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CIO Viewpoint

Saudi Arabia and Russia take a gamble on oil markets

Investment Solutions

27 March 2020

The end of a three-year accord between Russia and the Organisation of Petroleum Exporting Countries (OPEC) is proving a game-changing shock to the oil market as the Covid-19 pandemic hits demand. The resulting price war between Russia and Saudi Arabia challenges the US's dominance of the global market.

For only the third time in three decades, demand for oil is contracting. The Covid-19 pandemic is acting as catalyst. China has seen infections tail off and confinement restrictions start to lift as the focus turned to Europe, which the World Health Organisation described on 13 March as the 'epicentre' of the virus.

On 6 March 2020, Russia said that it would abandon its three-year old commitments that aligned its production with OPEC and increase supplies by as much as 500,000 barrels per day (bpd). While the announcement took markets by surprise, there were earlier signs that some in Russia were unhappy with the arrangement. Igor Sechin, PJSC Rosneft Oil Company's Chief Executive Officer and sometimes described as Russia's second most powerful man, reportedly told President Vladimir Putin that the continued production cuts posed a "strategic threat" to Russia. Each voluntary production cut handed market share to the US, according to a letter cited by Reuters in February.

'This is masochism'

"Our volumes are simply replaced by the volumes of competitors," said Rosneft spokesman Mikhail Leontiev more recently. "This is masochism." Russia's position was also influenced by Libya's production collapse, and a preference to wait-and-see how much demand would fall in response to the coronavirus.

The decision triggered an immediate response from Saudi Arabia and a price war that may be politically difficult to halt. The Kingdom said that it would increase output from January's 9.7 million bpd to a maximum capacity of 12.3 million bpd in April.

Market oversupply, says the International Energy Agency (IEA), may reach 1 million bpd by the end of this year. Overall, the full year may see oversupply of at least 2 million bpd. That may be a conservative estimate. In the near term, we expect oversupply in April to reach around 6 or 7 million bpd as stocks are replenishing fast.

OPEC, founded in 1960 to stabilise prices in the oil market, currently accounts for around one third of global production. With Saudi Arabia as its de facto head, the cartel has historically tried to set a price floor to encourage longer-term investment

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Russia's decision to ignore OPEC cuts saw Saudi Arabia retaliate, triggering a price war. Russia considers OPEC's cuts a strategic threat, handing US shale producers market share
- Covid-19 is curbing demand for oil and the market is expected to be in oversupply this year
- The price war squeezes higher-cost producers US shale companies, and undermines revenues of oil-revenue-dependent countries
- Oil prices are expected to remain volatile while markets balance the unknowns of the coronavirus and the political determination of Saudi Arabia and Russia. Our 12-month outlook is for oil prices to trade around USD 40 per barrel.

in the sector. But the Kingdom does not like having to shoulder output cuts alone as the 'swing producer,' and has in the past used the threat of flooding the market, for example against Venezuela, to strong-arm others into cutting supply.

The clash between Saudi Arabia and Russia, the world's second and third-largest oil producers, has more than halved the value of Brent crude since the start of the year, to around USD 27 per barrel as we go to print. Prices were little changed as the US appeared to reach agreement on an aid package for its economy and given the prevailing supply/demand imbalance, it is likely that prices will remain low. That will force high-cost producers to temporarily shut down and so rebalance the market.

Russian roulette

With President Putin securing his power base beyond his current presidential term that ends in 2024, the Russian leader may be looking for ways to shore up his relationships with those who dislike the country's production limits. The Russian parliament recently discussed a plan to allow Mr Putin to remain in power beyond his present term. In January, the president announced reforms to the constitution and the entire government resigned. The timing of the decision also coincides with expectations that Russia's oil production may peak before 2024, as falling investment and exploration take their toll on output.

Russia may have calculated that it can afford to take short-term dent in its budget with a loss in oil market revenues. More than one-third of Russia's national budget comes from oil revenue, compared with two-thirds of Saudi Arabia's. Russia's floating exchange rate also allows it to balance ruble-denominated costs against revenues in US dollars. The Russian currency is trading close to a four-year low against the US dollar. Oil prices fell nearly 30% and the ruble lost 9.5% on 9 March after Saudi Arabia announced its increase and the IEA released its oversupply estimates. Russia's budget break-even is around USD 40 per barrel. In contrast, Saudi Arabia needs oil prices to be around double that figure to balance its budget.

Russia may be counting on short-term pain, in return for a stronger, longer-term strategic position that weakens the US's market leadership. Saudi Arabia may have decided that only coordinated production cuts can balance the world's oil markets and there is no sign of US willingness to curb shale output.

Shale risks and sanctions

The US has done little to smooth its oil tensions with Russia. In December 2019, it imposed sanctions designed to delay the construction of the Nord Stream 2 pipeline linking Russia with Northern Germany through the Baltic Sea to deliver natural gas. Then last month, the US imposed sanctions to punish a Rosneft subsidiary for supporting President Nicolás Maduro's rule in Venezuela.

The price war squeezes higher-cost shale producers, who have made the US the world's biggest producer since 2018. President Trump's response on Twitter ("good for the consumer, gasoline prices coming down!") misunderstood the situation for oil producers who have to shut drilling in the short term and the threat to the US markets in the longer run.

Over the past two weeks, US shale producers responded to the fall in prices with spending cuts averaging more than 30%, and some cut dividends to protect their balance sheets. American shale producers are turning to the US government for support.

Harold Hamm, founder of US shale producer Continental Resources Inc., is already leading an anti-dumping complaint against Saudi Arabia that, if backed by the US Commerce Department, may result in countervailing duties on oil imports.

The US is trying to persuade Saudi Arabia to reverse course. The Kingdom must "rise to the occasion and reassure" the oil market, Secretary of State Mike Pompeo said 25 March.

Wider fallout and outlook

Still, amid the noise about the world's three largest oil producers, we must not forget that the fallout will inevitably hurt other economies that can ill afford today's prices. States including Nigeria, Iran, Kazakstan, Venezuela and Algeria, for example, all rely on oil revenues to run their economies. Such vulnerable countries, as well as other emerging market producers including Brazil and Mexico, may see the threat to revenues translate into knock-on effects in their bond markets and currencies.

We fully expect the monetary and fiscal response to the coronavirus to lead to a rebound in economic activity and markets in the months ahead, along with a recovery in oil demand. However, if global storage reaches capacity in the second quarter of the year, we may see an even more brutal, but temporary, decline in oil prices.

For now, the oil market is balancing two unknowns: the evolution of demand as the world economy comes to terms with the impact of the coronavirus, and the damage that Russia and Saudi Arabia are willing to inflict in their tussle. While that dynamic plays out, oil prices will continue to see heightened volatility. A year from now, we expect prices to trade around USD 40 per barrel.

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SWITZERLAND

GENEVA

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.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom ·
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LUXEMBOURG

Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

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Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66, 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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MILAN

Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

MOSCOW

Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st.2, bld.1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

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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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Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE ·
dubai@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG

South Africa Representative Office · Bank Lombard Odier & Co Ltd
140 West Street · Sandton · Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO

Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU

Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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06.2019