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MARKET UPDATE: THE OIL PLUNGE

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19/03/2020

MARKET OVERVIEW

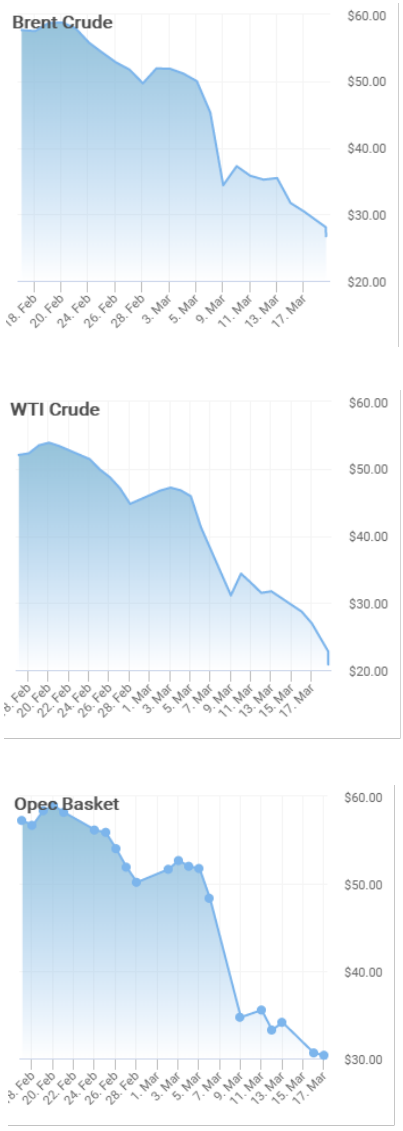

Figure 1: Brent crude, WTI Crude and the OPEC Basket have seen sharp price declines
Source: oilprice.com

On March 6th, OPEC and non-OPEC Ministerial Meeting, Saudi Arabia and Russia failed to find an agreement on the level of oil production. This has interrupted previous agreements to stabilize oil prices and led to an oil plunge. It is not clear how this situation will develop and for how long, but if it continues for long enough it might have important consequences on oil exporting countries, financial markets and aggregate demand.

On March 19th, the price of WTI crude and Brent crude once again fell 24% and 9% respectively. This was WTI's third worst day in history and highlights the volatility and extreme nature of this shock.

WHAT HAPPENED?

Since the COVID-19 outbreak in December, economies have been throttled. Many are predicted to have entered recession, which has led to significantly reduced oil demand and strained oil prices (see our recent market update "Crude Oil in the Time of COVID-19"). In particular, the European Union and China, the world's two largest importers of oil, have significantly reduced their imports over the last months.

In this context, OPEC countries, under the *de facto* lead of Saudi Arabia, wanted to further reduce oil supply. However, for maximum effectiveness and profitability, they needed Russia to sign the arrangement.

On March 6th, the eighth OPEC and non-OPEC Ministerial Meeting took place in Vienna. During the negotiation, the parties tried to extend output cuts beyond the level already set during the previous meeting on the 5th of December but were unsuccessful. Saudi Arabia pushed to reach a 1.5 million barrels a day reduction in supply, but Russia refused.

Among the reasons for the refusal was Russia's desire to better ascertain what the actual impact of the epidemic would be and a fear of losing market share to US shale. However, some analysts have suggested that Russia's real motivation is a predatory strategy against US producers, who are currently struggling between the demand slump and the highly leveraged positions they accumulated over the years.

As for Saudi Arabia, the uncooperative stance at meetings, together with limited contribution to cuts, made it less desirable to further seek for a compromise. All in all, the meeting ended neither with a deal on new cuts nor with the extension of the current production agreement expiring on 1st April.

Saudi Arabia, which is currently limiting its production to 9.7 million barrels a day, could increase extraction to its full estimated capacity of 12 million barrels a day. In the days that followed, Saudi Arabia contacted several refineries and offered some of the biggest discounts of the last 30 years.

On Monday 9th March, this news made the oil prices, both spot and future, plummet by around 30% of its value on New York and London exchanges, in what has been considered the deepest drop since the Gulf War in 1991. As seen in the above graphs there has been some recovery over the next days, but in general the price level was severely reduced.

On March 10th, Saudi Arabia declared that it would boost its supply of crude oil to 12.3 million barrels per day in April, thus flooding markets and starting a price war with Russia. Russia also declared its potential to increase extraction, despite experts claims that they already operate close to full capacity. Other OPEC countries such as Kuwait, Iraq and the United Arab Emirates could also potentially produce one million more barrels per day.

The situation was still evolving as of March 18th as the price of oil fell once again. This stemmed from a mix of unpleasant factors: the ongoing economic crisis due to COVID-19 leading to lower aggregate demand, lack of confidence in government stimulus measures and increased market volatility. At lows of $20 per barrel for WTI crude and $26 per barrel for Brent crude, the price of oil has never been this low in recent history. By allowing this to happen, Saudi Arabia and OPEC have shown their commitment to increasing production.

HOW LONG WILL IT LAST?

It is unclear how long this situation can last. Saudi Arabia is still interested in an agreement with Russia, but its industry is also more efficient in production and can afford lower prices while still breaking even.

