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The Investment Engineers

Pouring oil on troubled waters

- **Market has seen a 'perfect storm' in supply and demand**
- **OPEC can't risk a 'game of chicken' over production cuts**
- **Low prices are set to continue due to shale oil revolution**

Léon Cornelissen
Chief Economist

The oil price is likely to remain low as the market faces a 'perfect storm' that has affected both supply and demand, says Robeco's chief economist.

Brent crude, the benchmark world oil price, has tumbled by 22% in the year to date, sending a barrel of oil down to USD 84 in early November, its lowest level in over five years and below the cost of producing it for many countries.

However the ability of the world's leading oil cartel, OPEC, to cut production levels in order to artificially raise the oil price is quite limited, says Léon Cornelissen. In fact, the leading Middle Eastern producers have been strangely quiet on the issue, partly because they could wage a price war with the US, he says.

The US shale oil revolution has been partly responsible for massively raising supply, as it cuts its dependence on Arab oil, while at the same time demand for oil is falling as cash-strapped consumers use less fuel, and as countries resort to using greener power.

"The oil market has experienced a perfect storm from supply and demand side developments in recent months," says Cornelissen. "On the one hand, the oil market is currently experiencing a supply boom - the strong production volumes generated by the continuing oil revolution in the US has surprised everyone. US oil output is now running at the fastest pace since measurement began in 1983."

"At the same time the macroeconomic growth momentum of the global economy has slowed, leading to a less bright demand outlook for oil. The International Energy Authority cut its estimates for global oil demand growth by 250,000 barrels a day for 2014 and by 90,000 barrels a day for 2015."

"So the question that is now prevalent is *whether* the oil market is going to rebalance next year and if so, in which way this rebalancing process is going to take shape."

'The continuing oil revolution in the US has surprised everyone'

Benefits of low oil price

Cornelissen says the low oil price is mostly beneficial to the West, with research showing that a drop of more than 20% in oil prices typically generates an additional 0.4% in real GDP growth. This is mainly caused by consumers getting more spending power as fuel prices drop.

The oil price has plummeted since the summer. Source: Bloomberg

For the oil producers, he says a rebalancing in the market is needed, as the oil price in many cases has fallen below the fiscal breakeven level of production, which makes current market prices unsustainable from a sovereign budget perspective.

"However, the silence from OPEC's largest member, Saudi Arabia, about future production cuts following the sharp drop in oil prices has raised uncertainty about OPEC's strategy," he says. "This uncertainty has only increased after Saudi Aramco lowered its prices to the US and the Saudis did not hint on cutting production. This could suggest a strategy to gain market share instead of retaining pricing power."

Investors should also remember that OPEC, a collective of 12 highly diverse and often troubled countries from Angola to Venezuela, is not always unified, Cornelissen says. "The reluctance to cut production by Saudi Arabia could also be aimed at bringing more alignment and discipline among OPEC producers for a more meaningful production cut later on," he says.

"History (and game theory) has shown OPEC members to have an incentive to 'cheat' on production levels that were agreed at OPEC meetings, and the Saudis could use the recent price drop to increase their leverage over non-abiding members. It means the discussion at the forthcoming OPEC meeting on 27 November will be as tense as it will be crucial, as Venezuela has been calling for a production cut."

'History has shown OPEC members to cheat on production levels'

'Game of chicken' with the West?

Cornelissen says that OPEC may contemplate a 'game of chicken' with the US, given that many US oil producers are also suffering from the low oil price, and therefore they may be tempted to cut production themselves. However, this is countered by the scale of the US shale oil revolution and American political resolve to stop being reliant on the Middle East following the Iraq wars and continuing tension with Iran. And such a policy might also backfire within OPEC members, he says.

"Saudi Arabia knows that the longer oil prices stay below fiscal breakeven prices, the more stressed the fiscal situation in oil-producing countries becomes, risking civil unrest and geopolitical repercussions. This would be a price too high to pay for triggering a cutback in US oil production," he says.

In the US, Cornelissen believes that the dominant strategy is likely to be a continuing increase in production. "The lack of OPEC-like coordination mechanisms in the US industry and its history of maximizing output instead of cashflow leaves us with the view that the US oil revolution will continue," he says.

"Although it is very difficult to see how this potential game of chicken between OPEC and the US oil producers will play out, a return of oil demand could come to the rescue later in 2015. Although the US is clearly advancing towards energy self-sufficiency, it still remains dependent on OPEC."

'A return of oil demand could come to the rescue later in 2015'

Headwinds against oil price hikes

Further out, Cornelissen believes that headwinds for a rebound in oil prices will remain strong due to the impact of non-OPEC members such as Russia, which is one of the world's largest producers. "Even if there is a production cut by OPEC, non-OPEC supply will be encouraged to rise even further in reaction," he says. "Struggling emerging economies like Russia, Mexico and Brazil are clearly in need of additional oil revenues and will react with higher output if prices are propped up by OPEC."

Another impediment is the steadily appreciating dollar, he says. "A stronger dollar, as we expect for 2015, will be troublesome for the oil market as well because this makes the oil bill for importers outside the US more expensive."

"Therefore, our view is that oil prices are going to stabilize, but a significant rebound back to the USD 100-115 per barrel bracket will not happen next year. Prices will likely drift higher, but remain below USD 90 for Brent."