may not necessarily be fixated on quickly bringing this supply back online. This is because the group is possibly less worried about losing further market share to US Shale producers now than in the past. This marks a major shift in the dynamic between the two and could be the key force that drives oil markets higher.

According to the Professor, US Shale production is significantly impaired and this is driven by structural reasons. When West Texas Intermediate (WTI) oil was around \$70/barrel in 2018, the number of operating US oil rigs was 874. Today, it is 359. Similarly, the number of fracking crews in operation back then was 485 compared to 226 today. Investment in US Shale has fallen meaningfully and US oil production is likely to decline over the next 1-2 years.

But why might the reduction in investment be structural rather than something fleeting and related to the pandemic? The Professor cited a change in investor preferences and government stance as the two key factors. Investors who have not received dividends from US Shale producers in the last decade are now imposing a more stringent cost for their capital. They are not only demanding capital expenditure by the producers but want them to also be cash flow positive. Investors seeking carbon neutrality are also posing more challenging questions to oil producers which further raises their cost of capital.

The shift in government stance under President Biden is also noteworthy. Biden's freeze on rights of way for hydrocarbons across federal lands limits new pipeline capacity and increases breakeven costs for oil producers.

So even though rig counts have risen slightly in recent weeks, pre-pandemic levels of output are unlikely to be restored given there can be 15-20% impairment when bringing rigs back online. This means that

for production to remain flat, new wells need to be dug – something which seems challenging given the higher cost of capital.

As a result of this evolving dynamic, OPEC+ are unlikely to be rushed into bringing supply back online given the difficulties faced by US producers. They are likely to let prices rise amid an improving demand outlook. Oil prices at \$100/barrel within the next 6-12 months might not be beyond the realms of possibility.

A full version of the podcast episode can be found [here](#)

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