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MACROCOSM

Just What We Didn't Need: An Oil Price War

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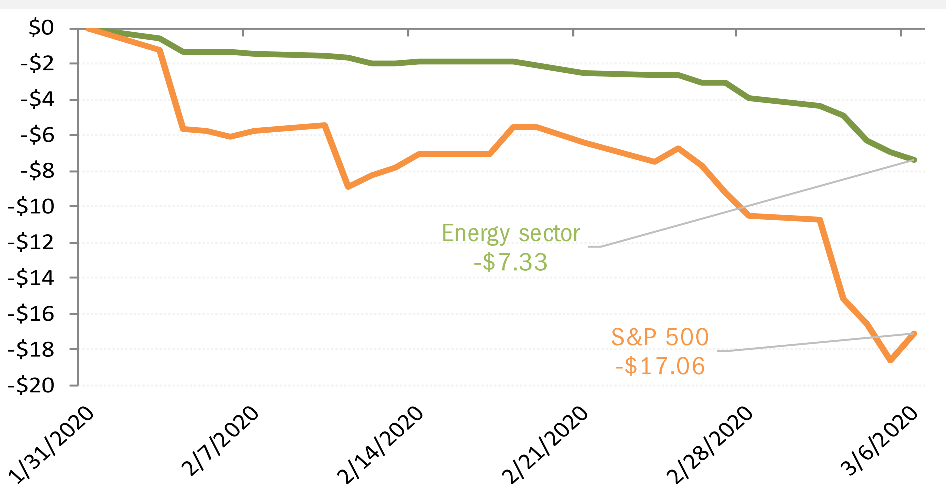
Michael Warren and **Donald Luskin**

Saudi and Russia have a falling out. This is the systemic risk we've been warning about.

We've been secular bears on oil prices for years, even when geopolitical surprises cause prices to spike (see, most recently, "After Soleimani, What If Peace Breaks Out All Over?" January 6, 2020). So we wish we could feel happier about what's happening now. *But we sure weren't expecting the OPEC-Plus "extraordinary meeting" of oil ministers to break up in an extraordinary bargaining failure and a possible oil price war*. We were expecting production cuts to support oil prices in the face of a temporary demand slowdown (see "Powell Not to the Rescue" March 4, 2020), and we were wrong. We warned from the beginning that an oil price collapse could open up a financially systemic dimension of the virus crisis (see "Another Damn Export from China" January 27, 2020), and that's now a clear and present risk. As a result, as of this writing Sunday evening, WTI crude was trading as low as $30, and S&P 500 futures and the 10-year Treasury yield are trading at new lows for the coronavirus correction. *Our outlook has to change considerably until and unless this OPEC mess is resolved.*

- Figuring out what will happen here requires some serious mind-reading of OPEC-Plus participants. But first, some background to explain why this is so critical.

Consensus forward earnings, change from January 31, USD billions



Source: Bloomberg, TrendMacro calculations

Update to strategic view

OIL, US MACRO, US STOCKS, US BONDS, US FED: We were wrong in forecasting that OPEC-Plus would cut production on Friday to track slack demand in the Covid-2019 crisis. Now it looks like the opposite: a price war between Saudi and Russia in which the US will be collateral damage. OPEC's 2015-2016 price war drove oil to $26 and nearly caused a US recession by blowing out credit spreads at the same time as the Fed was tightening. But OPEC couldn't stand the heat, and OPEC-Plus was born to control output and raise prices. The oil crash calls for another leg down in equities and Treasury yields, but the end could be in sight. With prices tonight already as low as $30, OPEC-Plus may have to come to its senses quickly, in which case US financial damage would be limited. Indeed, we think this price war is being engineered by Saudi – which just days ago was advocating production cuts, unilateral if necessary – to punish Russia for not sharing…

