OPEC: Déjà vu – No thank you!

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Brent oil has fallen 23% in the past month. Fears of oil market surplus have driven the slide. The suddenness of the collapse feels eerily similar to the November 2014 experience. However, we believe the Organization of the Petroleum Exporting Countries (OPEC) will act to stem the decline at its meeting on 6th December 2018, unlike in 2014. The cartel's experience in the 2014-2016 period was too painful for the group to want to return to an era of weak prices. Also, the context is very different today. Back in 2014, OPEC engineered the price decline to spite the US and other higher cost producers. This time, it appears price weakness is mainly due to the US production expansion. The 2014 experience illustrated that OPEC could not crowd out US production growth. Learning from this experience, OPEC is unlikely to want to keep production levels high to maintain market share; rather, they will seek to keep prices higher to maintain fiscal revenues.

A nightmare not worth revisiting

The collapse in oil prices, starting in the second half of 2014, hurt the fiscal balances of OPEC members whose governments are highly dependent on oil revenues for funding. It was not until the recovery in oil prices in 2017 that we saw a significant improvement in their fiscal position, despite the belt-tightening efforts in the interim years.

Fiscal balance of select OPEC nations

Source: IMF, WisdomTree, data available as of close 27 November 2018

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US driving price decline today

The US is expanding oil production at a rapid rate and is supressing global oil prices as a result. While the price decline in 2014 led to a sharp decline in oil rigs, a focus on cost control and improving the efficiency of rigs led to production expansion again in 2016. Today, the US is producing more than it ever has done and is now crowned at the world's largest crude oil producer. It has achieved that with 45% less rigs, compared to the peak in 2014.

US oil production: the engine of global growth

Source: US Energy Information Agency, Baker Hughes, WisdomTree, data available as of close 27 November 2018

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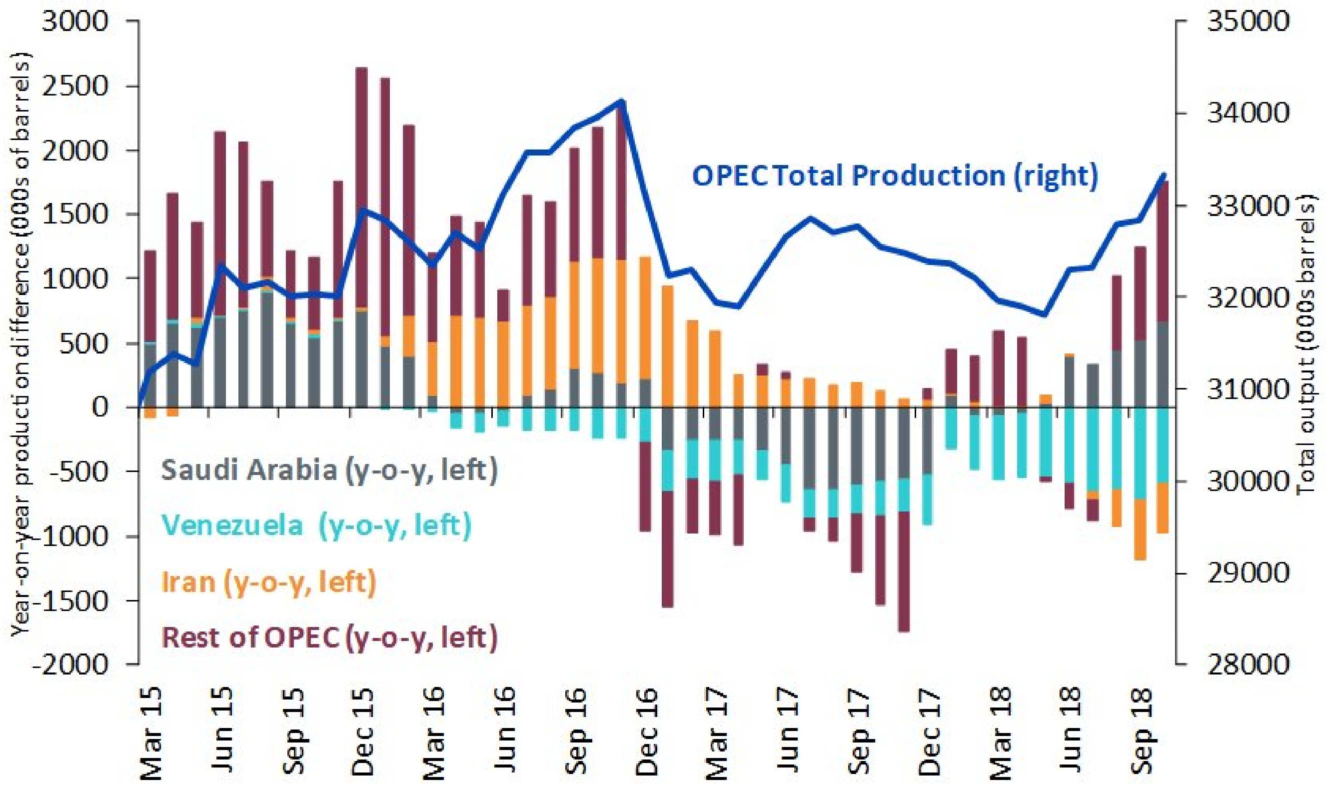
Production increases elsewhere not sustainable

