LOMBARD ODIER
INVESTMENT MANAGERS

Investment viewpoint

The "Old Economy" strikes back

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Executive summary

Oil prices are currently subject to spike risk. As geopolitical risk continues to build in the Middle East and supply-side dynamics remain relatively constrained, we believe the oil price could rise significantly in the coming weeks as the "Old Economy" strikes back.

As the US continues on its path of unilateralism, pulling out of the Iran nuclear deal in early May, a new World Order is emerging. The unconditional post-World War II alliances that have worked as a stabilising influence in the Middle East for the last 70 years, are being replaced by more issues-led relationships, leaving the region with a weakened safety net.

With the US also now significantly less reliant on the rest of the world for its fossil fuel supplies, thanks largely to the development of the domestic shale market, the US incentive to maintain ongoing stability in the Middle East is reduced.

However, the excess inventories resulting from the rise in shale contributed to a closer cooperation between OPEC and Russia, which has since been quite successful in cleaning up that over supply. As such, the geopolitical tensions in the Middle East come at a time when market balances are already quite tight.

Given the sharp fall in Venezuelan production and structural issues holding back the adjustment in US supply, what happens with Iranian oil will be key, in our view.

We believe geopolitical conditions, rather than a stronger global economy, will now be shaping oil as a risk factor.

Investment implications

- Correlations between Brent oil and other asset classes have shifted significantly
- Russia's underperformance versus other emerging markets may be reversed
- Energy equities, given their low valuations, stand to benefit, in our view
- A rise in the oil price adds to inflationary pressure, keeping upside pressure on US yields
- More broadly, we believe rising geopolitical tension is likely to weigh on risk sentiment, although risky assets are likely to remain supported by ongoing business cycle dynamics

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Introduction

When Brent oil went below USD 30 per barrel in early 2016, excess inventory coupled with doubts around OPEC's willingness and credibility to shift oil market balances implied that we were likely to be in a new "lower for longer" environment for oil prices. This was also supported by an increased focus on changing consumer habits (which are becoming more environmentally conscious) and cost structure shifts in energy-producing technology.

Just over two years later, Brent 1st Line Futures are now at nearly USD 80 per barrel and the "goldilocks" ride of 2017 is giving way to a build-up of geopolitical risk premium in energy markets. After several years of underperformance, the "Old Economy" of heightened oil prices may be making a comeback as oil looks subject to the risk of a significant price spike in the coming weeks.

Middle East's safety mechanism weakened as US moves away from post-WWII World Order

Despite President Trump's own volatility around key decisions in recent months, which has led to the occasional U-turn, the US president has effectively put an end to the Iran nuclear deal on 8 May.

This Iran deal, the Joint Comprehensive Plan of Action, was agreed in 2015 between Iran and China, France, Russia, the UK, the US, and Germany.

It has become increasingly clear since Donald Trump was sworn in as the 45th president of the US that the new administration is charting a path of unilateralism. As a result, the post-WWII World Order, built on unconditional alliances, is fracturing.

The Middle East is perhaps the strongest example to date of the emergence of a new World Order. Despite the US pulling out of the Iran deal and warning about sanctions on any entity dealing with Iran after the wind-down period, the EU, the UK, China and Russia have decided to uphold the deal.

This division on the nuclear deal, coupled with the very controversial decision by the US to move its embassy in Israel to Jerusalem on 14 May, marks a tangible move away from its traditional allies by generating an unconditional move towards region specific players. Saudi Arabia and Israel have now been joined by the US to openly confront the expanding influence of Iran in the region.

Increasingly, it seems, traditional alliances are being replaced with narrower issue-based relationships, which could be destabilising for the region, in our view. Historians are sure to compare this current path towards US isolation from its present day western allies to the days pre-dating WWII.

Despite numerous historical episodes of blow-ups in the world's most sensitive geography, there have been safety mechanisms engineered by western allies under US leadership that have kicked in to stabilise the situation. The 2015 Iran deal is among the most important developments in this regard.

