MacroVoices Oil Discussion:

OPEC Can’t Fix The Problem of Low Oil Prices

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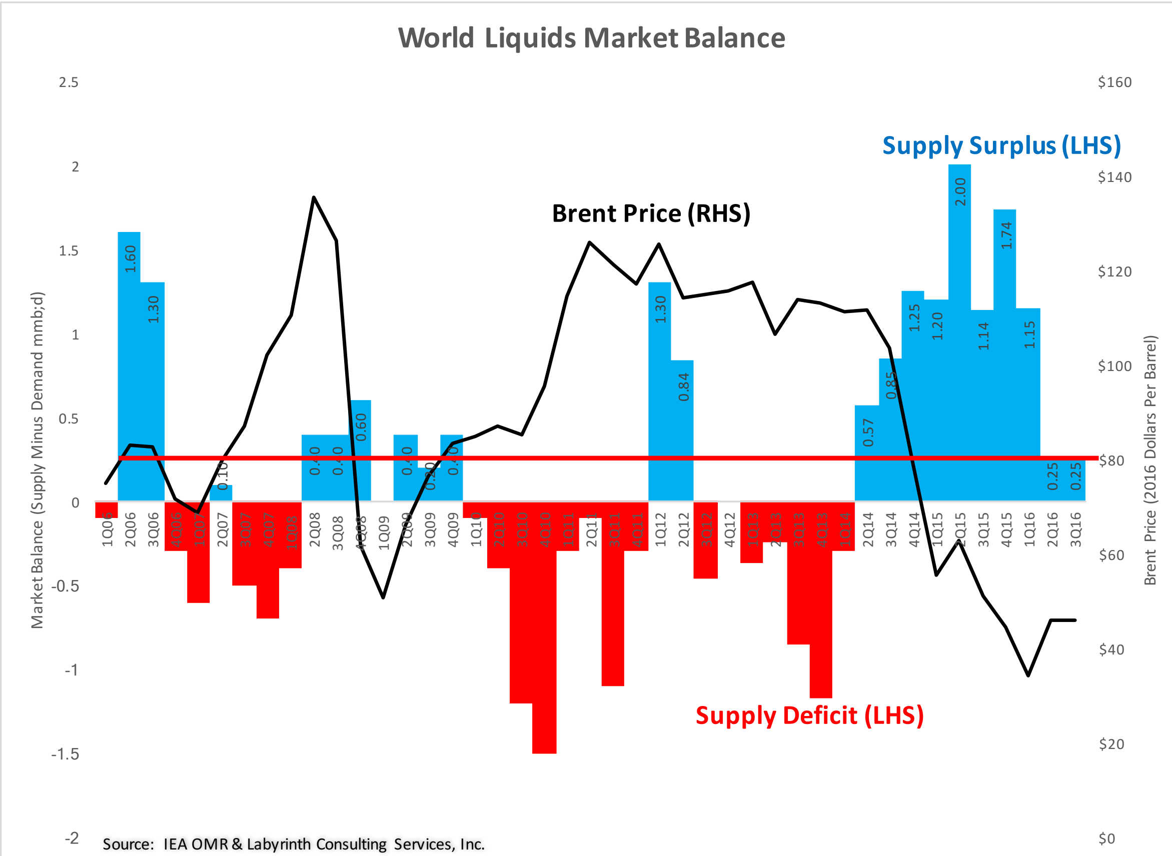
Overview: OPEC Can’t Fix The Problem of Low Oil Prices