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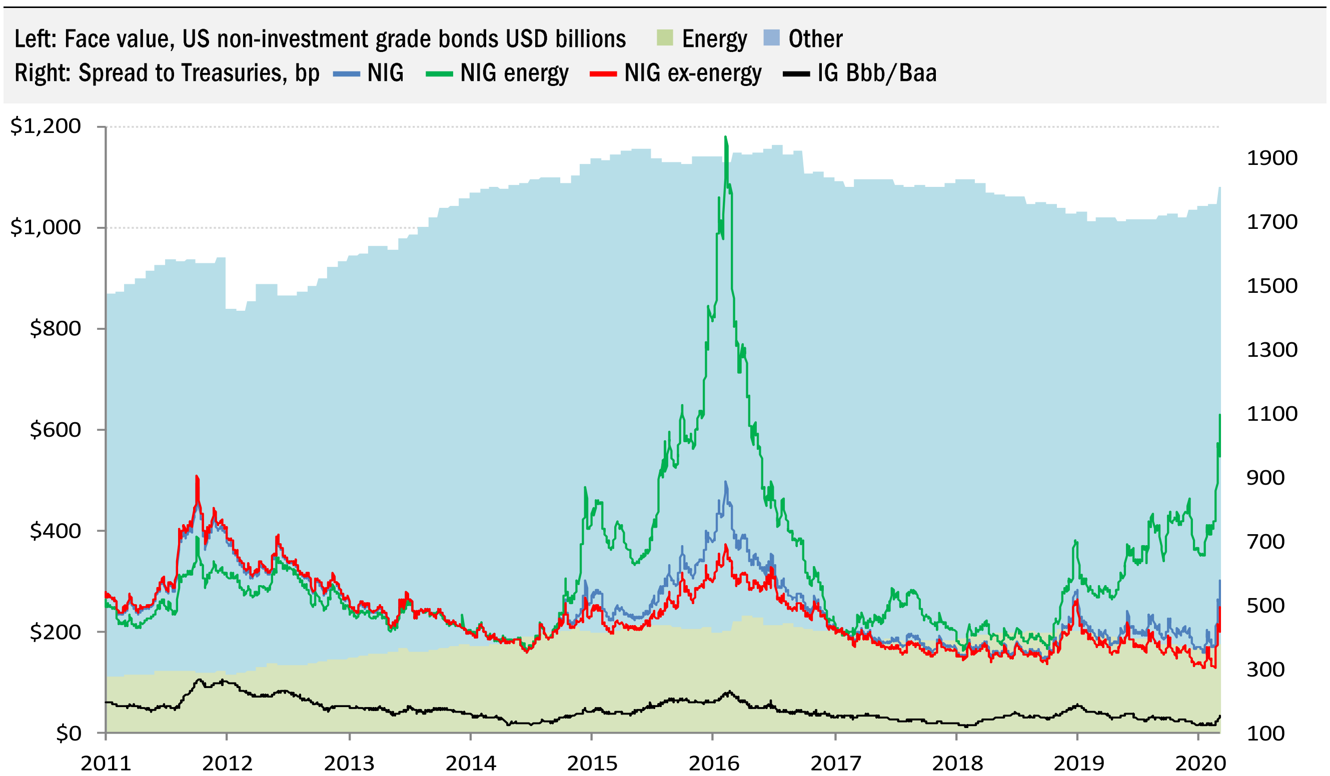
- *<u>In an important sense, lower oil prices are good news</u>* – they can help ease consumers through the hardships of any slowdown that might result from Covid-2019 and government mandates to contain it. That helps, but the costs can be greater than the benefits.
- *<u>By putting cash-flow pressures on highly-levered US oil producers and explorers, low prices raise the risk of defaults by borrowers whose coupons or maturities come due during even a short crisis. The marginal barrel of US fracked crude is an export product – and surely South Korea for example, hard hit by the virus and among our largest importers, isn't going to be there this month. The marginal producer of that marginal barrel may not have the free cash flow to pay a coupon this month without a check from Seoul. Energy sector consensus forward earnings already explain 42% of the S&P 500's rollover since the Covid-2019 crisis began (please see the chart on the previous page).</u>*
- *<u>16.1% of the US non-investment grade bond market is issued by the energy sector. So a default could be systemic, first in the sector and then at large. Credit spreads in the energy sector are already above 11% as of Friday (please see the chart below). If this goes on and worsens, next come the loan-loss reserves. Rollovers are put at risk in the energy sector, and the cost of financing goes up for the entire entrepreneurial economy.</u>*
- We saw a highly dangerous instance of this very thing in the near-miss recession of 2015-2016, when the energy sector spread-to-Treasuries got to 20% and the non-investment grade bond market virtually shut down for a couple months at the worst of it in Q1-2016 when oil was driven to $26 (see “The Recession Caused by Low



Source: ICE, TrendMacro calculations

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…the burden and bring them back to the negotiating table quickly. Trump's best play is to secretly call bin Salman and press him for higher prices. Doing nothing imperils his election, and could make the economy even weaker, imperiling his election further, which in turn weakens the economy further. On the good side, the Fed has already eased and will ease more, perhaps before the March FOMC. And lower oil prices at least support consumers worried about the virus crisis.