However, as we stand in 2018, this new World Order marks a significant weakening of those safety mechanisms, which had helped immensely in avoiding a full-blown conflict (involving numerous world players guided by narrow self-interests) breaking out in the region in recent years.

The optimistic view is that President Trump is just rocking the boat and will come back to the table to do another deal after winning some concessions. This tactic helps Trump with his voter base, which appears inclined to follow rhetoric more closely than actuality. His handling of the North Korea situation is an interesting template here, where the narrative shifted from name-calling and threats of nuclear strikes to productive diplomacy in a matter of weeks.

However, we are less sanguine about the chances of such a reversal happening in Iran's case. There are two key differences: first, North Korea was heavily isolated (even China abandoned them), which is not the case with Iran; secondly, there was a viable deal in place and Iran's compliance had been verified by independent authorities, leading all other parties to support the deal.

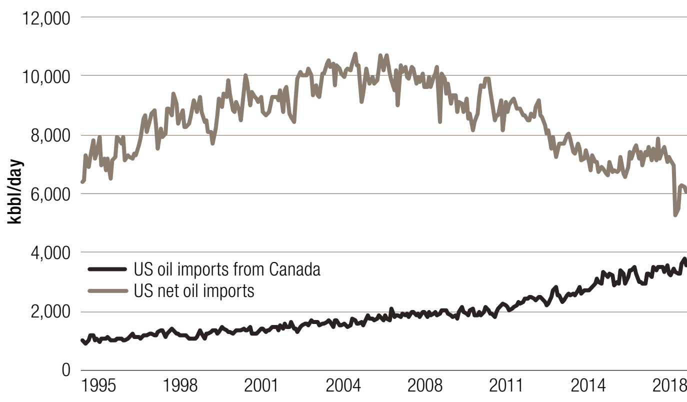
On balance, we think Trump's decision on the Iran deal has weakened the safety net in the region. Furthermore, in Saudi Arabia, the world's largest oil producer, the ambitious reform programme has damaged key power structures in the Kingdom, leaving it more exposed to serious domestic blow-back.

"Old Economy" strikes back as supply-side dynamics remain tight

The rising fragility in the Middle East comes at a time when aggressive actions taken by OPEC and Russia initiated in December 2016, have helped hoover up excess inventories in the market. Those excess inventories had led Brent oil to trade briefly below USD 30 in 2016, down from a post-2008/9 crisis peak of USD 126 in 2012.

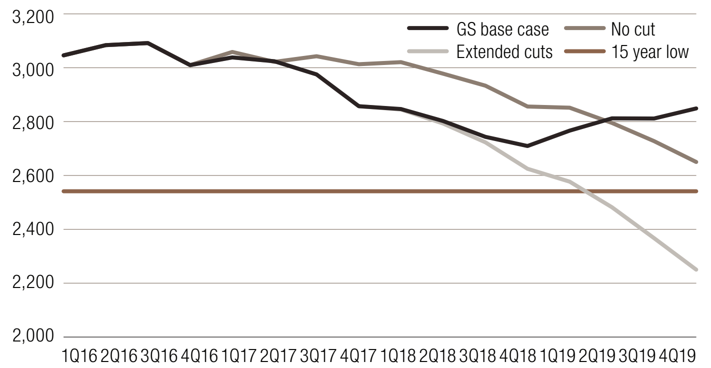
The interplay in oil markets has changed dramatically over the last decade with the rising importance of the US (led by shale) as a key producer in the market (Figure 1). According to the US Department of Energy, US crude oil production increased from 5 million bbl/day at the start of 2006 to 10.6 million bbl/day in April 2018. This has geopolitical implications in a sense that the US is now significantly less reliant on the world for its fossil fuel supplies and may explain (beyond Trump's populism) the reduced incentives for the US in maintaining ongoing stability in the region.

FIG. 1 NET OIL DEPENDENCY OF THE US HAS COLLAPSED



Source: US Department of Energy.

FIG. 3 OECD COMMERCIAL STOCKS (MILLIONS OF BARRELS AS OF PERIOD END)



Source: OECD, Goldman Sachs Global Investment Research.

