Market Insights & Strategy
Global Markets

OIL – Which Way Is Up?

For those of you who receive our regular commentaries and analysis you will already be aware that since January this year we have been warning about the growing risk of a potential oil price spike in the near to medium term, which is against the general consensus expecting an extended period for the current sub US$55 a barrel environment.

As we remain within the minority to hold this somewhat contrarian view, and because there is a lot of focus on the informal OPEC meeting currently taking place in Algeria this week, we have been asked by some of our clients to clarify the reasons behind our thinking. In order to do so I think it's important we first remind ourselves of the main factors behind the creation of the current oil supply glut, which are; the unprecedented growth of the shale industry, the rise of cheaper alternative energy sources, a weak global economy and finally competition over market share. Now let's take a look at what we think is changing in the background of each of these factors.

The Shale Industry – "Fracking is a retirement party not a revolution"

It's true to say that the emergence and success of the shale sector these past few years has been unprecedented, however its contribution to world output is now falling and we believe it will not return to the heady levels we experienced back in 2014. The 'retirement party' comment above was made by Arthur Berman a veteran US geologist who undertook an in-depth survey of the shale industry a few years ago, and one of the points he highlighted was the fact that an average shale field has a very short lifespan with a decline rate of 80-95% in its first 3 years of operation, this means that shale firms need to keep opening up new rigs in order to remain viable. Now with the drop in oil prices below US$50, and despite an improvement in technology many of these firms are struggling to find the cash to maintain current activities never mind seek out and explore new fields. According to a Texas based law firm Haynes & Boone, there have been 102 bankruptcies worth a total of US$ 67.5 bio in the North American oil & gas industry between January 2015 and August this year, thus banks are becoming more cautious in lending to this sector and some states have even begun looking at the environmental impact of shale production. As a result overall US production is averaging 8.8 mio bpd this year from a high of 9.7 mio bpd, while the EIA expects this figure to dip again to 8.5mio bpd in 2017 against a rise in US demand of 200,000 bpd to 19.74 mio bpd. Now some suggest that if oil were to bounce back towards US$60 per barrel then the marginal frackers could just turn on the taps again, however while restarting shale production is much easier than doing the same at a conventional field, it still takes time as all the related support infrastructure also needs to be re-established and previously laid-off workers rehired. In conclusion the shale industry will survive in some form or another but its overall influence is declining.

Alternative Energy

Green energy has definitely got a lot cheaper over the past decade especially in the areas of wind and solar power, and there is no question that it will become the long-term future for the world's energy needs. However right now its impact remains extremely limited and this was underlined by a BP study done in 2013 which revealed that 87% of global energy consumption is still provided by fossil fuels. Alternative energy's biggest hurdle is the lack of supporting infrastructure, we all know we can find a petrol station somewhere close-by no matter which city we live in, but looking for a battery charging point is much more of a challenge. Even nuclear energy, which despite a recent decision by the UK to proceed with the Hinkley Point facility, has lost a little of its once hallowed allure especially after events such as the Fukishima disaster in Japan, which encouraged some developed countries such as Belgium, Germany and Spain to phase out their use of atomic power plants. In conclusion alternative energy is here to stay but it will not supplant oil just yet.

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A Weak Global Economy & Market Share

A sluggish global economy has weighed on the demand for oil and its by-products, however natural demand growth for crude continues even in this current economic climate. The IEA forecast recently that this specific type of growth currently averages 1.3 mio bpd per annum, and Chevron stated back in 2013 that capital expenditure to maintain current conventional production capabilities and explore new fields just to keep up with this natural demand growth, would need to be in the region of US$600 bio per annum. However over the past two years such expenditure has collapsed due to the lower oil price, a situation highlighted in a recent Wood Mackenzie report which claims that CAPEX in both oil and gas has dropped by over US$1 trillion since 2014. Meanwhile the number of new conventional field discoveries is at its lowest level since 1947, this is unprecedented. Now as it takes around 3-5 years from inception to operation for most conventional fields, and bearing in mind most of the world's main producers are pumping at close or near to their maximum capacity in order to retain their market share, when the oil market rebalances (an event which most analysts expect to occur within the next 6-9 months) and taking into account the ongoing natural demand discussed above, combined with surprise but continued demand from China (7.7 mio bpd in 2016 agst 6.7 mio bpd last year as its builds it strategic reserves) it won't take long for us to enter into a shortage situation, so then the question will be where does the extra supply come from?

Much has been made of Iran's return to the global oil market since the majority of sanctions were lifted following the P5+1 agreement. We concede that Iran's output has increased faster than we and others expected this year, however overall Iranian production is still below its former peak, two thirds of its fields are over 70 years old and due to years of diminished spending on its oil production facilities they need a minimum of US$100 bio in fresh investment to maintain their current infrastructure never mind expansion. Another problem is that attracting financing and expertise for such projects by foreign banks and companies has been difficult at best for Iran due to the fact that there is still no real clarity from the US Treasury with regards to its remaining financial sanctions on the country. Considering the size of fines paid in the past, one can understand why offshore bankers in particular are nervous of entering into or supporting new commercial deals with Tehran. Thus we believe Iran will struggle at least in the near term in raising its production past 4 mio bpd. (Current production is around 3.63 mio bpd).

Elsewhere ongoing militant activity combined with successive years of limited investment into Nigeria's oil industry drove that country's crude output to a 22 year low earlier this year, Venezuela which has the world's largest proven oil reserves is the midst of an economic and social melt-down, while a sustained recovery in Libya's production is still unlikely as long as the civil strife there continues. We also cannot rule out a "black-swan" event disrupting the supply chain such as the wildfires experienced in Canada earlier this year.

Thus we believe players and oil-watchers are focusing too much on short-term noise while ignoring major structural changes occurring quietly in the background. To be clear we are not suggesting this potential spike will see us suddenly soar over US$100 a barrel again, sizeable global inventories will initially limit the scale of any rise, it's also difficult to estimate exactly when this supply crunch will occur, and of course unexpected issues could arise which may postpone this outcome for longer than we anticipate, such as another severe shock to the global economy or a major recovery in output by those producers suffering from internal strife, however barring such surprise events and due to the reasons outlined above we think prices will shift materially higher from where we are now sooner than most expect.

Finally using a completely separate crystal ball and just for those technical analysts out there, have a look at the head and shoulders pattern forming in the chart on the following page which also suggests the next move for oil may be up rather than down.

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