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Daily Note

OIL - DIFFERENT PLAYBOOK

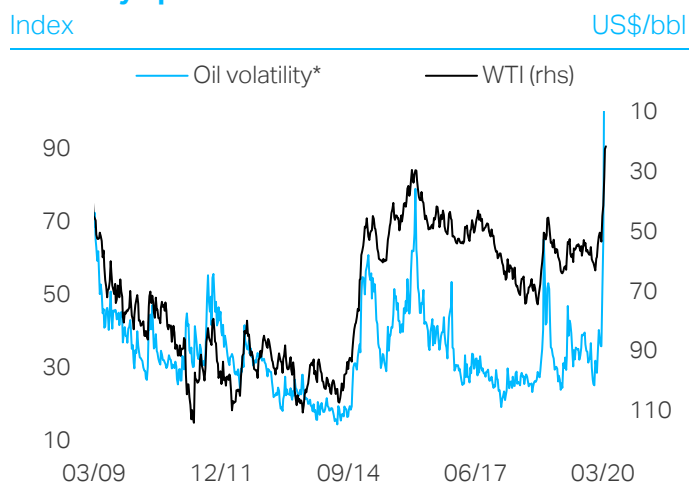
Konstantinos Venetis

- Oil under pressure as demand and supply point in the same direction
- Riyadh playing the longer game, putting US producers in a tough spot
- US shale going into a consolidation phase as the strong hands take over

Under pressure. This is one of those times when both demand and supply are forcefully pushing oil prices in the same direction with no turning point in sight. The economic fallout from the Covid-19 crisis underscores the way we prefer to approach the oil market, i.e. treating demand as the primary fundamental price driver and supply-side factors (output, inventories) as defining major turning points. In other words, tweaks in production tend to be of second-order importance for the direction of prices, except at the 'tails'. Most market participants will probably find this framework reasonable. Perhaps less obvious is what to expect as a rational response from the dominant oil producers when market conditions turn as extreme as they are now. Somewhat counterintuitively, just like experience with negative interest rates shows they can end up raising consumers' propensity to save, collapsing demand can be consistent with oil producers opting to ramp up supply – given the right trigger.

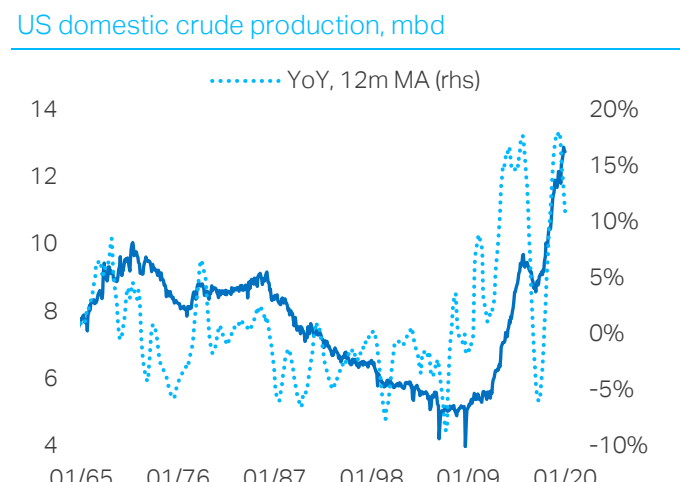
All about timing. We have [interpreted](#) the March OPEC+ fiasco as an accident resulting from a tactical disagreement between two principal parties whose strategic incentives remain closely aligned. The rationale behind Russia's position is relatively easy to see. Notwithstanding any political considerations, with oil demand in free-fall amid elevated uncertainty over the severity of the impact from Covid-19, committing up-front to the higher-for-longer supply cuts put on the negotiating table by the Saudi-led camp made little economic sense. From a strategic standpoint, output reductions are always more likely to prove effective when demand looks like it has bottomed out, not while it is lacking a pulse. It is no coincidence that in 2016 OPEC+ started taking action soon after it became evident that reflationary macro forces were kicking in, raising the chances that lower supply would succeed in bringing about higher prices and a sustained reduction in inventories.

Volatility spike



Source: Bloomberg, TS Lombard *CBOE crude oil volatility index

Time for a breather



Source: Datastream, TS Lombard

Your move, Riyadh. What perhaps still remains unclear is Saudi Arabian officials' frame of mind going into the March meeting. We are of the view that proposing deep, lasting cuts was not a face-saving gesture (the market was expecting *something*) but a genuine attempt to stabilise the market. Yet it would also be naïve to think that the Saudis were unprepared for what in game-theoretic terms could be 'non-cooperative equilibrium', even if that was not their preferred outcome. Not only do the Saudis know better than to fight – at least not on their own – a market that looks like it is about to break. They are also cognisant of the fact that their supply cuts have passively benefitted the US shale industry over the past three years by propping up prices and ceding market share.

