Absolute Return Partners

The Absolute Return Letter

May 2019

Addicted to Oil?

"We aren't addicted to oil, but our cars are."

R. James Woolsey, Jr.

Not the Absolute Return Letter

If you subscribe to the Absolute Return Letter (which, if you don't, you can do here), within the next week or two, you will receive a note from us called ***Not the Absolute Return Letter***. Here is what it is all about:

In response to the financial crisis, the EU introduced a legislative framework designed to restore the faith in the financial industry after all the damage caused by the virtual meltdown in 2008 and the years thereafter. The latest ruleset which has been implemented as part of that framework is known as MiFID II, and that kicked into action early last year.

MiFID II has had one critical implication for us as authors of the Absolute Return Letter. Given the current setup, where the Absolute Return Letter is offered for free, *under no circumstances* can we discuss specific investment opportunities in those letters. If we do that, the letters will be deemed research and will be subject to the MiFID II rules. Suddenly, the letters can only be offered to paying clients of the firm.

As we don't want to restrict these letters to paying clients, we have decided to introduce a new model. The Absolute Return Letter will continue to be freely available, but it will be subject to the MiFID II rules; i.e. we will *never* discuss specific investment opportunities.

For those of you interested in our work, and how we invest along the lines of the views expressed in the Absolute Return Letter, a new service will shortly be on offer, and that is what the forthcoming letter will be about. If you are already a paying client of Absolute Return Partners, you can disregard all of this. Nothing will change.

Oil price elasticity

Though oil prices are currently in the middle of the trading range of the last ten years and so could be deemed by some to be 'average', this does not reflect recent trends, as Brent is up nearly 40% year-to-date (Exhibit 1).

Exhibit 1: Brent crude oil prices (last 10 years)
Source: *MacroTrends.com*

The rally has encouraged me to re-visit the oil story. In the following, I will explain why prices are up so much in 2019, and I will suggest that the rally could quite possibly continue for a while longer.

My story begins with a note on oil price elasticity. In recent years, even modest changes to either demand or supply have had an outsized impact on oil prices with prices dropping steeply if supplies have increased modestly and vice versa (Exhibit 2).

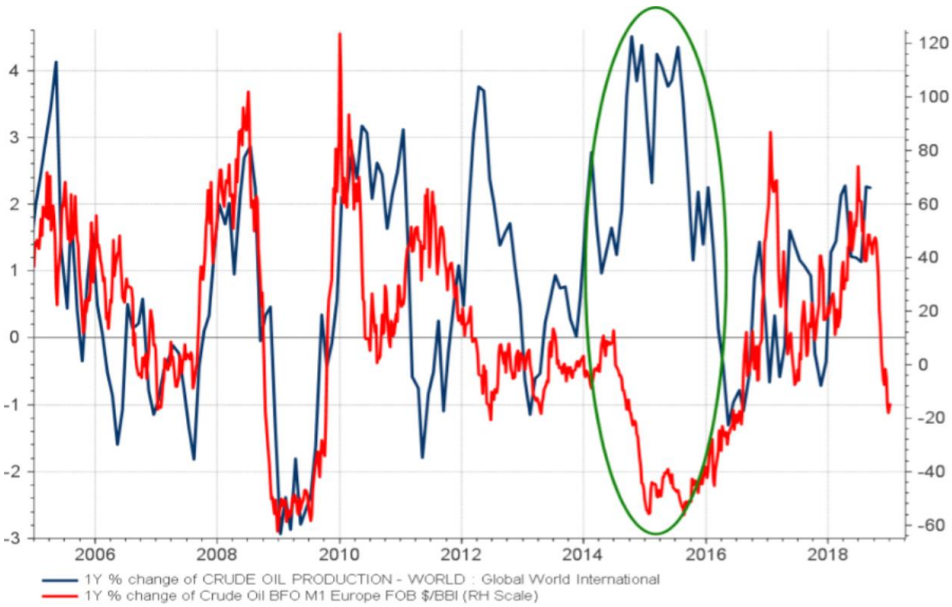

Exhibit 2: Global oil production (LHS) and oil prices (RHS) % change vs. year-ago
Source: *MacroStrategy Partnership LLP*

Take for example events of 2018-19. According to the Washington-based U.S. Energy Information Administration (EIA), between April and November 2018, global crude oil production increased by 2.75 million barrels per day (mbpd) – an increase of just 3.36%. This was mostly because of increased OPEC+[1] production. The increase in supply led to a 40-45% drop in oil prices in the second half of the year with WTI falling slightly more than Brent.

