Global Political Drivers

PETROGEDDON

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- **The timescale in which the oil price war could rage before one of the belligerents blinks may be longer than some more vulnerable oil producers can survive.**
- **Already close to political collapse before the outbreak of the oil price war, Iraq is now at serious risk of being pushed over the brink.**
- **This risk may appear to be mitigated by our view that the OPEC+ fiasco was an accident that belies continued alignment of fundamental incentives.**
- **Now landed in a non-cooperative play, however, the belligerents can find the rationale and the means to dig in for long attrition.**
- **The pain for the US shale oil industry may lead Trump to mediate – and a hint of this has already relieved some pressure on the oil price.**
- **But any such breakthrough will likely depend on more visibility about the scale of the coronavirus-driven demand shock.**
- **An optimistic timeline of three months before any 'oil peace' feelers may be too long for Iraq to hold without breakdown and conflict driven by Shia militants with Saudi Arabia itself in their sights.**
- **This dramatic potential side effect of the COVID-19 crisis creates a structural buy-on-weakness case for oil – and there will no lack of weakness.**
- **The elevated risk of new Mid-East conflict makes gold a candidate to lead the way back to normal asset price correlations.**

Oil price war as man-made earthquake

How about an earthquake analogy as a way of gauging political risks from the pandemic crisis? Cracks appear in many buildings, from which the inhabitants emerge alive but their ordinary life is interrupted pending reconstruction work. But the weakest structures collapse.

Back in the 2007-09 shock, the collapses occurred in various pockets of the North Atlantic financial system – by definition, since that was a financial crisis. The political pay back from those collapses was indirect and lagged. The policy response of governments and central banks cushioned losses of jobs and incomes, but that response came to be perceived as helping Wall Street more than Main Street and in any case entrenching the stagnation of living standards over time. Cue political backlashes during the following decade such as Trump and Brexit.

This time, with COVID-19, the collapses will hit the general population in a more direct way, hence with the potential for more instant political responses. The survivors of this earthquake – i.e. vast swathes of the population – will be "temporarily housed in tents" such as their lost wages being compensated by governments. For the purpose of this analogy, the equivalent of "victims buried in the rubble" means not the people who succumb to COVID-19 itself, but rather those suffering acute distress. An example might be shortages of food, power or heat caused by critical infrastructure failures resulting from widespread sickness among relevant workers.

Whether such collapses (e.g. infrastructure) happen is, of course, unpredictable; and the same unpredictability applies to the political response to any such unhappy events. On the one hand, recriminations would be blunted by COVID-19 being a natural rather than manmade disaster. On the other hand, public anger could boil over if some popular consensus were to form that governments were guilty of culpable negligence and incompetence as regards their preparedness or response. Speculating about such hypothetical collapses hardly seems a priority at a time when there is no shortage of real live crisis challenges to be addressed: but one such collapse – with strong potential to trigger an aggravating political response – is already hiding in plain sight, and deserves attention.

Look to Iraq

The imminent collapse stems from the oil price war – a manmade shock that concerns bystanders much more than belligerents (Saudi Arabia and Russia, with the US as an accessory). The belligerents' logical core agenda, or calculation, must be to withstand the pain longer than their opponent(s), who would then exit the market – leaving the victor with both higher prices and volumes. Long before this struggle plays out, or gets called off in favour of some new compromise, a side-effect could be the collapse of one or more of the weaker 'bystanders' – meaning vulnerable smaller oil producers.

The IEA has this week flagged up the main candidates: two are in Africa – Nigeria and Algeria; but the most precarious of all is Iraq. The root cause of last January's crisis over the US assassination of Khassem Soleimani was the fact that Iraq had by late 2019 drawn close to social and political collapse. The economic blow from the oil price war could now push Iraq over the brink. Still with only a caretaker government, the country will struggle to pay public sector wages – including the army, and, critically, the Shia militias or Popular Mobilization Units (PMUs), which are angry about this week's nomination as prime minster designate of Adnan al-Zurfi, a Shia politician with long-standing links to the Americans. Last week already saw another round of tit-for-tat rocket and air strikes between PMU and US forces in Iraq. If the Iraqi state runs out of cash, even before any generalized breakdown across the country, the PMUs would seek revenge, and tactical advantage. They would know who to blame for the oil price freefall leading to this sorry state of affairs – i.e. Saudi Arabia, their long-standing sectarian adversary that has chosen to wage an oil-price war. This perspective would also be shared by their coronavirus-stricken Iranian sponsors, Further rounds of violent lashing out at both US and Saudi interests have to be on the cards. To assess this risk more fully, it is worth stepping back to look for relevant clues in the origins of this oil price 'war of choice'.

