MyStratWeekly
Market views and strategy

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N° 061 // **March 14, 2022**

Topic of the week: Focus on the oil market

- **Energy is at the heart of economic and geopolitical adjustments in the coming years;**
- **Prior to the outbreak of the Ukrainian conflict, supply-side market imbalance and lack of investment supported rising prices;**
- **In the short term, there are insufficient alternatives to deal with current price pressures;**

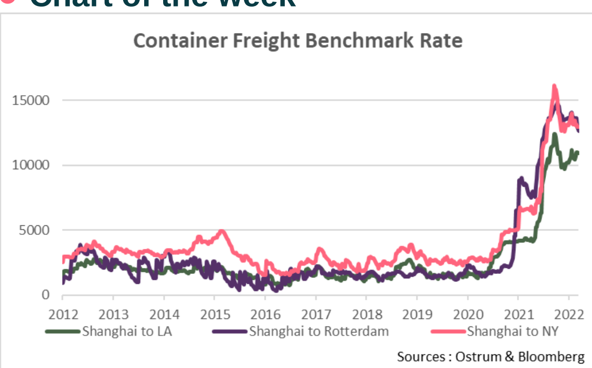
Second topic of the week: Who will buy the Italian debt?

- **Italian banks from 2010 to 2015, then the ECB, absorbed the Italian debt issuance. With the end of QE, these two buyers disappear.**

Market review: The ECB surprises

- **ECB accelerates QE tapering, sovereign spreads under pressure;**
- **US inflation highest since 1982;**
- **Extreme volatility in equities, violent short covering;**
- **Europe lays out a strategy for energy independence.**

Chart of the week



Sources : Ostrum & Bloomberg

The new wave of Covid in China raises fears of new problems in global production chains.

In the meantime the bottlenecks have not disappeared. Witness the prices of shipping from Shanghai, one of the main export routes for China. Container transport prices are still 6 times higher than their pre-2020 average. The signs of relaxation remain for the moment very limited.

Figure of the week

25%

Source : Ostrum AM

The average Chinese HY credit yield zoomed pass 25% last week.
This is a historic high and it is worrisome.

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● **Topic of the week**

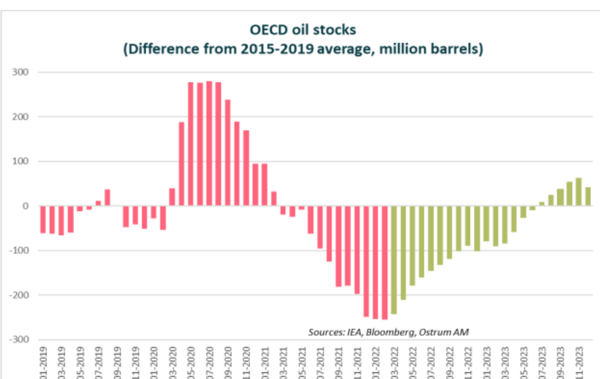
Focus on the oil market

This week, we'll be looking at the black gold market. The highlight of the crisis in Ukraine was the surge in crude oil prices above $130 a barrel. The issue of energy will remain at the heart of all economic and geopolitical adjustments in the coming years.

A post-COVID market imbalance, linked to supply

Inventory surplus was quickly absorbed

The oil market was already out of balance after the COVID crisis, which explains the upward pressure on prices before the Ukrainian conflict. The chart below shows that inventories accumulated by OECD countries during the pandemic have been quickly absorbed. This reflects a low supply of oil, particularly from OPEC+, which has maintained limited production, below its 2015-2019 average, according to data from the International Energy Agency. The crisis in Ukraine could exacerbate this supply imbalance and put further pressure on the price of black gold.



A lack of investment

The oil sector has suffered from low investment since the beginning of the pandemic. According to S&P, and according to the National Energy Forum held on December 7, 2021, the investment reductions of international oil companies and national oil companies in 2020 were about 35% compared to 2019. In 2021, businesses saw a further 23% reduction in investment levels from pre-pandemic levels. Oil companies spent $525 billion in 2019, down to $341 billion in 2021. However, according to the National Energy Forum, we would have to go back to the level of spending in 2019 in order for the market to return to balance.

