Letter n°3

Oil : a temporary meltdown and a mindless equity crash

« Wait and Hope », Alexandre Dumas – The Count of Monte Cristo

The price of crude oil is down 45% this year at USD 36/bl. Equity markets have just declined the most since 2008. That both events occur at the same time does not make sense and shows that Investors are now clueless. Such discount to the yearly invoice for oil importing countries amounts to USD 1000 billion, i.e. over 1% of world GDP. These savings will directly flow to oil consuming industries and to households, less taxes levied by their governments. The resulting inflation decline will provide more leeway for central bank policy and leverage budget initiatives that oil consuming countries are disclosing to buttress economic activity.

Oil & Gas equities suffered the worst sector performance in the last ten years, its share in the SP 500 index plummeted from 14% in 2009 to 4% recently. Huge crude oil price declines have followed economic contractions: from $147 to $36 a barrel in 2009, from $ 115 to $28 / bl in 2014. Many investors now shun fossil fuels.

Prospects for demand

For the first time since 2009, world demand for crude oil could decline 4% this year according to the AIA. Three reasons for this: China demand - 15% of world consumption – is receding by 2 to 4 million bl/day in the first quarter and will take another few weeks to recover. Global airborne traffic – 8% of world consumption – is clearly receding and this trend will persist into the second quarter. Last, global economic activity is slowing, and World Bank has reduced its forecasts for global GDP from 3% to 2.4%, which would mean a recession for a number of countries.

Prospects for supply

Since 2008 the share of US oil production has increased from 9% of total to 17% including condensates and 13 million bl/day. Russia (11.6 mb/d) and Saudi Arabia (9.7mb/d) finally reversed their policy of steady oil rent and are starting to increase production to weaken the US shale oil industry, handicapped by high indebtedness - $ 60 billion high-yield debt to be refinanced this year - and high production costs.

Political stakes

For the US, a lot of bankruptcies in Texas, Dakota or other oil states would compromise Mr Trumps' re-election chances. Russia is in a favourable situation to lead an offensive to reply to US-led economic sanctions and pressure to prevent completion of the Nord Stream II pipeline: currency reserves amount to USD 570 bn, a full one third of GDP, of which $150 bn are invested in a sovereign fund. The 20% devaluation of the RUB will help Russian oil companies to stay competitive, but at the expense of the $300 billion plan to modernize the economy.

The stakes are different for Saudi Arabia. With $500 bn in currency reserves and an average production cost under $3/bl, the country has a huge competitive advantage but severe handicaps: the 29m population should double within thirty years, productivity of non-oil sectors is disastrous given the outlandish manpower costs, making sustainable employment growth and effective economic diversification out of reach. Current policies require a crude oil price at $80/bl to balance the budget. A difficult challenge for MBS. Other oil producing countries will also meet problems this year.

Market recommendations

Stay clear of deep offshore producers, uncompetitive in this buyer's market. Avoid highly leveraged companies such as Occidental Petroleum. Avoid shale oil producers, both uncompetitive and highly leveraged. Major producer shares pay rich dividends, with a cautious interest Total has the best operating ratios and production prospects. The best oil service companies now offer deep value, some diversification and strong balance sheets, Schlumberger is a survivor.

Conclusion

The crash in oil prices and record low interest rates are very good news for households and may bring some comfort to animal spirits disheartened by helpless central banks and governments. Transportation and industry are starting to recover in China. In the short term, the current 3.5mb/d oversupply will start to dwindle while E&P budgets decline, and reserve replacement keeps non-existent.

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Geneva, March 10th, 2020

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