In 2019, on the other hand, relatively modest OPEC+ production cuts (of about 1.2 mbpd) have had precisely the opposite effect with oil prices rising almost 40% year-to-date.

The 2014-15 supply shock

In the past, when supply and demand were out of sync, you could almost always rely on Saudi Arabia to re-establish equilibrium in what has proven to be an increasingly fragile oil market. For that reason, many have, for many years, considered the Saudis the key swing oil producer of the world.

They still are but, in the age of shale oil, the US has earned the title "the key marginal producer of the world". The marginal producer is far more sensitive to price swings than the swing producer is. When the price is high enough to make its higher-cost wells profitable, it pumps, and US production is now big enough to make a difference (see for example here). With daily production running of 12.2 mbpd, the US is now the largest crude oil producer in the world (Exhibit 3).

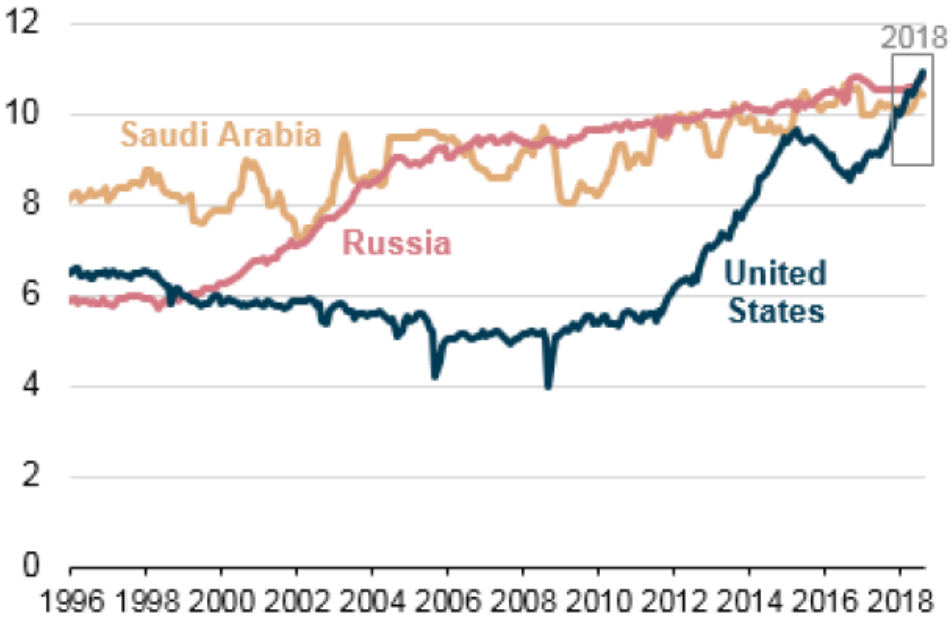

Exhibit 3: Monthly crude oil production to August 2018 (mbpd)
Source: *EIA*

The key difference between the two countries is that US producers always run on all cylinders. They do not, and cannot, attempt to manipulate the price with their output - at least not yet.

The one major exception to Saudi Arabia's (self)appointed role as key swing producer was (as you can see if you take another look at Exhibit 2) 2014-15, where US shale oil producers suddenly flooded global oil markets.

[1] *OPEC+ is mostly OPEC + Russia.*

In the second half of 2014, US shale producers had ramped up total crude oil supplies by 1.1 mbpd. Under normal circumstances, you would expect OPEC (Saudi Arabia) to cut back, but that didn't happen in 2014. The Saudis chose to protect their market share and continued to produce as if nothing had happened.

The aim was quite clearly to bankrupt US shale producers whose costs on average were (and still are) about $60 per barrel. I should add that a growing number of people argue that the marginal production cost for shale producers is now down to about $50, but that cost does not include several significant items, e.g. transport and leases. The de facto marginal cost of shale oil production is still around $60.