Fateful Saudi choice

"Price war was not our choice", says Russia – in public form as a brief statement by Prime Minister Mikhail Mishustin at the start of the weekly government plenary session on 12 March. This claim is factually sound. It was the Saudis rather than Russians who reacted to the failure of the OPEC+ negotiations by ramping up production. As for the reasons for that failure, the Russian wait-and-see negotiating position made sense in its own terms. On this Russian view, with oil demand in free fall amid total uncertainty over the scale and duration of the global economic shock from the pandemic, it made no sense to agree up-front to another deep production cut of1.5mbpd. Perhaps the decisive deal-breaker was the position of the Saudi-led OPEC camp on maintaining that lower output level for a fixed period of nine months. The Russian stance on maintaining existing production cuts amounted to accepting that the wave of coronavirus-driven demand destruction would break over the oil market, and waiting until the market had recalibrated thereafter before deciding what further output measures might be appropriate. Russia's counter-cyclical fiscal buffer and, above all, its floating exchange rate, make it relatively resilient in the face of such passing storms.

However rational that Russian position, Putin's antennae let him down on this occasion. For Saudi Arabia, the state of affairs going in to that OPEC+ meeting in early March was already intolerable. Despite continued voluntary additional Saudi production cuts (i.e. below their official OPEC+ quota), Brent had already fallen to $50/bbl and was bound to head further down, whereas the 'comfort' oil price level for Saudi Arabia is around $80/bbl. It clearly never occurred to the Russian side that in the event of the negotiation failing to reach agreement, MBS would react as he did – by flooding an already tanking market with another 3mbpd of extra crude production. Viewed from Moscow, that was an irrational if not suicidal response.

Had Putin looked at the question more from his Saudi counterpart's standpoint, however, he would have seen that the MBS gambit entailed swapping one kind of pain for another. Assuming that Saudi Aramco can both sustain a 30% output increase for months if not years and sell those extra barrels, its gross oil revenue would be no lower than it was on the eve of the OPEC+ fiasco even if the oil price averaged close to $30/bbl. While Saudi oil revenue would thus remain, for the time being, at the same intolerably low level, the Kingdom would at least have a chance of turning the game to its advantage. 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. The need for MBS to make a radical move was clearly accentuated by political struggles at the top of the Saudi royal family that burst into the public domain on the very same day as the OPEC+ debacle. The arrest on that day of no less than two former crown princes was followed a week later by a purge of 300 senior officials, including army generals and security chiefs.

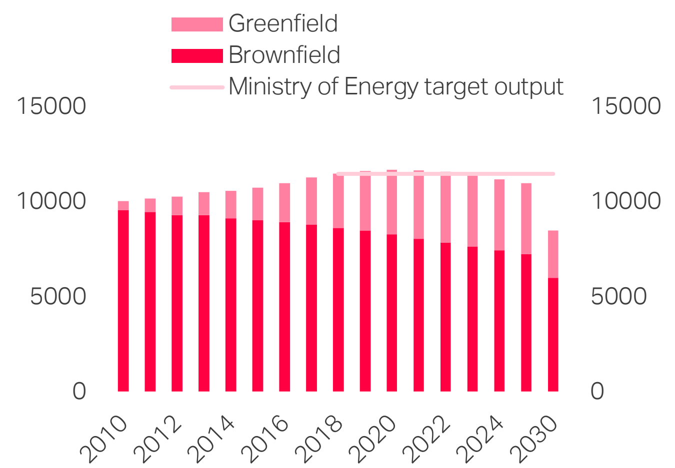
Perverse war incentives

It will be clear from this analysis that we do not subscribe to 'deep strategy' view of the causes of this oil price war. Instead, we see this as an accident resulting from a tactical disagreement between the two principal parties whose strategic incentives remain closely aligned. That said, now that the parties find themselves locked into a logic of non-cooperation, strategic rationales will not be hard to come by.