This rise of shale and subsequent excess inventories that incentivised the cooperation between OPEC and Russia, and the later interest by Saudi Arabia in securing value when it came to the Saudi Aramco IPO, have been the major drivers behind our long standing bullish call on oil.[1]

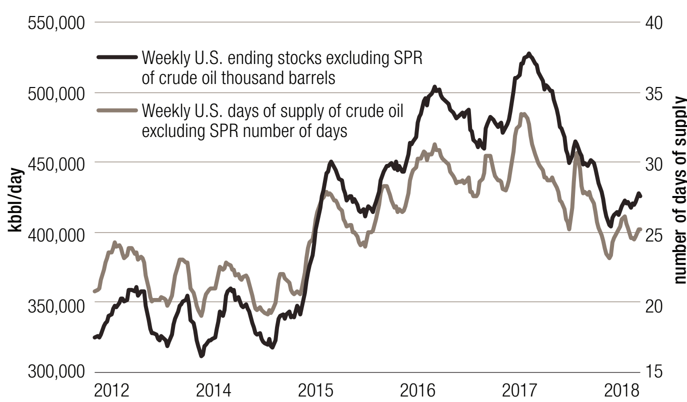
The inventory clean-up operation led by OPEC and Russia, which has been quite successful (see Figures 2 and 3), means the current Middle East issues are coming at a time when market balances are quite tight. We are seeing a continued increase in demand (the backwardation in the Brent and WTI curves are a strong indicator of a tight market). In addition, the sharp fall in Venezuelan production, which is unlikely to recover any time soon, has added further pressure from the supply side.

As such, in our view, the current backdrop has increased the risk of a sharp spike in oil prices in coming weeks.

In terms of barrel counting, what happens to Iranian oil, where production bottomed in 2013 and has since risen by more than 1 million barrels/day, will be key. Currently, the bulk of Iranian supply is sent to China and India (Figure 4). How stringently the US applies the renewed sanctions would determine whether Iranian supply is re-routed or if it is completely pulled out of the market.

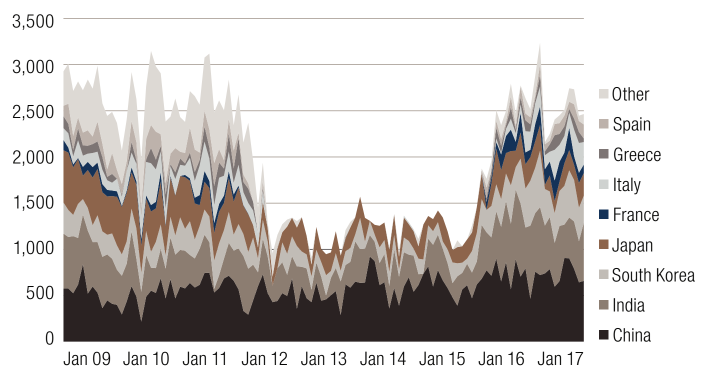
In terms of stabilising factors in the oil market, many investors expect that the rise in oil prices may be contained thanks to the incentive US producers have to increase production. However, some structural issues are holding back the adjustment in US supply.

FIG. 2 TOTAL US CRUDE OIL INVENTORIES



Source: US Department of Energy, Bloomberg.

FIG. 4 MONTHLY IRAN EXPORTS BY DESTINATION COUNTRY (KB/DAY)



Source: GTT, Goldman Sachs Global Investment Research.

[1] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

The fact that the oil futures curve is in backwardation affects US shale producers, as they have to sell their production forward to finance their investment. Moreover, on top of the downward slope in the forward curve, there is also a discount of about USD 12 currently on the price producers in the Permian Basin receive for their production (Midland oil prices) compared to the benchmark (WTI) (Figure 5). This means the price at which these producers sell their oil has not increased to the same extent as WTI, making an increase in production less attractive than the level of WTI would suggest.