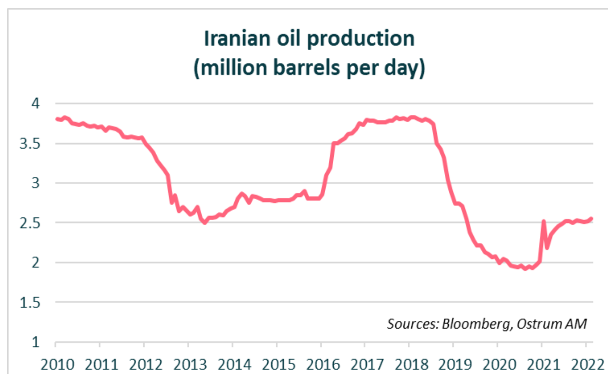
This explains the upward pressure on crude oil prices before the outbreak of the Ukrainian conflict. A highlight of this crisis was the surge in oil prices above $130, which threatens the global economic outlook. The J. Biden administration is trying to reassure market operators by unveiling several alternatives to compensate for the lack of Russian oil.

What alternatives to calm the current pressure on prices?

Russia is the world's third-largest producer of crude oil, after the United States and Saudi Arabia, with a production of 11 million barrels per day (Mb/d). It is the world's largest exporter of oil to global markets and the second largest exporter of crude oil after Saudi Arabia. It will not be easy to do without Russian oil.

Iran

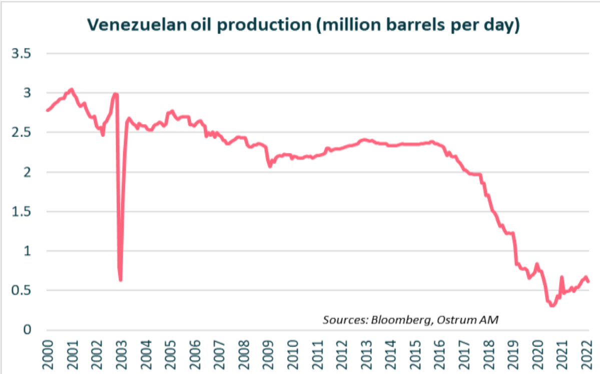
Thus, J. Biden resumed negotiations on the Iranian nuclear agreement. Iran accounts for 8.9% of OPEC's oil production. Prior to the US withdrawal from the 2015 Iran nuclear deal and sanctions on its exports, Iran produced 3.8 Mb/d. Next, production fell to 1.9 MMb/d and is currently 2.55 MMb/d, down 40% from the peak in 2018.



It will take time for Iranian production to return to pre-sanctions levels due to this significant decline and weak investment in the sector in recent years due to the US embargo. It should be noted that when the first Iranian nuclear agreement was signed in 2015, the sanctions were only lifted six months later once Iran's nuclear facilities had been verified by UN observers.

Venezuela

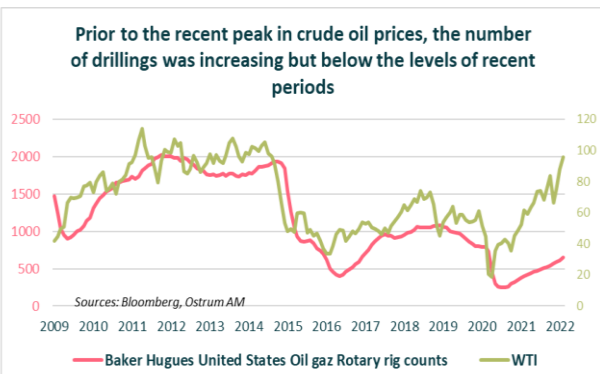
The United States, which did not recognize the re-election of President Maduro in 2018, is now also interested in Venezuela. The country was the main supplier to the United States before the embargo was put in place. Relations between the two countries seem to be getting warmer after Caracas freed two American prisoners, including one of the "Citgo 6", on March 8, 2022, International Women's Day, six former executives of Citgo, a US-based subsidiary of the state-owned oil company PDVSA. Venezuelan crude oil production was 3 MMb/d in 2020, the severe economic crisis reduced it to 0.65 MMb/d.



Political instability and the American embargo have also penalized investment in the sector, which explains the weakness of production. It will also take huge investments for Venezuelan production to regain its full capacity.

U.S shale: the new norm

The US government is pressuring the shale industry to increase production and ease price pressures. Despite high oil prices, US oil production is at 11.6 MMb/d, below pre-pandemic levels. The chart below shows the number of shale oil and gas drilling in relation to the evolution of the WTI price.