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Oil Prices" January 8, 2016). Then we saw it again, at smaller scale, in the less-serious near-miss recession of 2018-2019 (see "Video: What you're not hearing about the recession of 2019" December 30, 2019).

- *Both those "reverse oil-shocks" were made worse by the Fed's obliviousness in the face of collapsing oil prices and exploding credit spreads*. In the first instance, Janet Yellen's Fed hiked rates in December 2015, moving them off zero for the first time after seven years, at exactly the wrong moment (see "2016: Two Charts, Six Words, One Man" December 31, 2015). In the second instance, Jerome Powell's Fed executed the one too many rate hikes in December 2018, and shattered confidence with his gaffe about the balance sheet being "on automatic pilot" (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).
- *The good news now is that the Covid-2019 crisis has already set the Fed on an easing cycle. Even though it bungled the roll-out of what unfortunately has become forever known as the "emergency cuts" of last week* (again, see "Powell Not to the Rescue"), at least the Fed is cutting, not hiking as in the last two cases. The money-market curve is priced for two more cuts at next week's March FOMC, and with the stench of panic in the air it is inconceivable those expectations won't be catered to – probably sooner.

Then again, we would have told you it was inconceivable that OPEC-Plus would not have agreed to an output cut, at least a temporary one to match the temporary fall-off in demand likely to materialize during the Covid-2019 crisis. So what the hell happened?

- This is actually the second failure of OPEC-Plus to curb production. The ministers met in early February. Their Joint Technical Committee recommended deepening the existing quotas by an unspecified amount through mid-year, and thereafter maintaining the present quotas through the end of 2020. (In December, when the present quotas were put in place, they did not have an explicit end-date, but it was understood they would be reviewed in March.) But none of that could be agreed.
- *It is always difficult for members of a cartel to agree when it comes to production cuts.* Every member knows that those cuts will lead to higher prices – which is the whole point – but every member also knows that cuts require sacrificing market-share. So there is always a great deal of gamesmanship around burden-sharing. Typically Saudi Arabia bears the biggest burden. That's because it is the biggest producer, and indeed perhaps the only true swing-producer – and the other cartel members know that and try to free-ride to the extent they can.
- *In early February before the meeting, Saudi made the stupid mistake of letting the* Wall Street Journal *know that it would consider a unilateral cut of 1 million barrels per day. A smart guess is that someone in Russia – the other large player and potential burden-sharer in OPEC-Plus – reads the* Wall Street Journal*. Apparently Saudi resented being taken up on its offer, and so nothing was done.*

