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Investment Strategy Bulletin

Oil back in the headlines: we reiterate our USD 75/BBL target (12m, Brent)

Investment Solutions

19 November 2018

A combination of adverse factors placed oil in a perfect storm...

It all started with **uncertainties about demand** arising from the risk-off sell-off in October, and continued with the unexpected announcement of **waivers for eight countries importing Iranian crude**. Meanwhile, the supply side of the equation had already deteriorated, with a **surprising jump in US supply** coming from the conventional Gulf of Mexico. Finally, **technicals played a meaningful role as** the fall seems to have been amplified by a "negative gamma" effect, when the spot price reached option strikes used by US producers to hedge their sales – USD 55/bbl and USD 60/bbl being the most popular levels on WTI.

... but prices should find some automatic buffers

With prices now below the fiscal breakeven estimates for most OPEC members, **the next OPEC + Russia meeting scheduled for December 6 should result in some production cuts**. In addition, we believe that the current environment **(lower oil prices/wider credit spreads) will influence the US E&P budgeting process**, which typically occurs in the December-February period.

LO baseline scenario unchanged (brent at USD 75/bbl at a 12m horizon, WTI at USD 65/bbl) yet, expect more volatility

Medium term, we see few fundamental changes likely to derail our baseline scenario. Our supply/demand balance already took into account a more cautious demand assumption than the consensus, and Iranian production will eventually drop further. **We thus keep our 12M target unchanged**.

However, as the US administration seems increasingly inclined to interfere in the oil market, it is reasonable to prepare for more volatility going forward. **For the reasons explained above, we think Brent's most likely trading range is USD 65-85/bbl.**

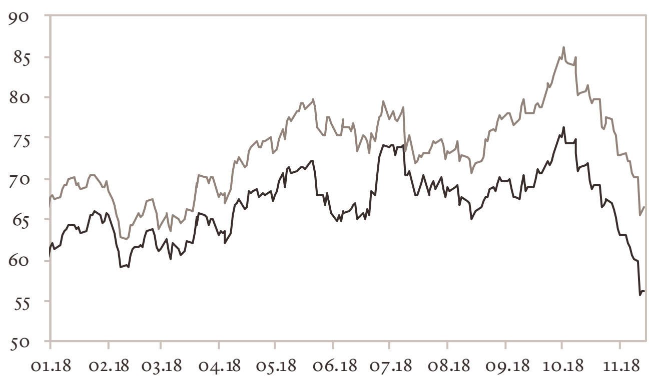
Over the past six weeks, oil price shifted from posing a risk to the macroeconomic cycle –when it hit a four years peak at USD 86/bbl on Oct 3, to crystalising growth angst as it entered in bear market (chart 1).

LO baseline scenario: some adjustments, but the overall fundamental picture remains the same.

In a context of intensified trade wars, and heightened fears about the macroeconomic backdrop – as highlighted by October's renewed rise in cross-asset correlation, the market has started to discount much lower oil demand for 2019. **We have always assumed 1.2Mb/d (chart 2) – and we maintain this forecast based on our outlook for global growth**, which at some point was 200kb/d below main agency forecasts. The first downgrade to demand forecast came on November 13, with the release of the OPEC Monthly Oil Market Report: in 2019, world oil demand growth is forecast at 1.29 Mb/d YoY, which is about 70 kb/d lower than last month's projection. Interestingly, the following day, the IEA confirmed its expectations for solid demand, from an increase of 1.3 Mb/d this year to an increase to 1.4 Mb/d in 2019. Nevertheless, it is worth highlighting that without the recent drop in oil prices, the forecast would have certainly been revised down, given the comments made in the last Oil Market Report