In the past, the number of drillings was very well correlated with the rise in WTI prices. In the recent period, before the recent peak at $70 a barrel (before the Ukrainian crisis), the number of drillings was increasing but at a rate that remains below the levels of recent periods.

The reason is that the economic model of the American shale industry is no longer working, even if oil prices continue to rise. The U.S. shale industry has lost $300 billion[1] over the last decade by producing oil and selling it at a price below its cost of production. This was possible despite the losses, as investors continued to fund the indusry. However, as reported in the Wall Street Journal[2], "capital markets have shown little interest in financing new expansive drilling campaigns." Companies in the sector can no longer access cheap capital. Without new financing, industry cannot drill for more oil.

IEA Emergency Reserves

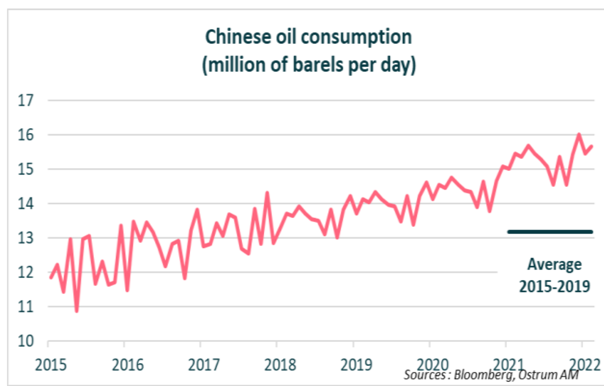
In order to ease the pressure on crude oil prices, J. Biden mentioned the release of 60 million barrels of emergency stocks from the IEA (4% of total reserves), equivalent to 2 million barrels per day, or 30 days. The use of these reserves is not a major change in the situation, as it can only partially compensate for the lapse of large oil producer like Russia.

Towards sustainably high oil prices?

Strong global demand for oil

The International Energy Agency (IEA) increased its forecast for global oil demand growth by 3.2 MMb/d in 2022, reaching a record high of 100.6 MMb/d, exceeding its pre-pandemic level. The upward revision is related to the Asia-Pacific region with a demand of 37.5 MMb/d.

In China, a major oil consumer, oil consumption reached a record high of 16 MMb/d, exceeding its (2015-2019) average of 13 MMb/d.



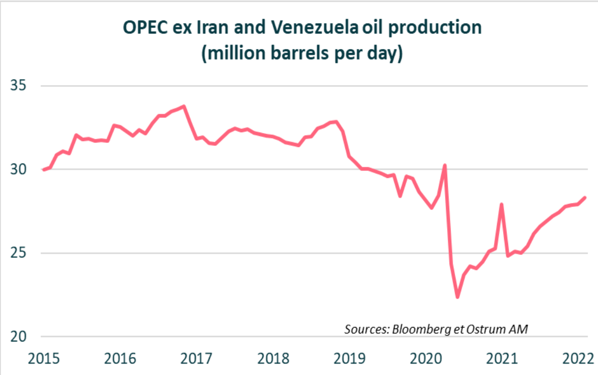
The main risk to Chinese oil demand is its housing crisis. However, the Chinese authorities have set an ambitious growth target for 2022 of 5.5% while the average between 2020 and 2021 was 5.1%, which should support its gross demand.

Inability (or unwillingness) of other countries to produce more.

The graph below shows OPEC production excluding Iran and Venezuela.

[1] https://www2.deloitte.com/us/en/pages/energy-and-resources/articles/covid-19-implications-for-us-shale-industry.html

[2] https://www.wsj.com/articles/american-frackers-show-restraint-as-oil-tops-70-11625823000



Production of other OPEC members is 2 Mb/d lower than in 2019. This means that other countries have not increased their production because they probably want to benefit from high crude oil prices to improve their budgetary and external situations. Aramco, the Saudi oil giant, paid $80 billion to the kingdom's sovereign fund in February. The OPEC+ member countries have so far resisted requests from the United States to increase production in order to lower prices. Saudi Arabia does not want the resumption of negotiations on the Iranian nuclear power and should therefore continue to maintain a firm position vis-à-vis the United States.