The long game. In short, while the sell-off entails pain for all parties, the current backdrop of extremely weak demand provides just the type of environment where it is opportune for the large lower-cost suppliers like Saudi Arabia (and Russia, helped by ruble devaluation) to play the longer game. As my colleague Christopher Granville aptly [notes](#), "by going for an oil price war, Saudi Arabia moved from a position where it was being boiled like a frog to one where one or more of the other oil producers might be forced to exit the market, opening the way for both price and volume gains further down the road".

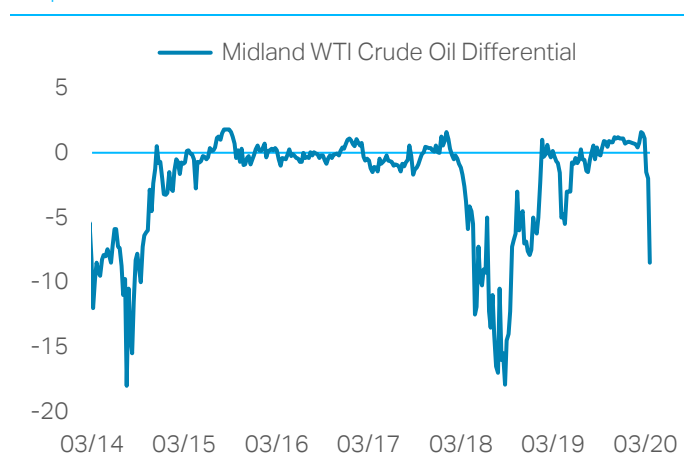
Shale pain. With production uneconomical at prices below \$35/bbl even for the more efficient operators, the US shale industry now looks in trouble. Worse still, the fracking model requires constant drilling to maintain productivity, especially after years of 'high grading' (i.e. drilling the most promising wells first). Talk of pipeline capacity constraints has given way to concerns about a shortage of storage tanks as the front part of the forwards curve quickly flipped from backwardation into steep contango. Prices are under pressure from the growing demand-supply imbalance, with portfolio insurance-type selling related to hedging activity amplifying the decline.

Stage three. All this means that the US shale revolution is fast transitioning to its third stage. The first phase (2011-15) was marked by a growth-at-all-costs mentality backed by strong capital inflows. The 2014/15 downturn exposed the industry's vulnerability to sharp oil price falls – providing a valuable lesson for both producers and their investors – and triggered a shift towards discipline and sustainable expansion. What comes next will be characterised by pockets of credit distress and a wave of consolidation that sees the strong hands take over, with Big Oil expanding its presence further.

No respite yet. Predictably enough, the growing threat to US shale producers is making President Trump [nervous](#). Yet, with or without any American prompting, [we still see](#) the OPEC+ consultations in late June as the earliest window for 'oil peace' feelers. Until then, and depending on the course of the pandemic, prices are more likely than not to stay on the back foot. How long this period of acute oil weakness lasts remains to be seen. What can be said with more confidence is that when the dust settles, the oil market playbook will be different.

US supply glut returns as storage runs out

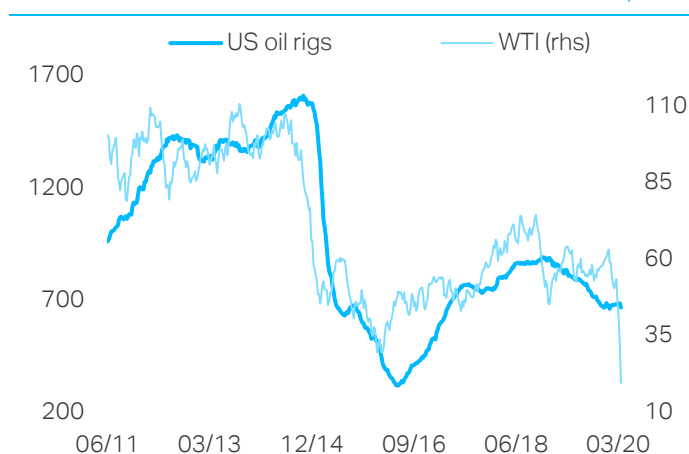
US\$



Source: Bloomberg, TS Lombard.

Rig count to follow suit as oil prices collapse

US\$/bbl



Source: Datastream, TS Lombard.