As oil prices dropped below $30 in early 2016, at first, the Saudi strategy seemed to work, but the Saudis underestimated one crucial factor – the Americans' willingness, and ability, to restructure through Chapter 11. Consequently, US crude oil production has continued to increase (Exhibit 4) and, with the benefit of hindsight, it is hard not to consider the Saudi strategy of 2014-15 anything but a failure. And that would also explain why the Saudis have since returned to a price-protecting strategy.

Exhibit 4: US crude oil production (kbpd)
Source: The Daily Shot (Wall Street Journal)

Why the near-term outlook for oil prices is bullish

With oil prices up nearly 40% year-to-date, I often run into people who argue that oil prices can only go down from here, but they seem to ignore a few hard facts. I can think of (at least) four reasons why oil prices could go higher in the near-term:

1. President Trump's sanctions on Iran
2. IMO 2020
3. Shale economics
4. Falling spare capacity within OPEC

President Trump's sanctions on Iran

President Trump and his administration continue their tough talking on Iran. In one of the most recent announcements coming out of the White House it was announced that, after May 1, it will not renew the exemptions given to eight countries that has enabled them to buy Iranian oil. Those affected include China, India, Japan, Italy and South Korea, and they will face sanctions from Washington if they do not comply[2].

With Iran producing around 3 mbpd, if Washington succeeds with its policy, oil prices could rise dramatically. And President Trump's plea to Saudi Arabia to step in as the swing producer is bordering on a joke as there is plenty of evidence that Saudi Arabia is simply not capable of raising output by 3 mbpd (more on that later).

Even worse, these sanctions come at a time where big oil-producing nations like Libya, Nigeria and Venezuela (producing almost 4 mbpd between them) all face serious issues. In other words, 3-7 mbpd of crude oil production could be at risk. That level of spare production capacity simply does not exist *anywhere*.

Just one word of caution. Despite President Trump's waivers, Iranian exports have already fallen below 1 mbpd, which is significantly lower than during the previous Iran oil sanctions of a few years ago. In other words, further upward price pressure from this source alone is not likely to be dramatic.

IMO 2020

The International Maritime Organisation (IMO) has regulatory powers and has decided to lower the limit for bunker fuel sulphur content worldwide from 3.5% to 0.5% from the 1st January 2020. Sulphur dioxide has been linked to a wide array of diseases, and the lowering of the sulphur content should reduce the number of lung cancers, various cardiovascular diseases and asthma cases.

From an investment point-of-view, the implication is that, as we approach the implementation date of the new IMO policy, demand for low-sulphur (sweet) crude oil will increase by as much as 2 mbpd[3] which could have quite a dramatic impact on oil prices.

Some oil producing nations will benefit from the policy change whereas others will lose out. How it will all pan out remains to be seen, but oil price benchmarks like Brent and WTI will most likely rally further as they are both sweet. In Exhibit 5 you can see some of the winners and losers of this policy.

Shale economics

The questionable economics of shale oil partially have to do with breakeven prices and partly with the expected lifetime of the average shale field. Let's take breakeven prices first. As I stated earlier, the average US shale field breaks even with WTI around $60. Even at $70 – i.e. 10% above current price levels – only one-third of the 21 major US shale producers generate positive cash flows and, at $50, only one does[4].

[2] *Source: scroll.in.*

[3] *Source: MacroStrategy Partnership LLP.*

[4] *Source: MacroStrategy Partnership LLP.*

As far as the expected lifetime is concerned, most of the lending to the shale industry is based on the assumption that the oil will keep flowing for 30-40 years, like in conventional wells; however, reality is far less rosy. The Wall Street Journal reported recently[5] that some of the biggest shale fields in the country are failing to live up to expectations. If lifespan expectations have to be dramatically reduced, the appetite for near-term losses will also drop, and a loss-making industry may suddenly find it much harder to fund itself.