Other countries cannot increase production because of their aging infrastructure, such as Angola, Africa's second largest crude oil producer after Nigeria. The oil sector accounts for 50% of its GDP, 90% of its exports and 60% of its budgetary revenues. Between 2007 and 2015, the country was China's second-largest oil supplier, after Saudi Arabia, and was then outperformed by Russia and Iraq. 70% of Angola's crude oil exports go to China. Today its oil production is 22% lower than in 2007, at 1.17 MMb/d. Angola has also borrowed more than $42 billion from China, or 1/3 of China's loans in Africa over the period 2000-2019 and is repaying its loans in oil exports. The country must continue to attract China's interest in its oil, which has provided $6.2 billion in debt relief over the next three years. China's support[3] is expected to be less forthcoming than in the past because of its energy transition to natural gas as the only fossil fuel.

Conclusion

Oil prices are expected to remain persistently high. In the short term, the alternatives for easing upward pressure on prices are proving to be insufficient and OPEC does not want to increase production. Member countries benefit from current high prices that improve their budgetary and external situations. Other countries cannot increase their production because of their aging infrastructure. In the long term, the goal of carbon neutrality by 2050, especially for European countries, implies a drastic reduction in investment. The IEA report, Net Zero by 2050, calls on governments to refuse to approve any new oil and gas deposits by the end of 2021.
The crisis in Ukraine should also accelerate the energy transition for many countries, especially European countries, whose energy needs depend on abroad. The energy market is expected to be permanently disrupted, and this should translate into higher oil prices.

Zouhoure Bousbih

[3] MyStratWeekly : Emerging Countries Debt; Changing

Who will buy the Italian debt?

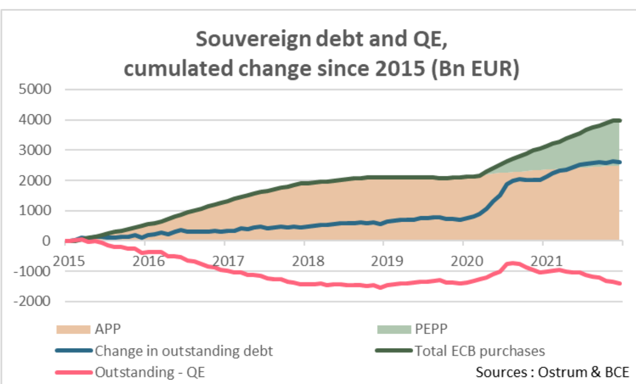
Italian banks from 2010 to 2015, the ECB since then, absorbed the Italian debt issue. With the end of QE, these two buyers disappear.

This week the ECB announced that its QE will be reduced in the second quarter: the end of the PEPP in March and purchases that drop from 40 billion in April to 30 billion in May and 20 in June. At this rate it is very likely that the program will not be renewed further. Although Christine Lagarde has told us over and over again that, given the current uncertainties, all options remain on the table. New version of Draghi's "We never pre-commit".

The fact remains that the ECB will no longer be the last resort buyer. And that, in terms of flows to absorb, radically changes the situation.

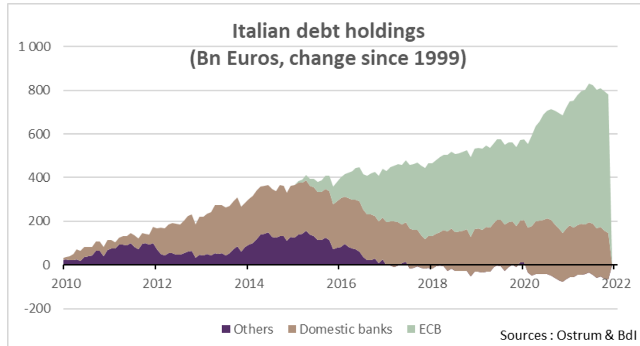
Some figures (all from the ECB): between January 2015 and the end of 2021, the Eurozone's public debt increased by €2,590 billion, while the ECB absorbed €3,987 billion. The sovereign market has therefore shrunk by 1,397 billion!

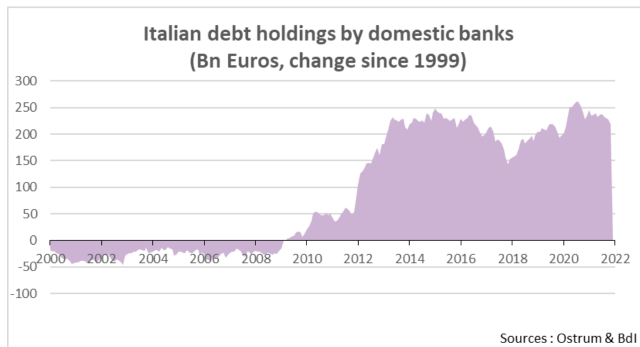
With the ECB gone, we'll have to find another buyer.