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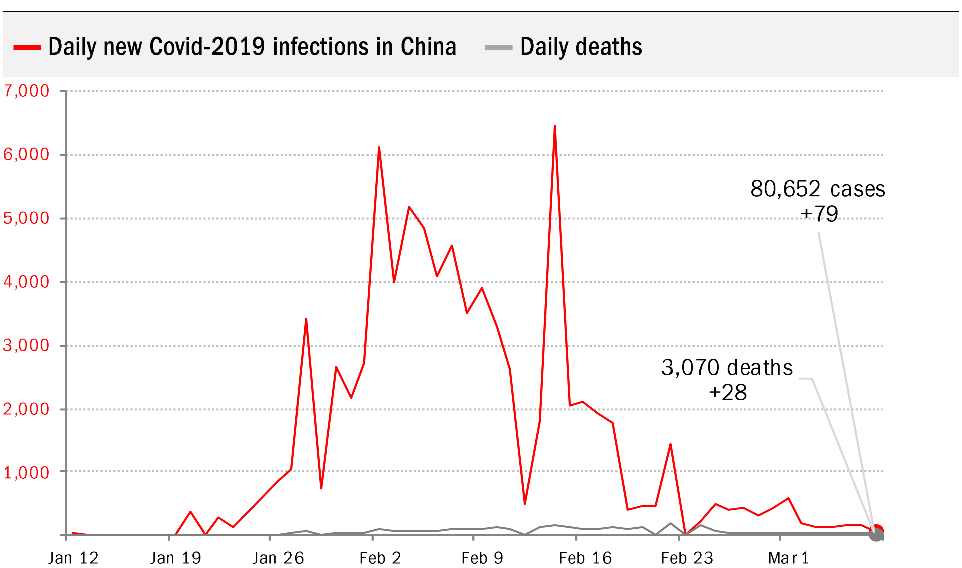
- *It seems someone – perhaps another OPEC member, not Saudi – made the same stupid mistake ahead of the March meeting, telling Reuters that OPEC would cut production even if Russia didn't join in. So why would Russia join in? Why not free-ride and enjoy the higher prices with the same volumes?*
- *And it appears that's what Russia did. Except it also appears that Saudi Crown Prince Muhammed Bin Salman lost his temper about it. Not only did OPEC fail to follow through with cuts without Russia, instead it is reported that Saudi is opening up the spigots to start an all-out price war. Within the span of a week, it seems the mercurial MBS has gone from wanting to raise oil prices to wanting to lower them, and supposedly imagining it can "make it up in volume."*
- *Russia, for its part, is telling the press that OPEC-Plus will now "pump at will."*
- *Why?* There's a lot of speculation in the press and on Wall Street.
- As to Russia's motives, we think our free-riding argument is about right, and sufficient – except that Saudi called their bluff. Alternately, we're hearing that Vladimir Putin is, effectively, declaring war on American frackers, driving prices down below their break-evens. Supposedly, this is revenge for US sanctions against construction of Russia's Nordstream 2 gas pipeline into Germany – but Russia has already figured a way around the sanctions. Or, supposedly, it's a general attempt to drive the frackers out of business – indeed, much as OPEC itself tried from 2015 to 2016 with its suspension of all production quotas and a hell-bent-for-leather war for market share. *But that war against the frackers ultimately failed, even though it did come close to causing a US recession. It failed because Russia's and other oil production-dependent economies are more at risk from low prices than the US is. In the US, there is a larger proportion of consumption that benefits from lower prices, and a lower proportion of GDP arising from production that is harmed by them.*
- As the Saudi's motives – remember, they're the ones who have wanted to cut production all along, even unilaterally if necessary – remember also, they're the ones with the Aramco flotation to protect, the share price of which is trading now for the first time below its IPO price – *this just has to be a reaction to Russia's perfidy, because that's what changed between Saudi's initial position and its new diametrically opposed one*. It may be a costly but sensible move to teach Russia a lesson so that it will behave better in the next round of the "repeated game" they are playing together. But it's also very possibly an ill-considered and emotional over-reaction. But then again this has been a tough week for the Crown Price – he had to put more members of his own family under arrest. As far as we know at this time, bone-saws were not involved.
- *We really doubt that Saudi wants to repeat the self-destructive war for market-share of 2015 to 2016*. Then, as bad as it was for the US frackers (and their financial backers), it was so bad for oil-producing countries that the OPEC-Plus structure had to be created to put broad enough production cuts in place to stanch the bleeding.

- *This schism between Saudi and Russia may very well be the end of the OPEC-Plus structure. But we think that probably MBS believes he can drive Russia back to the negotiating table if prices fall sufficiently, in which case it would be the salvation of the meta-cartel. It took an oil price of $26 to get their attention. While it's very bad news that oil has traded tonight at $30 already, that's only $4 off the level that got their attention last time – we could conceivably get this over with very quickly.*

So what's the impact of all this?

- *Even if it is, as we think, just a pissing-match between Saudi and Russia, the US is likely going to be collateral damage to some unknown extent, depending on the duration of the oil price dip.*
- We can't be sure how bad it will be, because the demand situation is so cloudy. *Nobody really knows yet how much and for how long oil demand will be affected by the Covid-2019 crisis – if demand comes back, that supports prices.*
- *So far China has been the nation hardest-hit by the virus, and unfortunately it is also a nation that has disproportionately sustained oil demand-growth for the last several years*. But the severe lockdown that has likely put a huge dent in Chinese oil consumption has also been quite effective at containing the spread of the virus in China. If we can believe the statistics, new infections have been under 1,000 a day for two weeks, and under 200 for the last six days. Deaths per day have been under 200 for the last two weeks, almost entirely in Hubei Province (please see the chart below). The draconian lock-down that achieved this happy result is unwinding, so *oil demand should come back quite quickly*. As to the rest of the world, it's hard to say until we understand more about the degree of degradation of economic activity that will be entailed



Source: Johns Hopkins, TrendMacro calculations nation by nation. *It could be that a production cut wasn't necessary in the first place.*