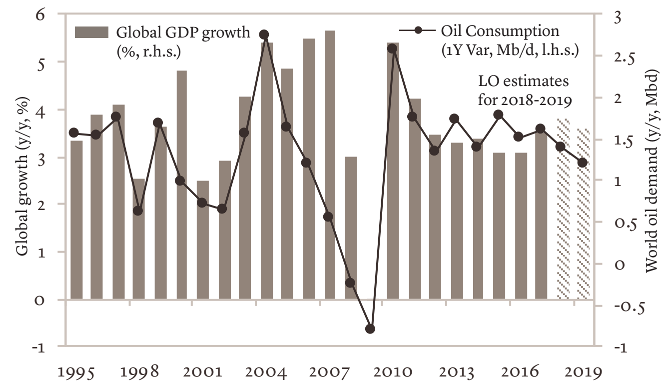
I. Oil prices in bear market

Brent and WTI, USD/bbl



Sources: DataStream, Bloomberg, Lombard Odier calculations

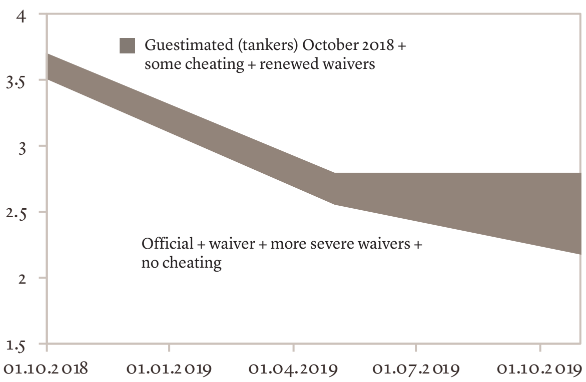
II. Our demand forecast reflects a slight deceleration of the global activity



*left hand scale, ** right hand scale
Sources: DataStream, Bloomberg, Lombard Odier calculations

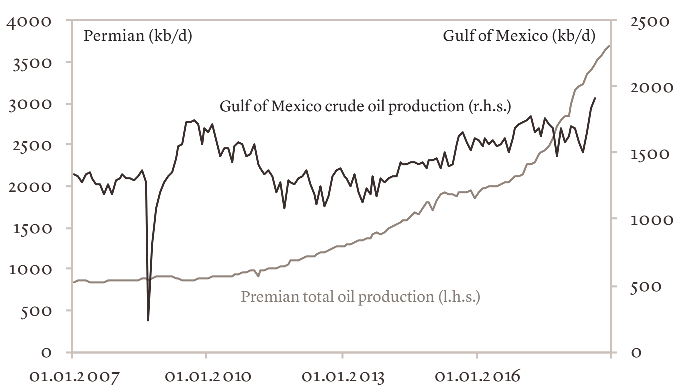
III. Possible scenarios for Iranian production

Mb/d



Sources: DataStream, Bloomberg, Lombard Odier calculations

IV. US crude oil production



Sources: DataStream, Bloomberg, Lombard Odier calculations

on hard-pressed consumers in developing countries who are already facing domestic headwinds following the sharp depreciation of their currencies during the summer. Even in the US, regular gasoline retail prices increased further by 2 cents/gal in October versus September, marking the sixth consecutive month they have remained at USD 2.85-2.90/gal. A relentless rise in gasoline prices would surely at some point weigh on consumption.

Turning to the supply side of the equation, the largely commented **US sanctions on Iranian exports came into effect on November 5**. First seen as a risk on the upside for oil prices, the implementation of these sanctions eventually triggered another leg to the sell-off when, in parallel, waivers were granted to eight countries. Based on our understanding, the countries have been given the option to import up to 1.2-1.3Mb/d of Iranian crude. The waivers will remain in place until May 2019, which suggests that all else being equal, Iranian May 2019 production could be around 2.5-2.6Mb/d, although some level of "cheating" should be accounted for. Last reported production in October 2018 was 3.5Mb/d. It is worth mentioning that there are several unknowns at this point:

- Will the waivers be renewed in May 2019?
- How long will China accept the waiver regime as the trade war against it lingers?
- How much cheating will occur?