As we argued in Limited oil and gas investment could be shoring up tightness in the future, only the US has made significant investment in oil in recent years. While we may have seen temporary oil expansion from Saudi Arabia, Russia, Libya and Nigeria in recent months, we doubt these sources will remain stable without new investment. Additionally, the world needs to grapple with declining supplies from Venezuela and Iran.

Year-on-year difference in OPEC oil production



Source: Bloomberg, WisdomTree, data available as of close 27 Novmeber 2018

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Trump’s stance out of touch

Given the renewed importance of oil in the US economy, one would think that policy makers in the US would welcome high and stable prices. Instead US President Trump is urging OPEC not to cut oil production at the OPEC meeting next week. Trump appears to want weak oil prices to stimulate business/consumer spending in the US. While weaker prices may encourage a paring back of production that would help deal with the glut in US oil, infrastructure is currently being built to deal with the glut. Sudden price weakness could discourage that effort and prematurely end the shale energy revolution we have witnessed.

Trump has been one of the world's few defenders of Mohammed bin Salman bin Abdulaziz Al Saud (MbS), the crown prince of Saudi Arabia after the killing of journalist Jamal Khashoggi. However, his support may evaporate if Saudi Arabia does not bow to his pressure to keep production flowing at current levels. Saudi Arabia increased production after the last OPEC meeting, when the group abandoned individual country targets to counter the decline in Venezuelan production. The country is now producing at an all-time high. It is likely to recognise that its current production is too high. In the spirit of keeping OPEC a relevant organisation – a bastion of market balance – we believe Saudi Arabia will cut production. Producing at such high levels is not sustainable without new investment (which is difficult to deploy when prices are weak). If Saudi Arabia pushes the group not to cut, it will be rightly accused of making a political move which could rupture the group. The cartel is supposed to leave politics at the door of the meeting, and we doubt that Saudi Arabia, after having brokered an enhanced OPEC (including deals with 10 non-members to participate in the production restraint), will want to jeopardise the institution.

G20 meeting: opportunity for fire-side deals

The G20 meeting that will take place today (Friday 30th November 2018) and into the weekend could serve as an ideal venue for pre-meeting deals. The market is already anticipating trade deals between US and China to counter the surge in protectionism we have seen in the past year. That could ease some concerns around a decline in energy demand from China. Trump may also soften his stance with Saudi Arabia. More importantly energy ministers from both Saudi Arabia (largest OPEC member) and Russia (largest OPEC partner) are scheduled to attend. The meeting of these two energy ministers has historically foreshadowed OPEC deals. Locking in higher prices is likely to serve both countries' interests rather than hope for larger and unsustainable market share.

Conclusion

We expect OPEC to cut production to counter price declines. Weak prices were too painful a memory. Higher production from the group today looks unsustainable. Although the largest member faces political pressure from the US to keep current production levels, we don't expect Saudi Arabia to break ranks with the rest of the cartel after it has worked so hard in the past two years to broker deals with OPEC and non-OPEC members.

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