On the other hand, current oil prices fall below Russia's budgetary rule (i.e. the lowest price Russian officials assume when composing the federal budget). However, since the beginning of US sanctions, Russia has hoarded a $570 billion fiscal buffer that, according to Russian Minister of Finance, could cover the shortfalls in oil revenue if the price were to fall to $25-$30 a barrel for up to 6 to 10 years.

Additionally, the Russian rouble is a flexible currency, as opposed to the Saudi riyal which is pegged to US dollar. Some devaluation may help sustain oil exports over the next years. Due to Monday's fall in oil prices, the rouble's value has dropped by around 13%. It recovered a little on the 10th, remaining 8% lower than last week's value. Currently, Russia is attempting to stabilize it by selling its foreign denominated reserves and ceasing its Central Bank purchases of roubles (figure 2).

Figure 2 – Exchange rate: Russian Rouble to US dollar 84th to 11th March
Source: xe.com

To see how long this situation may last, we must consider the political agenda of Riyadh and Moscow. Saudi Arabia's economic reforms initiated by crown prince Mohammad bin Salmand need oil revenues for funding. Failure could create more discontent within the royal family and further purges of dissidents.

Russia also recently announced an ambitious outlay of $400 billion by May 2024 towards social programs and infrastructure. Funding was expected to come from the very fiscal buffer which is now needed to cover the prospected losses for the drop of oil prices. Therefore, it is not sure who will bail first from this game of chicken, but its continuance will cause severe losses on both sides.

In any case, after Saudi Arabia's pledge of record oil shipments on the 10th March, Russia gave the first signal that it would be open for a truce, based on a public statement of Minister Novak.

CONSEQUENCES

If these conditions were to last, several issues may arise: the economic damage of oil producing countries; financial distress, in particular in the high

yield bond market; and the impact on aggregate demand.

Given the shortfalls in aggregate demand due to the COVID-19 outbreak, many countries were already suffering from shortages in oil revenue, which generally accounts for a relevant share of producing countries' GDP. This means that households' income may further fall and there could be less money to implement the social programs needed to contain the risk of social unrest.

As seen in Figure 3, in 2017 oil revenue amounted to as high as 37.78% of GDP in Iraq, 23.10% in Saudi Arabia and 15.34% in Iran. Adding on to this slack of demand, US sanctions and political turmoil have further reduced that income significantly in countries like Iran, Libya and Venezuela. This incipient price war comes as the ultimate ill-fated shock, that can put in serious trouble those economies.

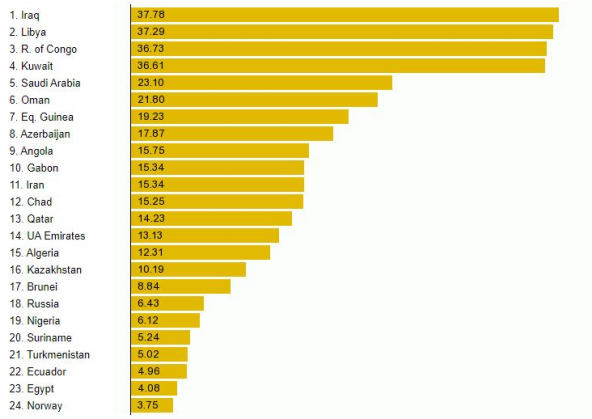

Figure 3 – Revenue minus production cost of oil, percent of GDP, 2017 - Country ranking. Source: theglobalecoomy.com

As for the financial implications of the oil shock, this price war has already shown its impact on most of the big oil companies' share values, which plummeted on 9th March together with the oil indexes.

For instance, over the weekend the Russian Rosneft lost around 14% of its market capitalization. Saudi Aramco lost 15% c.a. and Exxon Mobil lost 12. 6%, the greatest loss in 11 years. Important American fracking companies such as Occidental, Eog and Continental Resources, lost more than 40% on Monday, and smaller companies lost up to 80%.

The corporate bond market too has suffered this oil plunge. In particular, high yield corporate debt has experienced a drop in the prices and a surge in the cost of default insurance. According to Deutsche Bank, contagion to the broad high-yield market outside the energy sector (which anyway accounts for a fair share of it), is very likely. Moody's noted that exploration and production companies had $86bn of debt coming due before 2024.

Access to liquidity has already become more difficult for energy companies, raising default risk (see our latest report "The Corporate debt Virus"). However, according to BNP Paribas, big US companies should already be well hedged against price fluctuations for this year, the problem may subsist for smaller companies instead.

Prolonged oil shock may contribute to weaken an already ailing financial sector. Economists worry that in the current situation an illiquidity crisis may boost economic distress, adding to the current uncertainty and fickle developments on financial markets.

If this plunge in oil prices was to endure, it may affect aggregate demand. On the one hand, as oil gets cheaper, energy costs reduce and hence most goods and services get cheaper as well, thereby producing positive effect on demand. On the other hand, in the short run some analyst question whether the reduction in energy costs will result in a sufficient stimulus of investments, given that Coronavirus crisis together with trade war and uncertainty on the markets reduced the demand for production and hence the need for energy in the first place.

It is not clear whether cost savings stemming from reduced oil prices will be employed to invest in businesses development. For the petroleum producing economies, lower prices will be a mixed blessing. Everyone is likely to benefit from lower prices for gasoline and other oil products, but those people who work in oil related industries may risk losing their jobs.

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