FIG. 5 INCREASING SPREAD BETWEEN MIDLAND AND BENCHMARK CRUDE OIL PRICE (USD)

Source: Bloomberg.

The widening spread between the Midland oil price and WTI is due to capacity constraints in the pipeline network. Any increase in production has major difficulties reaching consumers (refiners and export hubs) or storage tanks. As a result, this oil became considered as excess supply, leading to a lower price and to a widening discount relative to WTI. This is very similar to the situation Canadian producers went through between 2011 and 2013.[2] In our view, the spread is likely to remain in place until new ways of transporting oil are established, such as shipping oil by train or barges, but these take time and are more costly than using pipelines.

Oil price spike – global investment implications

The rise in oil prices witnessed since the volatility shock of early-February has been different in character from both a macro and markets perspective. Our correlation analysis has picked up this switch, with the correlation of Brent oil versus other asset classes shifting significantly in recent weeks. For instance, 24-month rolling correlations between Brent oil and emerging market (EM) currencies is now close to zero compared to a 40% average since 2011. Similarly, we observe a switch in correlation versus US equities, EM equities and the US Dollar Index (DXY) (Figure 6).

As such, the rise in oil seen since its 2017 lows was more of a "goldilocks" increase, in our view. We believe geopolitical conditions will now be shaping oil as a risk factor, rather than a stronger global economy.

[2] When oil turns against you, Nomura Economic Research, 12 December 2012.

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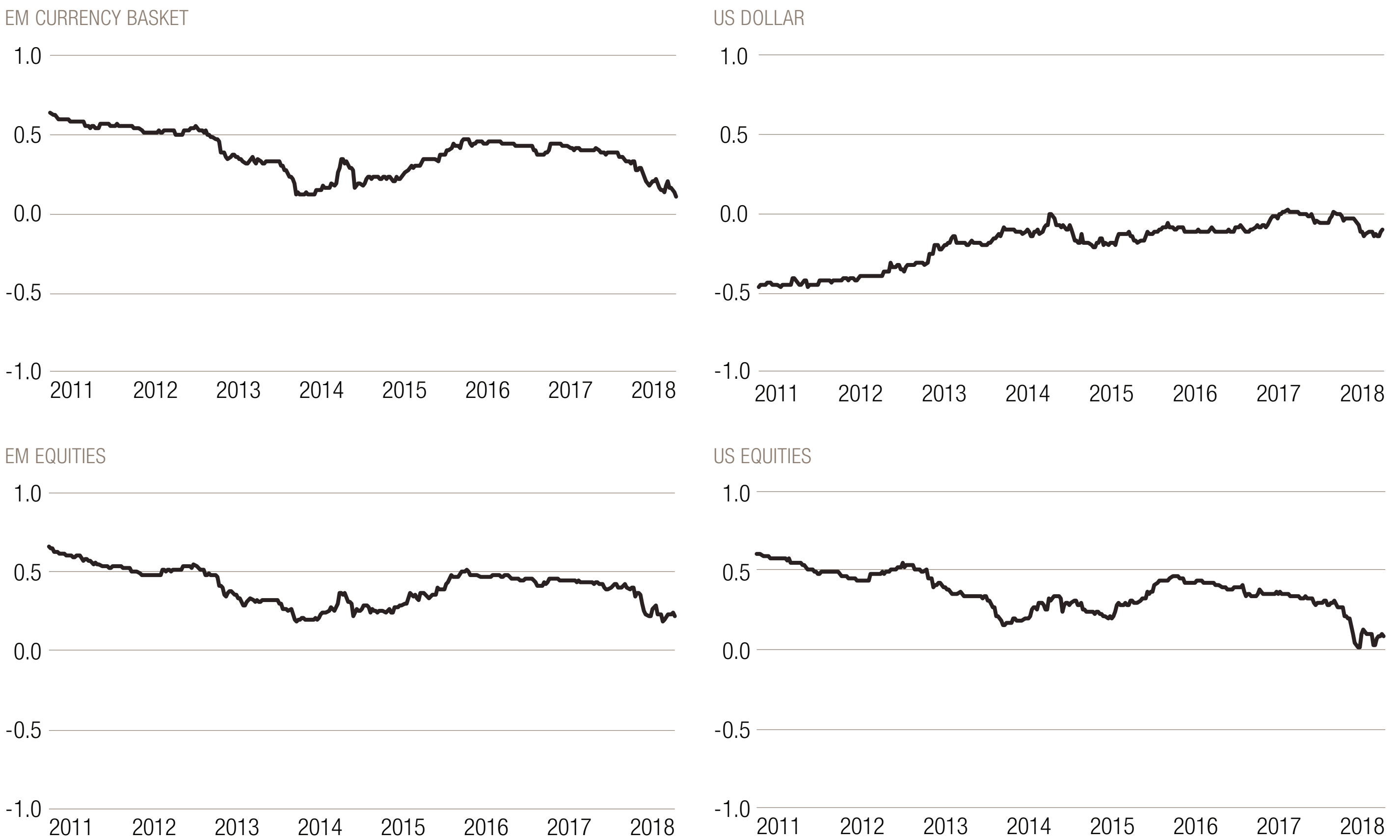
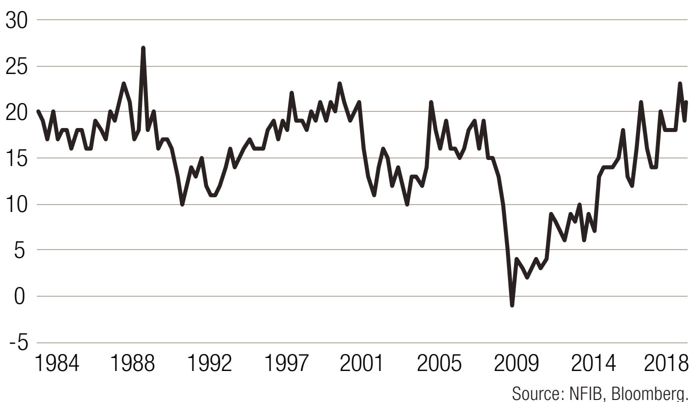
FIG. 6 24 MONTH ROLLING CORRELATIONS OF VARIOUS ASSET CLASS RETURNS WITH BRENT CRUDE OIL