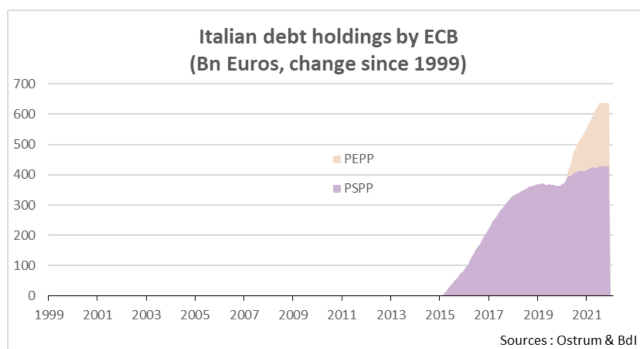


The reaction of the markets has not been long in coming: rising rates, the level of market equilibrium is no longer the same, and a jump in the risk premium, spreads have increased considerably.

Here we will focus on the Italian case. Everything is said in the three graphs opposite. Since the beginning of 2010 there have been two phases of absorption of the Italian debt. Over the first five years, 2010-2014, the debt increased by 330 billion, and domestic banks absorbed by far the bulk of it; two-thirds, i.e., 218 billion. Over this period, foreigners bought 54 billion, or a quarter, so they made up for the complement. Since 2015, the debt has increased by 451 billion, the ECB has bought 636 billion, which is more than the total net offer, which has allowed some investors to reduce their positions.







Two phases therefore, one during the sovereign crisis and before the QE, where domestic banks absorb the State's financing need, the other since the QE where the ECB not only matched the State's financing need but also offered a gateway to some investors. All this is a story of the past, we'll have to find a buyer.

And it may be a challenge!

Stéphane Déo

Market review

The ECB surprises

ECB accelerates tapering, extreme volatility in all markets

The war in Ukraine is entering its third week. The constant bombardment of Ukraine is appalling. The meeting, organized in Antalya, between Russian Foreign Minister Sergei Lavrov and his Ukrainian counterpart Dmytro Kuleba did not produce any progress. On the Russian side, Vladimir Putin remains, in any case, the only master on board so that any diplomatic effort in his absence has little chance of succeeding. The neutrality of the Ukrainian state is not understood in the same way by the two parties. Ukraine's non-participation in NATO is nevertheless a point of convergence, but Russia demands that Ukraine never joins the European Union. At the same time, tensions over energy are generating an unexpected warming of relations between the United States and Venezuela - and progress in Vienna for a nuclear deal with Iran while the UAE suggested an increase in OPEC+ crude production. Saudi Arabia is no doubt watching closely the negotiations between the EU, the United States and Iran. Sanctions against Russia are increasing, and Putin responded by banning exports of 200 products (including fertilizers), obviously excluding raw materials. In the United States, the $1.5 trillion US budget bill, including $13.6 billion in aid to Ukraine half of which is military spending, passed Congress. In Europe, there is now consensus on the need to develop European defense and a comprehensive energy independence strategy. The aim is to reduce dependence on Russian gas by two-thirds. The EU strategy should be communicated shortly.

This new EU debt will provide further market depth for what should become a euro benchmark bond. The ECB faces an immediate inflation problem amplified by the consequences of the invasion of Ukraine. Annual inflation stood at 5.8% in February. Price increases will continue to accelerate. The ECB announced a more rapid reduction in asset purchases. Purchases of the PEPP, which ends at the end of March, had already been slowing down for several months. The APP will be calibrated at €40 billion in April, €30 billion in May and then come to €20 billion purchases in June. The ECB will retain a considerable hold on the markets given the size of the forthcoming reinvestments, but the hawkish policy tweak was not expected by market participants. Christine Lagarde, also tipped as a possible next Prime Minister in France, insisted on the need to keep all monetary policy options open. The Bank is therefore studying alternative scenarios as the interest rate policy remains uncertain. The expected rise could come several months after the end of QE.