We have tried to show a scenario for Iranian oil production from now on to November 2019, keeping in mind that National Security Advisor John Bolton was eager to "squeeze Iranians very hard". It is likely YE 2019 production will end between 2.2 Mb/d (30% reduction in waivers from May 2019, full compliance) and 2.8Mb/d (no change in waivers and some cheating). This is still a meaningful reduction from H1 2018 that was around 3.8Mb/d (chart 3).

Our base case scenario accounts for **US oil production reaching 10.7Mb/d in 2018 on average, and 11.9Mb/d in 2019**. Recent data points suggest there could be upside to our estimates (chart 4):

1. We currently assume that Permian production will grow by 0.5Mb/d between December 2018 and December 2019, as pipeline bottlenecks in H1 2019 should force producers to slow the pace of completion. The latest EIA Drilling Productivity Report highlights that Permian production should steadily grow in Q4 2018 at around 55kb/d per month. Extrapolating this pace of growth, we would be closer to 0.7Mb/d exit-to-exit growth.
2. We think US Gulf of Mexico production should increase more modestly by 30kb/d in 2018e, and by another 100kb/d in 2019. July and August 2018 data have set new highs at around 1.9Mb/d. While this is above what we have assumed, it is important to recall that offshore production remains more volatile due to regular maintenance and huriccane-related shutdowns. More data points are thus required to confirm the sustainability of this uptick.

Nevertheless, **investors should not underestimate the impact of the recent correction on the US E&P industry**. Producers, at the wellhead, get prices that are trading below WTI. Producers in the Bakken get USD 45/b, to be compared with USD 50/b in the Permian, while their northern neighbours (in Canada) get prices below USD 20/b. These levels are eating into the cost curve (we peg higher full-cycle economics for US shale at USD 55-60/b on rising costs).

With companies now fully committed to spending within cash flows (the capital discipline mantra), lower cash flows will dent their ability to reinvest in the rocks. The E&P budgeting process typically occurs in the December-February period, and it is strongly influenced by the prevailing oil price environment. In addition, **the impact of rising financing costs on the sector should not be downplayed**. The stress is already visible in the energy high-yield segment, where spreads have jumped by 100 bps as oil prices dropped by over 25% (chart 5). Thus, the longer prices remain subdued, the more likely it is that 2019 capex numbers will come down, with production numbers eventually being revised down for H2 2019.

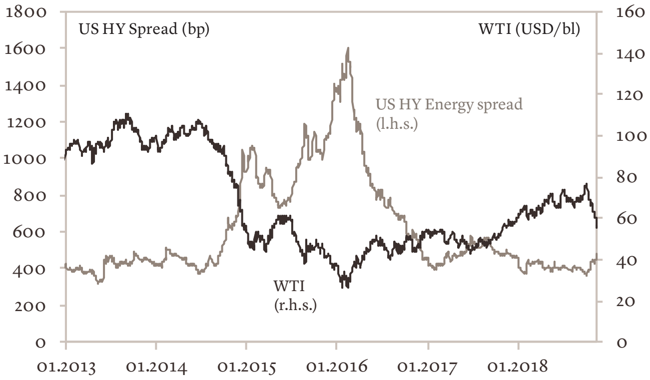
Overall, **recent data points suggest that the supply/demand balance might be looser than initially thought in H1 19**. However, with spot prices now below Saudi Arabia fiscal breakeven (chart 6), **we expect OPEC to act if needed to manage the downside – the next OPEC meeting will be held on December 6**. In fact, OPEC + Russia cooperation enterprise has already expressed its willingness to act as a central bank for the oil market, i.e. be ready to add or cut its production to balance the physical market and ensure an environment likely to encourage international investment in new production capacities in the Middle East. October OPEC production of 33.3Mb/d is well above what we believe is the call on OPEC at around 31.5Mb/d in H1 2019. The key unknown at this stage remains the speed at which Iranian exports will drop under US sanctions. However, as mentioned above, the scenario of an abrupt fall in exports that drove speculative positioning to recent highs is no longer the base case.