On the Russian side, the obvious rationale would be the prospect of US shale oil output collapsing if the oil price remains below $40/bbl for a prolonged period. To repeat, however, we do not share the popular view in much media commentary that Putin made a pre-meditated move to knock out US shale. The 'evidence' for this view is the powerful Rosneft CEO Igor Sechin's well-known dislike of the long-term effect of OPEC+ output restraint in ceding global market share to US shale oil. While Sechin's influence may account for the Russian refusal to budge beyond a no-change stance at the OPEC+ negotiations, we have no doubt that Putin remained committed to the logic of the OPEC+ arrangement. He had only recently launched a fiscal pump priming with a clear eye on next year's parliamentary election and the ensuing supreme power game – whether that involves getting himself elected yet again (an option he has just last week put in place) or installing a chosen successor. Even without the massive coronavirus shock, this would not have been the time for risky gambits against the US shale oil industry involving years of up-front economic pain before seeing the potential gain.

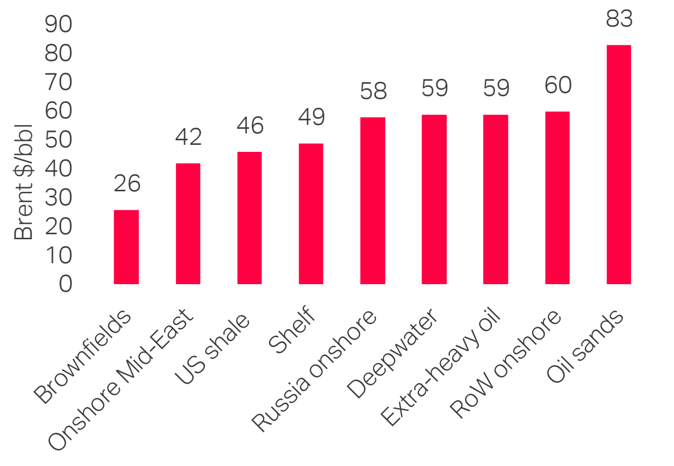
In any case, Putin's hallmark has always been judo-style reactions against existential threats rather than impetuous initiatives. Unlike, for example, the prospect of Ukraine falling into the US military camp in 2014, American efforts to stop the Nordstream 2 gas pipeline to Germany do not qualify as such a threat – especially as Russia is winning that fight anyway. If Putin does not 'do' impetuosity with voracious risk appetite, this is most certainly the style of MBS as revealed by his track record, starting with his first big decision in 2015 to go to war in Yemen.

Russian oil output (kbpd) – now peaking



Source: Petroleum Intelligence, Ministry of Energy

Real break-even oil price for greenfield projects



Source: Rystad

Now that MBS has rolled the price war dice, reinforcing strategic agendas can easily be formulated on the Saudi side too. As on the last occasion – in November 2014 – that the Saudis launched an oil price war, the Kingdom will once again have US shale oil in its sights. This time, however, teaching the Russians a lesson must also be part of the agenda. Saudi Arabia had clearly been looking forward to recovering market share with Russian oil output set to plateau as early as next year (see left-hand chart above). While Russian brownfields are competitive, with all-in production costs of no higher than $15/bbl, Russia's untapped reserves are a different matter. As shown in the right-hand chart above, Russian greenfield reserves replace will replace US shale as the world's highest cost oil – assuming unchanged tax regimes. This chart understates the case since the bulk of Russia's greenfield resources lie under the Arctic continental shelf; and to be profitable, most of these projects are going to need an oil price not much below $70/bbl (at the ruble exchange level before the current oil shock).

Since last year, Russia has been openly drawing up plans to go ahead with these greenfield projects anyway by granting them tax breaks. In the Saudi perspective, therefore, Russia was bent on using the reserves it had built up thanks to the OPEC+ price support (for the sake of which the Kingdom has been sacrificing additional output) to fund otherwise 'uneconomic' projects that will maintain Russia's aggregate crude oil production at present levels for years to come. Saudi Arabia may therefore rationalize crashing the oil price as a way to prevent Russia from ever bringing on those projects.

Russia will not roll over easily or quickly, however. In fighting this oil price war, it has an effective weapon at its disposal that the Saudis seem eternally bent on denying themselves – namely, devaluation. A 50% ruble devaluation from its pre-oil price war levels would make all Russia's greenfields economic. The same result could be achieved without quite such a huge devaluation shock by blending more moderate ruble depreciation with some tax subsidies. On a shorter horizon, the ruble has already depreciated by almost enough since the start of the price war to make Russian brownfields comfortably profitable at an average oil price of $35/bbl – i.e. below the presumed viability threshold for US shale.

Live conflict risk

With all the major oil producers experiencing acute financial and economic pain during this price war, they might be expected to patch up their quarrel before long. Since the flexible exchange rate and sovereign reserves can anaesthetize Russian households against much of the pain for at least three years, Putin will not make the first move, In our view, however, he would pragmatically pick up the phone. But MBS may be in no hurry to put out renewed negotiating feelers, as has no record of climbing down on anything: and Saudi Arabia can meanwhile tap its own reserves, however unsustainable that may be on a longer-term view.