Regarding the financial markets, volatility remains very high and largely traceable to information from Ukraine. The surprise of an accelerated exit from ECB QE hence also spurred volatility propelling the yield on Bunds to a weekly high of +0.31%. Sovereign spreads, which had welcomed the draft European plan at the start of the week, widened sharply on the announcement of the reduction in asset purchases. The spread on the Italian BTP has thus risen to around 160bp against the Bund. Nevertheless, sovereign spreads did closer last week at tighter levels. The shift in the ECB policy stance has led to a reversal of the recent curve steepening. The German 2–10-year spread had contrasted with the sharp flattening observed in the United States. US inflation hit a 40-year high at 7.9% in February and all categories of goods and services indeed recorded increases way above the 2% price target. Household inflation expectations rose in March to 5.4% on the one-year horizon. The 10-year breakeven inflation rate is now trading near 300 bps. The Federal Reserve should therefore proceed with a rate hike on March 16, probably by 25 bps whilst putting an end to QE. Quantitative tightening could also be brought forward and carried out in conjunction with rate hikes. The objective of the QT will be to limit the flattening pressure. The US dollar appreciation and the tensions building up in the interbank money markets will, however, retain the attention of policymakers. That said, the risks to US growth remain measured at this stage, particularly given the surplus in the US energy trade balance.

The equity market is currently disconnected from fundamentals and seems to depend only on investors' perception of immediate risks. However, the lack of visibility on 2022 earnings surely requires a risk premium. Short covering trades are often violent during bear markets and Wednesday's trading session (+7% on the Euro Stoxx 50) is a great example of bear market rallies. Exposure to Russia (banking, food distribution) is obviously detrimental to stock performance, but it is striking to note the homogeneity of sectoral returns over the past week. Outflows from European equity funds have been massive since the beginning of the Russian invasion. The Euro Stoxx 50 is indeed down 16% in 2022.

The credit market remains under significant pressure, as are equities. In the United States, a bond deal nevertheless attracted 106 billion in demand, a sign that the markets are still functioning. In Europe, euro IG spreads trade around 150bp against Bunds. The iTraxx XO, however, eased about 50bp from its recent highs. The European high yield market (456bp) remains sold by institutional investors.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	14-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.35%	+33	+1	+27
EUR Bunds 10y	0.37%	+38	+8	+54
EUR Bunds 2s10s	71.1bp	+6	+7	+28
USD Treasuries 2y	1.82%	+27	+25	+109
USD Treasuries 10y	2.11%	+34	+12	+60
USD Treasuries 2s10s	28.6bp	+7	-12	-49
GBP Gilt 10y	1.59%	+29	+0	+62
JPY JGB 10y	0.2%	+5	-3	-1
€ Sovereign Spreads (10y)	**14-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	46.72bp	-2	0	+9
Italy	159.57bp	-2	+2	+24
Spain	97.99bp	-4	0	+24
Inflation Break-evens (10y)	**14-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.66%	-6	+61	+56
USD 10y Inflation Swap	3.11%	+3	+40	+34
GBP 10y Inflation Swap	4.71%	-7	+36	+54
EUR Credit Indices	**14-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	153bp	+2	+34	+58
EUR Agencies OAS	66bp	-6	+6	+17
EUR Securitized - Covered OAS	75bp	-8	+13	+29
EUR Pan-European High Yield OAS	455bp	-10	+75	+137
EUR/USD CDS Indices 5y	**14-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	80bp	-6	+12	+32
iTraxx Crossover	380bp	-34	+49	+138
CDX IG	75bp	-1	+8	+26
CDX High Yield	405bp	+5	+38	+112
Emerging Markets	**14-Mar-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	497bp	-15	+107	+128
Currencies	**14-Mar-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.098	1.124	-2.927	-3.5
GBP/USD	$1.304	-0.488	-3.607	-3.6
USD/JPY	JPY 118	-2.238	-2.052	-2.4
Commodity Futures	**14-Mar-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$105.9	-$17.3	$11.5	37.69
Gold	$1 959.9	-$38.2	$88.7	7.14
Equity Market Indices	**14-Mar-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 201	-0.01	-4.57	-11.9
EuroStoxx 50	3 741	6.52	-7.96	-13.0
CAC 40	6 370	6.48	-7.04	-10.9
Nikkei 225	25 308	0.34	-5.80	-12.1
Shanghai Composite	3 224	-4.43	-6.46	-11.4
VIX - Implied Volatility Index	31.19	-14.43	10.10	81.1

Source: Bloomberg, Ostrum AM

Additional notes

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