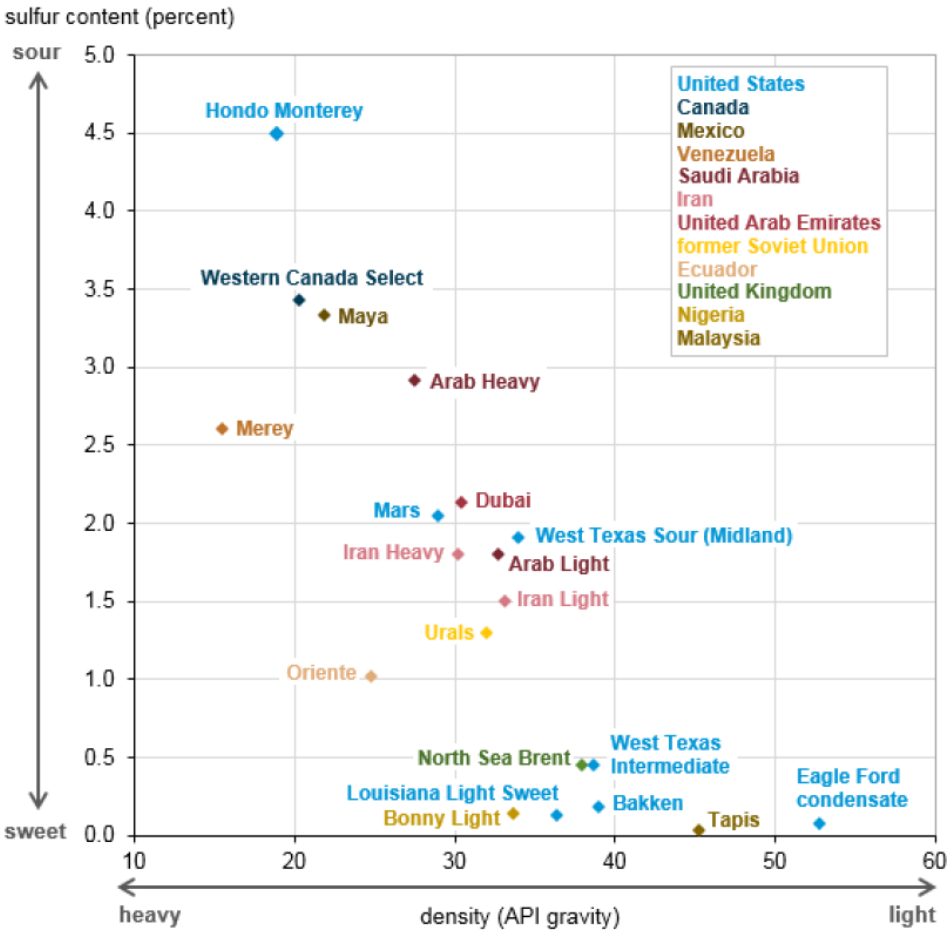

Exhibit 5: Density and sulphur content of selected crude oils
Source: *EIA*

Falling spare capacity within OPEC

Although the Saudis are in denial, there are good reasons to believe that OPEC's spare production capacity is significantly below the levels of only few years ago when it was estimated to be around 3-4 mbpd (Exhibit 6).

According to EIA, OPEC's spare production capacity is down to 1.5-2 mbpd these days, and the drop is largely due to extraction snags, mostly caused by freshwater problems. A sudden spike in production capacity is therefore very unlikely, and one can only conclude that President Trump is playing a very dangerous game if he counts on OPEC – and particularly on Saudi Arabia – to be the swing producer in case of trouble elsewhere.

[5] *Source: Dallas Business Journal. In the interest of full transparency, I should point out that Pioneer (the company referred to in the article) disputes Wall Street Journal's findings.*

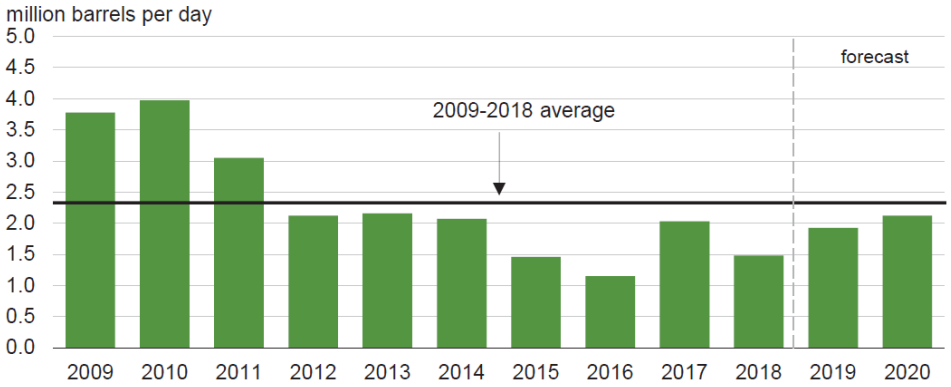

Exhibit 6: OPEC surplus oil production capacity
Source: EIA

The tactics of President Trump

I have already discussed President Trump's 'war' on Iran, but the story is even bigger than that. The US is not only the biggest producer of oil these days (see Exhibit 3 again); it has also become a significant exporter (Exhibit 7). Hence it is only a reasonable question to ask whether President Trump is sincere when he argues that oil prices must come down?