Medium term, we see few fundamental changes likely to derail our baseline scenario. Our supply/demand balance already took into account a more cautious demand assumption than the consensus, and Iranian production will eventually drop further. I**n light of our fundamental analysis, we are convinced that this correction is overdone, and the next OPEC+R meeting scheduled for December 6 should lead to production cuts of at least 1 Mb/d to reduce the oversupply**. Lower oil prices would only be reached if demand were to slow sharply. We are not about to experience a revival of the 2014-2015 commodity rout. Contrary to 2014, US shale is the only source of near-term supply growth, and the current growth rate should start to moderate in 2020/21. This should leave more room for OPEC+R to increase production to meet growing demand in a more mature shale growth environment.

However, as politics, and more specifically the US administration, is increasingly inviting itself into the market – exacerbating geopolitical tensions in the Middle East one day, or requesting an action to the OPEC when the rise in gasoline prices becomes too unpopular – one should reasonably prepare for more volatility going forward (chart 7). For the reasons explained above, **we think Brent will most likely trade within a wider USD 65-85/bbl range** in the coming months.

Sophie Chardon, Cross Asset strategist
Bastien Dublanc, Equity analyst – Energy, Metal & Mining, Utilities

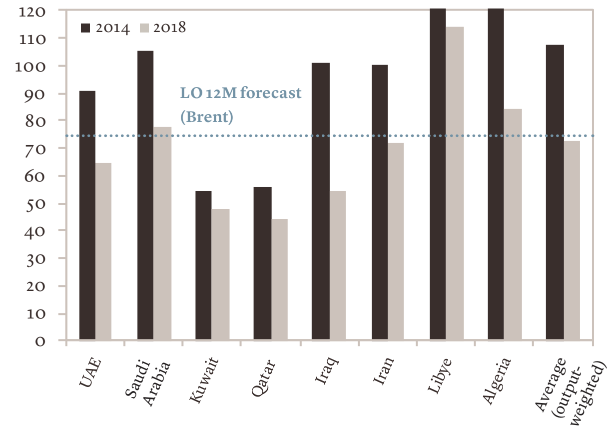
V. Financial conditions are tightening



Sources: DataStream, Bloomberg, Lombard Odier calculations

VI. OPEC fiscal breakeven

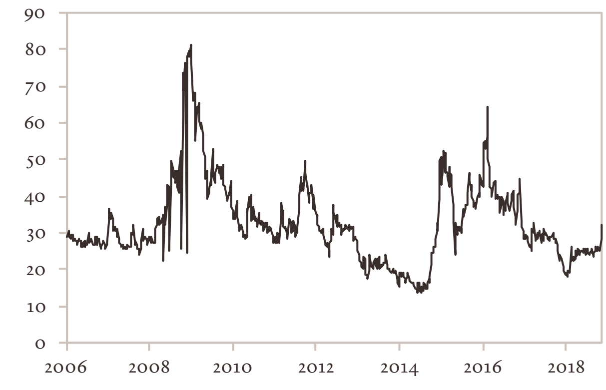
USD/bbl



Sources: DataStream, Bloomberg, Lombard Odier calculations

VII. Toward a higher volatility regime

Crude oil 3M implied volatility



Sources: DataStream, Bloomberg, Lombard Odier calculations

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SWITZERLAND

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
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Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Letnikovskaya st.2, bld.1 · 115 114 Moscow · Russian Federation · moscow@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France.
RCS PARIS B 803 905 157 · paris@lombardodier.com
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South Africa Representative Office · Bank Lombard Odier & Co Ltd
140 West Street · Sandton
Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
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MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305 · 11300 Montevideo · Uruguay
montevideo@lombardodier.com
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MONTREAL
Lombard Odier & Cie (Canada), Limited Partnership
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
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Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
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