- *At the same time, the 30% drop in oil prices since the Covid-2019 crisis began – not even including tonight's crash – has already blown-out credit spreads* (again please see the chart on the second page) *and has already begun to add to the macro risks facing the US economy. Whether or not this creates a tipping-point for the economy is going to be a function of the demand situation, as we just mentioned, and how long it takes for Saudi to drive Russia back to the bargaining table – or give up.*
- *The potential for constructive US policy response is a mixed picture.* On the one hand, the Fed is already doing the right thing, unlike the last two times they faced a similar situation. *But it's not clear to us what President Donald J. Trump, for his part, can do about it, at least in the short term and unilaterally.*
- *Late this evening the White House has let it be known that is working on various economic relief measures, including special paid sick leave and direct financial relief for virus-affected businesses.* This isn't exactly the "stimulus" we have been expecting (again, see "Powell Not to the Rescue"), but it pushes in the same direction.
- *As to the issue of too-low oil prices specifically, Trump has demonstrated his willingness (and he has the statutory authority) to use tariffs to achieve various ends – so he could support prices by putting duties on OPEC and Russian oil, claiming that they are "dumping."*
- The US is now mostly supplied by internal production and by imports from Canada and Mexico, so a shaky story could be told that these tariffs don't harm American consumers. But that probably wouldn't wash, because the whole point of them would be to support prices of domestic oil – and the consumer-focused narrative is very much that lower prices are always better. So while supporting prices might be the right thing to do to support the economy overall, *the political optics of that – or anything else to support prices, for that matter – are likely unacceptable*.
- Sanctions against Russian oil would be slightly more optically acceptable, since the US imports very little crude from them (even though the purpose would be to raise prices everywhere, it's a slightly less obvious maneuver). But that would take congressional action.
- Surely the best course is private personal diplomacy. By breaking the Obama-era Iran nuclear deal and re-imposing sanctions on Iran that have driven their oil production to new lows, he has done a huge geopolitical and economic favor for Saudi, Iran's regional arch-rival (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018). *The Crown Prince owes Trump one – and if Trump is wise enough to make the call asking for higher prices, he'd probably get them.*

Adding to these straightforward risks, don't forget that we have been writing all year about the risk of a "reflexive" vicious cycle in which a weakening economy diminishes Trump's chances for re-election, which in turn – because that would put at risk his pro-growth agenda, including the new 21% corporate tax rate – would weaken the economy further, and so on (again, see "2020 Outlook: After a Near-Miss Recession, It's the Election").

So Friday's OPEC-Plus failure is potentially a very negative development. We're glad, at least, we called for a big correction in early February even though it looked like the coast was clear (see "Is Coronavirus a Chinese Bio-Weapon?" February 3, 2020), *and then characterized our bottom-fishing venture a week ago Friday – which looked pretty smart for a while – as "timid"* (see "Covid-2019 Becomes Covfefe-2020" February 28, 2020). *Looks like we're going to have to take another leg down, with this correction maturing into something closer (in US equity terms) to the 20%-25% type we've seen twice since the bottom in 2019. Given where futures are trading at the moment, that's not really all much further down.*

The next several days will be crucial, as we hear statements from Saudi and Russia, to see what kind of mating-dance they might be going through. Another meeting of the Joint Technical Committee, that includes representatives of Russia and Saudi, remains on the books for March 18.

Bottom line

OIL, US MACRO, US STOCKS, US BONDS: We were wrong in forecasting that OPEC-Plus would cut production on Friday to track slack demand in the Covid-2019 crisis. Now it looks like the opposite: a price war between Saudi and Russia in which the US will be collateral damage. OPEC's 2015-2016 price war drove oil to $26 and nearly caused a US recession by blowing out credit spreads at the same time as the Fed was tightening. But OPEC couldn't stand the heat, and OPEC-Plus was born to control output and raise prices. The oil crash calls for another leg down in equities and Treasury yields, but the end could be in sight. With prices tonight already as low as $30, OPEC-Plus may have to come to its senses quickly, in which case US financial damage would be limited. Indeed, we think this price war is being engineered by Saudi – which just days ago was advocating production cuts, unilateral if necessary – to punish Russia for not sharing the burden and bring them back to the negotiating table quickly. Trump's best play is to secretly call bin Salman and press him for higher prices. Doing nothing imperils his election, and could make the economy even weaker, imperiling his election further, which in turn weakens the economy further. On the good side, the Fed has already eased and will ease more, perhaps before the March FOMC. And lower oil prices at least support consumers worried about the virus crisis.