Source: Bloomberg, LOIM Calculations. Indices for returns calculations: US Equities - S&P 500, EM Equities - iShares MSCI Emerging Markets ETF, US Dollar - US Dollar Index Spot (DXY). EM Currency basket consists of Turkish Lira, S. African Rand, Brazilian Real, Russian Ruble, Indian Rupee and Chinese Yuan (equal weighted).

We think energy equities, given their relatively low valuations, stand to benefit from this environment. Meanwhile, the ongoing rise in oil further adds to inflationary pressures (Figure 7), which should keep upside pressure on US Treasury yields, although we think the loss in growth momentum may cap the upside of 10-year Treasuries at 3.1%.

FIG. 7 NFIB SMALL BUSINESS COMPENSATION PLAN INDEX EXEMPLIFIES US INFLATIONARY PRESSURES



Source: NFIB, Bloomberg.

We think the de-linking between oil and EM we are seeing currently could continue over the short-term as emerging markets see a rise of idiosyncratic risks against a stronger US dollar environment. However, we believe the underperformance of Russia versus other emerging markets is likely to be reversed as the country's macro conditions continue to improve. Furthermore, given Russia's measured response to very stringent US sanctions, we believe the risk of further sanctions is receding.

From a broader perspective, increased volatility in the Middle East following President Trump's decision is likely to weigh on risk sentiment. Markets may start to focus on the more immediate implications of the break-down of the safety mechanisms in the world's most geopolitically fragile region.

That said, the stance of EU and other western countries (which now agree with China and Russia) will also be key to watch when it comes to the negative impact coming from the US's unilateral foreign policy decisions affecting the Middle East. We continue to think that risky assets will be supported by ongoing business cycle dynamics, but volatility is likely to remain elevated.

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