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CIO Viewpoint

Oil price reflects more optimism than structural demand

Investment Solutions

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Oil prices have doubled since late October to their pre-pandemic levels of 15 months ago, as the global economic outlook improves and markets anticipate more travel, commuting and consumption. At this stage of the recovery, that may be a better indicator of economic optimism than evidence of a solid resurgence in demand.

In April 2020, some crude oil contracts briefly became worthless as economies locked down, demand slumped and Saudi Arabia and Russia disagreed on output cuts. Against the background of the past year's Covid pandemic, the rising oil price looks like a sign that economies are finally getting back on their feet with improving job and manufacturing data. Vaccination programmes worldwide coupled with fiscal and monetary stimulus, including a USD 1.9 trillion package signed into US law last week, are also supporting higher oil prices.

The OECD forecasts that the global economy may expand by 5.6% in 2021, and another 4% in 2022, according to its outlook released this month. That is more than 1 percentage point higher than its December 2020 estimate.

Early this month the Organisation of Petroleum Exporting Countries and its most notable allies Russia, Mexico and Kazakhstan (OPEC+), surprised markets by leaving production quotas for April unchanged, despite the improving economic environment. Brent crude, the benchmark for world oil, rose to USD 70 per barrel. As we go to print, the commodity traded at USD 69.90 per barrel.

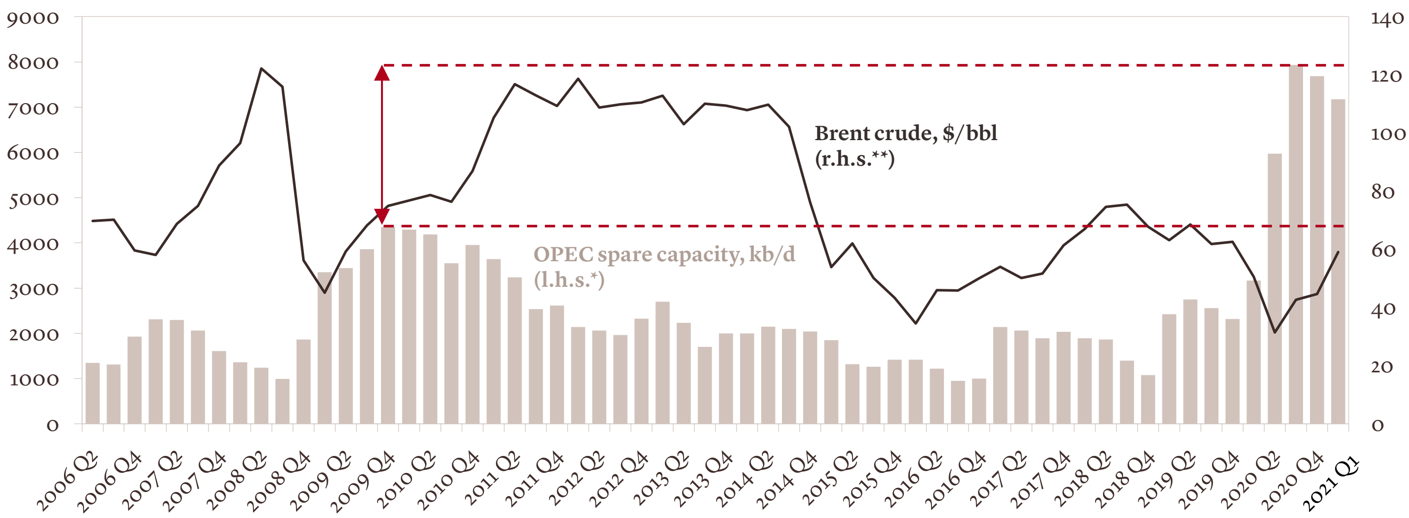
Oil capacity, still close to double its peak of 2009/10, could quickly return to the market (see chart). Until some of this capacity has been absorbed, oil prices are unlikely to rise to the levels seen pre-2014.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Oil is back to pre-pandemic prices as the economic outlook improves
- OPEC+ has left supply unchanged as inventories decline, and looks set to react rather than anticipate demand
- As markets look for a post-pandemic balance, the long-term shift to alternative energies is already underway. The geopolitical impact remains unclear
- We see oil at USD 60/barrel in 12 months, and are closely watching the normalising market and changes to wider structural demand.