If we assume that oil prices' impact on US economic activity is largely a wash these days (which is what all calculations suggest), suddenly, President Trump's rhetorical games on Twitter make sense, as he can do so without running the risk of damaging US GDP growth a great deal. Last year he tweeted a highly inflammatory message to Iranian President Rouhani:

> *"Never, ever threaten the United States again or you will suffer consequences the likes of which few throughout history have ever suffered before. We are no longer a country that will stand for your demented words of violence and death. Be cautious!"*

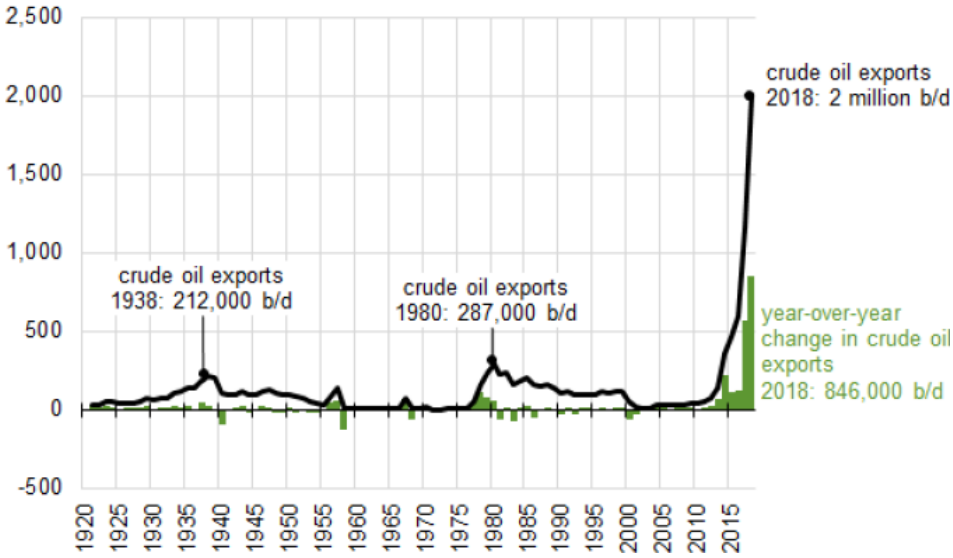

Exhibit 7: US crude oil exports
Source: US Energy Information Administration

Oil prices could have reacted violently but, in this case, they did not. Having said that, the luxury of oil prices not mattering a great deal these days as far as US GDP growth is concerned, allows President Trump to play games like this. And, if oil prices run away, he will simply tweet (and I paraphrase) that *"... it is the Saudis' responsibility to get runaway oil prices under control"*.

This way, he can suck up to consumers (the electorate) and major corporates (his sponsors) at the same time. To the uninitiated, it may come across as a little contradictory if not outright stupid, but it is all part of a very shrewd plan designed to get him re-elected next year, I believe.

Concluding remarks

If oil prices have become more sensitive to short-term swings in demand and supply (as they have), it follows that industrial activity is perhaps not as important a driver of oil prices as it used to be, and that is precisely what I have found (Exhibit 8). As you can see, oil prices have simply decoupled from global manufacturing activity more recently. Global PMI numbers have been quite weak; yet oil prices have been strong (the red square in Exhibit 8).

