Oil Market Armageddon

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A tumultuous week for OPEC was followed by a weekend of chaos, leaving global oil markets on the precipice of total meltdown. It had all started off so well with an optimistic OPEC+ oil minister meeting in Vienna to discuss collective actions the group might take to support oil prices. OPEC's Joint Technical Committee was recommending that the current agreement be extended for the remainder of the year and be augmented with 600,000 – 1,000,000 barrels per day of additional production curtailment. On Thursday the official ministerial meeting began and defacto OPEC leader Saudi Arabia proposed the group take an even more aggressive action: 1,500,000 in production cuts. All in attendance were in agreement, but Russia's oil minister Alexandar Novak had left early to discuss the oil markets with his boss, President Vladimir Putin. The Russian President has seen himself as ring leader within the circus that is OPEC+, and this new agreement made without his blessing was akin to an Animal Farm-style revolt. On Friday, Mr. Novak returned to Vienna carrying the message that Russia would not participate in further cuts and OPEC+ members were free to start pumping all of the oil they want when the current curtailment agreement concludes at month end. Russia's stated reasoning was that OPEC+ cuts serve to support U.S. shale oil producers at the expense of Russian companies. The week ended with no new OPEC+ agreement and the weekend concluded with the Kingdom of Saudi Arabia launching an oil price war. This comes at a time when oil markets are already reeling from a COVID-19 induced demand shock and sets the stage for an oil price Armageddon which could leave unprecedented energy sector carnage in its wake.

In 2014, excess supply led to a dramatic oil price crash. In an effort to stabilize the market, Russia, Mexico, and Kazakhstan joined forces with the Organization of Petroleum Exporting Countries (OPEC) in 2016 to create OPEC+. The expanded club accounts for over half of total global crude oil output. For the most part, OPEC+ has been successful in stabilizing prices, but there has always been tension between the groups two largest players: Russia and Saudi Arabia. Russian oil producers are independent companies who have been told by President Putin to constrain growth while longing to increase production. These same Russian companies have watched with envy as U.S. shale producers continue to increase output, which is partially due to supportive OPEC+ policy. Russia has looked to portray itself as having a diversified economy with oil income as only one piece of the broader fiscal revenue pie. The country's 2020 budget was set with an oil price assumption of $42.40 Brent. In contrast, the Saudi Arabian budget is almost entirely dependent on oil exports. The actual price needed to balance the Saudi budget remains opaque, but is frequently cited in a range between $60 and $80 per barrel. This is the key reason the Kingdom has remained committed to OPEC+ and taken the lead in managing output. For Russia, OPEC+ membership is part of a broader strategy in which Putin seeks support for his Middle East policy efforts and investment opportunities for Russian companies. Until now this has worked for Saudi Arabia, which needed to protect its own interests as the United States withdraws from the region.

Good things can't last forever and often end in tears. Over the weekend the Kingdom announced it would take Mr. Novak's advice and open up the taps while simultaneously telling buyers around the globe that Saudi oil prices for April delivery would be cut as much as $8 per barrel. This would push Brent crude below $40 per barrel and below Russia's 2020 budget price. U.S. shale producers would become collateral damage in this price war, but there could also be implications for the broader U.S. economy. For example, energy sector companies make up a significant portion of the high yield corporate debt market, and low oil prices may dramatically increase default risk. The demand side of the oil price equation has already been hobbled by the global outbreak of the COVID-19 virus, and now a supply shock threatens devastation of the energy sector. OPEC president Barkindo says he remains hopeful cooler heads will prevail and the sides will come back to the table.

If Russia and Saudi Arabia are not able to back away from a price war, there could be broad ramifications. Energy sector investors will likely not stick around to find out and head for the doors come Monday morning. Within the energy sector, refiners would likely be better placed than producers and service companies. Airlines who have been hit by COVID-19 would find a tailwind in lower fuel prices. Falling gasoline prices would be positive for the consumer, but auto companies likely see a continued preference for large SUVs and trucks as they are trying to launch more electric vehicles. Many industrial companies rely on the energy sector for a significant portion of sales, and increasingly technology companies have seen the energy sector as a new avenue of growth. It is worth noting that many U.S. shale producers have hedged a significant portion of their 2020 production, but to date that has been something investors have completely ignored. For those that have not, capex programs, dividends, and share buybacks are in jeopardy. If a protracted price war is indeed in the works, we would continue to advocate an underweight sector position rather than trying to buy any dip.

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