Perhaps the pain being felt in the US shale industry could make the difference. Bankruptcies and unemployment in Texas, North Dakota and other shale fracking provinces could prompt political action. Trump suggested as much himself in remarks to the press yesterday that stabilized the oil market rout (with Brent rallying from the low to the high $20s/bbl). Asked to comment on a *Wall Street Journal* report quoting anonymous sources to the effect that the US might use various types of coercion and suasion to prevail upon the Saudis and Russians to desist, Trump said that he might intervene when the time was right.

The course of the pandemic will determine when that time is ripe. Even with a change of heart, the Saudis and Russians would struggle to have a rational negotiation until there were at least some visibility on the global economic shock at least being contained – and oil demand stabilizing. Before that point is reached, US pressure for renewed negotiations might not have much effect. Trump and all other leaders will in any case have so many other pressing distractions during this peak period of the COVID-19 crisis that painstaking diplomacy to put OPEC+ back together again may hardly be a priority. We have already seen in this story how distractions can make a difference. Previous tense OPEC+ negotiations have been settled thanks to Putin-MBS phone calls. On 6 March, however, MBS appears to have been too preoccupied with foiling, or perhaps pre-empting, a palace coup to have had time to call Putin (a Saudi claim that Putin refused to take a call has been denied by the Kremlin).

With or without any American prompting, the earliest window for peace feelers looks like being the traditional OPEC+ consultations in late June at ministerial level. Although there is no formal reason for any such meeting now that OPEC+ has collapsed, the routine status of this June gathering would facilitate attendance without loss of face. That makes for a revealing signpost by the end of June for better or worse. Even exploratory and non-committal exchanges between the Russian and Saudi energy ministers at that time wold be all the more positive as they would only happen if they had been preceded by confidential talks-about-talks.

Returning to our focus on Iraq risk after reviewing this whole story and the principals' incentives, the conclusion is sobering. In the very best case, it may be three months before there is any positive signal on a resolution of the oil price war; and it may take much longer. In the meantime, the oil market will remain a battlefield. The attrition is almost certain to get worse in April and May as demand remains in freefall – especially in the European market, where Saudi and Russian crude compete head on – and storage capacity, floating as well as fixed, fills to the brim.

Even three months of attrition may be more than Iraq can survive without renewed, and perhaps terminal, destabilization. It is not necessary to make the case for dire scenarios of, say, Iranian revenge attacks on Saudi Arabia to support the view that conflict risk is rising. The tail-wags-dog rule of proxies in Middle Eastern conflict zones is ample basis for conflict scenarios. Last September's effective drone attacks from Yemen on the giant Saudi oil processing facility at Abqaiq are a harbinger of what might lie in store. Even without any pandemic and oil price shocks, Iraq was already a high-risk theatre of conflict. In case this sounds alarmist, it is worth recalling the country's 'form' in this area. A previous breakdown six years ago led to the eruption of Islamic State across the region. As noted above, Shia militants look set to open hostilities this time around, with an even more powerful breakdown catalyst.

Investment conclusion

Iraq faces an up-front existential threat. While the oil price war has existential long-term implications for the economies of its principal belligerents – Saudi Arabia and Russia – they have capacity to fight their war for years rather than months. For Iraq, the oil price war has existential risks for the country as a whole and in a much shorter timeframe. The collapse of Iraq similar to Libya in 2011 might relieve oil price pressures by removing substantial production from the market (4mbpd in 2019). But any such breakdown in Shia-dominated Iraq would give militants the incentive to bring down Saudi Arabia with them. Even spasmodic attacks against Saudi interests would spell serious regional conflict. Once again, an impetuous gambit by MBS would boomerang.

We draw two investment conclusions.

- **This week's oil price action – hammering followed by bounce – will be repeated.** With the oil price likely to explore new lows in this crisis, it would make sense to position for bounce-backs given the plausible scenarios of a loss of output in Iraq (and perhaps other vulnerable producers), a violent backlash against Saudi Arabia itself, and, as a backstop, the scenario of a US-sponsored rapprochement between Russia and Saudi Arabia.
- A highlight of the crisis phenomenon of normal correlations breaking down in this week's market rout has been the fall in the **gold price** alongside risk assets amid the general dash for cash. The elevated risk of new Middle East conflicts makes gold seems a good candidate to lead the way back to normal correlations.

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