OPEC spare capacity vs Brent oil price



* left hand scale, **right hand scale
Source: US Energy Information Administration

In January 2021, Saudi Arabia cut daily production by 1 million barrels to around 8 million, a level that will continue through April.

While OPEC recognises the pandemic's destabilising impact on demand, the decision shows that the kingdom is happy with the current price level. That also suggests that Saudi Arabia, the world's third biggest producer after the US and Russia, does not believe it is enough to trigger the increased production in the US that traditionally follows a price rise.

On 5 March, Saudi energy minister Prince Abdulaziz bin Salman said that "'drill, baby, drill' is gone for ever." American producers have said that they will not make significant changes to their output, instead choosing to distribute higher dividends and pay down their debts.

In 2021 a large share of US oil company debt matures, and peaks in 2022, especially for the most vulnerable high-yield rated producers. These refinancing needs will force these firms to adopt more cautious and disciplined capital spending this year.

Structural shift and forecasting demand

The post-pandemic recovery is expected to accelerate demand for alternative energies, and erode demand for fossil fuels. BP, the world's seventh-largest oil company by market capitalisation in 2020, last year wrote that falling fossil fuel use and rising renewable technologies are structurally altering energy demand and can be expected to exert downward pressure on oil prices in the longer term. The company estimated that the demand for oil (and coal) has already peaked, although it must be pointed out, this is not a view universally shared in the oil industry.

Along with rising oil prices, the market for government bonds began to anticipate an economic recovery and higher inflation last month with rising yields. Oil and metals prices historically rise in line with economic expansion, and are a component of inflation. For now, the Federal Reserve appears at ease with higher yields as long as it reflects increasing economic optimism.

The current economic outlook does not change the structural shift in consumption, and the recovery in oil demand has still not brought it back to 2019 levels. Prices may be more driven by supply constraints than confidence that long-term economic demand will fully resume.

How OPEC+ adjusts to the recovering demand will be the main driver for oil prices this year. As inventories fall, OPEC+ looks ready to react, rather than anticipate increasing demand. That may create the environment for some short-term overshooting of the USD 70 per barrel level.

Geopolitical risk

Rising oil prices have uneven effects on global economies. The growth models of Gulf producing states as well as Russia and Latin American exporters such as Colombia are tied to oil export income. Net importers, such as China, may see their current account balance deteriorate, while India, which has already appealed to OPEC to cap price rises, is exposed to a worsening trade balance and higher, energy-driven inflation.

Oil market movements are inseparable from geopolitics. Ahead of Joe Biden's election, investors speculated that the US would begin to normalise relations with Iran, potentially lifting sanctions and allowing the country to restart oil exports officially. On 25 February the Biden administration ordered an air strike in Syria. That targeted facilities on the Iraqi border used by Iranian-backed militants whom the US said were responsible for attacks over the previous week. So far, the US administration has indicated that it is not in a hurry to return to the nuclear deal with Iran.

Looking further ahead, the massive social and economic impacts over this past year have accelerated trends away from fossil-fuel dependence. While the longer-term geopolitical consequences are hard to forecast, the strategic landscape has already changed for the oil industry as demand shifts to alternative sources of energy.

Investors already have the opportunity to make a choice in favour of firms offering or transitioning to, cleaner solutions. In some cases, these may include oil companies that are making investments after recognising that this strategic shift is well underway.

Oil market inventories, supply and prices will all balance out as a function of the recovery. The main risk is that tensions within OPEC+ make production decisions even less predictable. As the oil market approaches an equilibrium over the course of the year, OPEC+ producers may see fewer incentives to reach a consensus on production levels. In this light, our 12-month forecast stands at USD 60 per barrel and we are monitoring closely the impact of normalising oil prices on our portfolios.

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