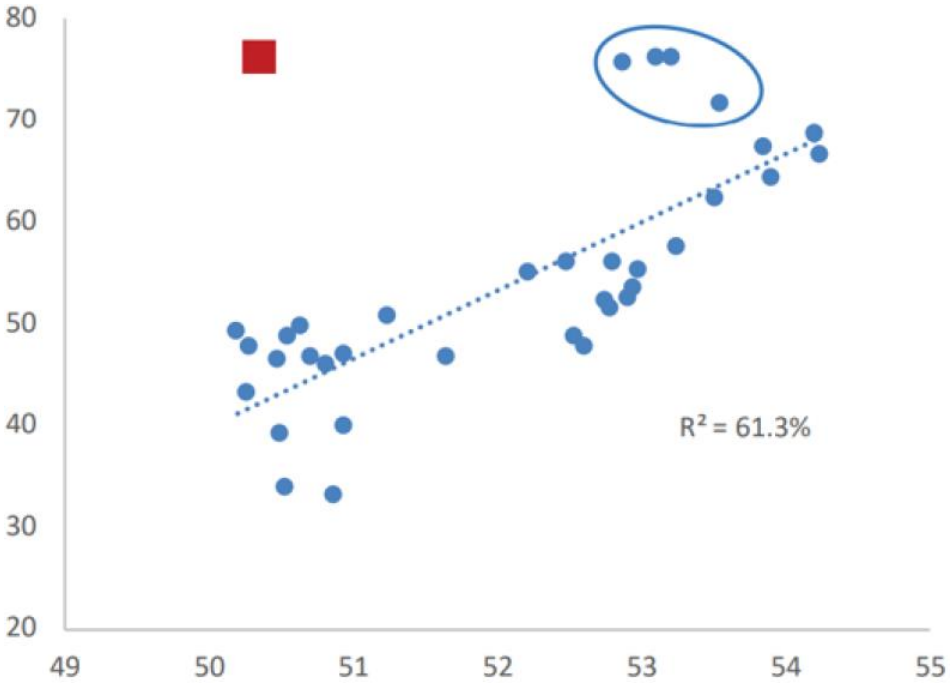

Exhibit 8: Brent oil price vs. global manufacturing PMI 3-month average, 2014-18

Source: The Daily Shot (WSJ), FTN Financial

At the same time, that implies that geopolitical risk plays a bigger role today than it did not so many years ago, and that is worrisome, given the problems in Libya, Nigeria and Venezuela.

Before calling it a day, I have one more point to make. Yes, it is indeed quite conceivable that oil prices could trade significantly higher over the next 6-12 months. Having said that, I expect a very different story to unfold over the next several years.

Governments around the world are increasingly declaring war on global warming and, in that context, fossil fuels are seen as the primary culprit. Governments want to electrify virtually all heating and transportation, as that will allow wind and solar energy – and eventually fusion energy – to take over from fossil fuels. That will have a devastating impact on all fossil fuel prices at some point.

A major problem with alternative energy forms has been storage of electricity which can only be stored in batteries. Take for example my home

country Denmark, which now generates well over 40% of all the electricity it needs through wind power.

When it is very windy during off-peak hours, Denmark generates too much electricity for its own needs, and any excess electricity is sold to either Germany or Sweden. There is now a solution on the way. A new technology using electrolysis converts electricity to hydrogen which can easily be stored, and it is widely expected that, within a few years, many vehicles will run on hydrogen; hence the short-term nature of my bullishness.

Finally, a sincere *Thank You* to James Ferguson of MacroStrategy Partnership LLP. He was tremendously helpful when I put this paper together. We don't pay for much research at Absolute Return Partners, but we do pay for MacroStrategy's work. It is quite simply brilliant!

Niels C. Jensen
3 May 2019

Important Notice

information provided is not intended to provide a sufficient basis on which to make an investment decision. Information and opinions presented in this material have been obtained or derived from sources believed by ARP to be reliable, but ARP makes no representation as to their accuracy or completeness. ARP accepts no liability for any loss arising from the use of this material. The results referred to in this document are not a guide to the future performance of ARP. The value of investments can go down as well as up and the implementation of the approach described does not guarantee positive performance. Any reference to potential asset allocation and potential returns do not represent and should not be interpreted as projections.

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

Visit www.arpinvestments.com to learn more about us.

Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	T +44 20 8939 2901
Mark Moloney	mm@arpinvestments.com	T +44 20 8939 2902
Shameek Patel	sp@arpinvestments.com	T +44 20 8939 2906
Ed Broomhall	eb@arpinvestments.com	T +44 20 8939 2909
Alison Major Lépine	aml@arpinvestments.com	T +44 20 8939 2910