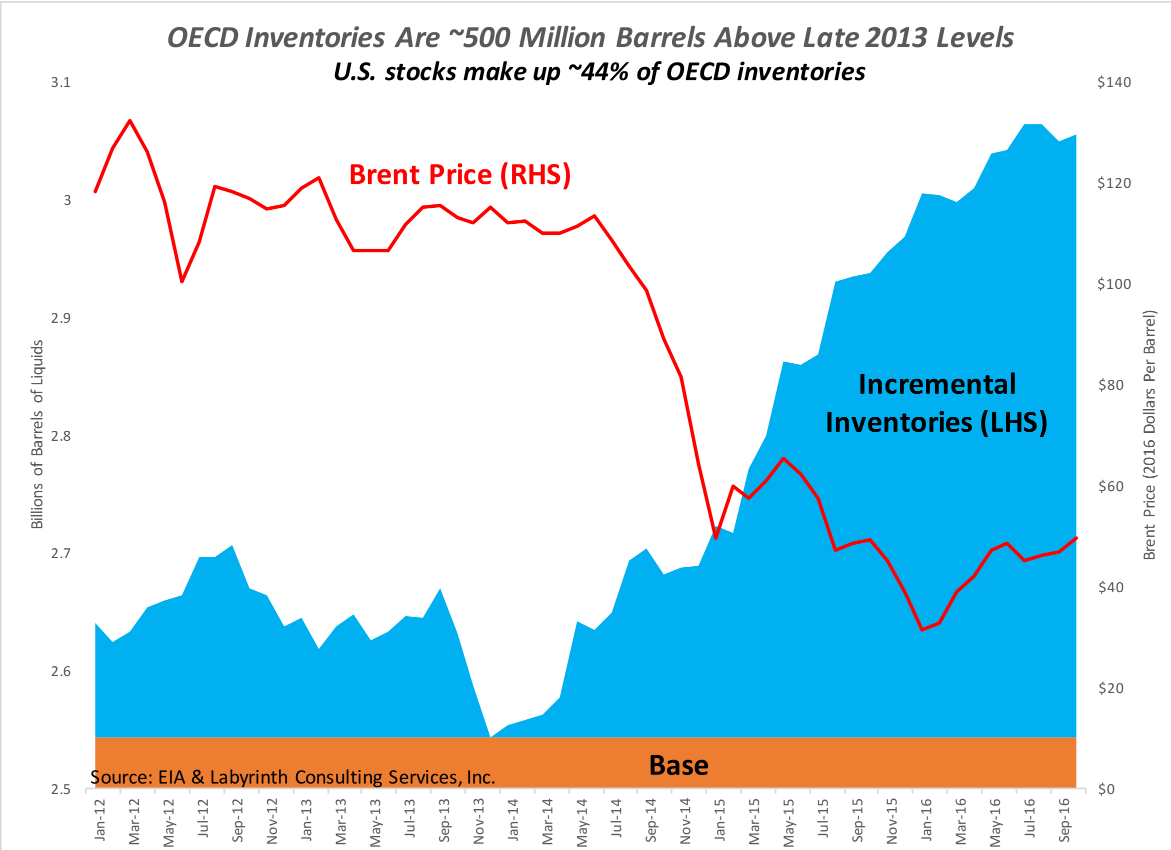
- OPEC may reach some agreement today on an oil-production cut…or not.
- In either case, execution will be more important than accord.
- There are at least 6 good reasons why a production cut can’t fix the problem of low oil prices.
  - The Market Is Already In Balance,
  - There Is Too Much Oil In Storage,
  - Demand Growth Is Weak,
  - U.S. Production Has Started Increasing Again,
  - OPEC Is Not As Desperate For Higher Prices As Many Believe…Yet,
  - It’s The Economy Stupid.

Reason 1: The Market Is Already In Balance



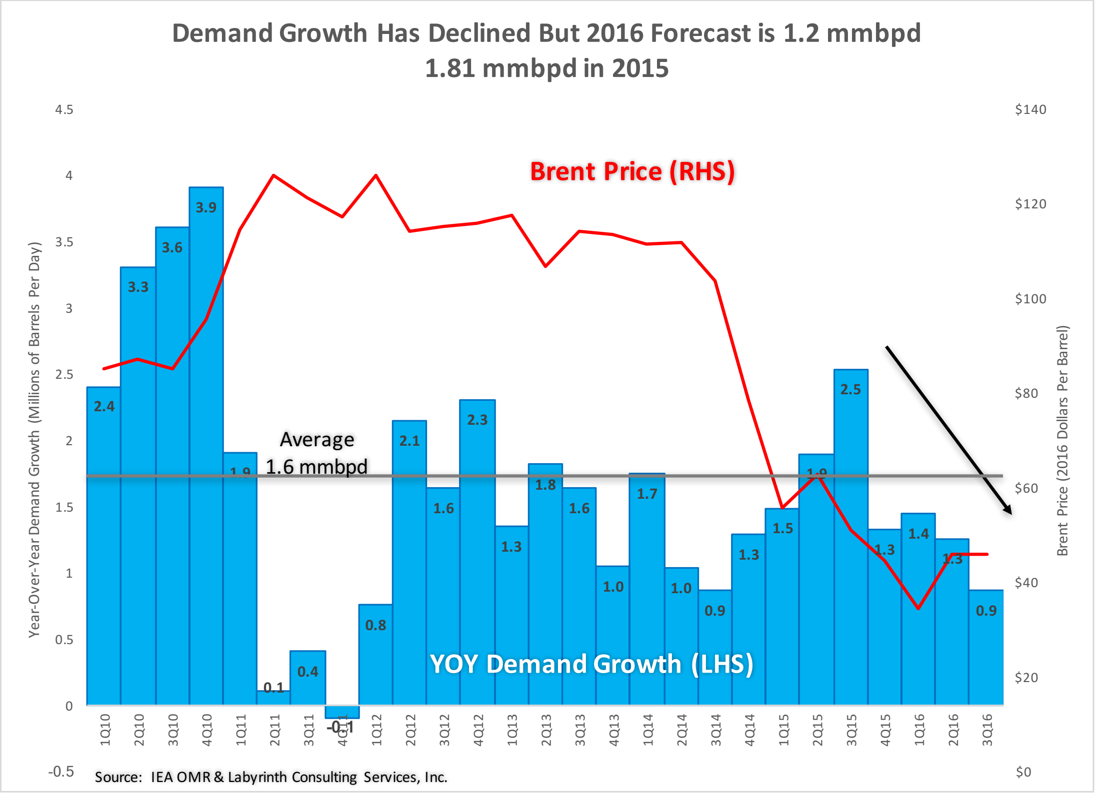
- The idea of a production cut is to bring the market into balance by reducing supply.
- But the market is already as close to balance as it ever gets.
- It has been just 0.25 mmbpd above balance for 6 months.
- Prices have not responded.
- Any price increase has been from expectation of an OPEC cut.

Reason 2: There Is Too Much Oil In Storage



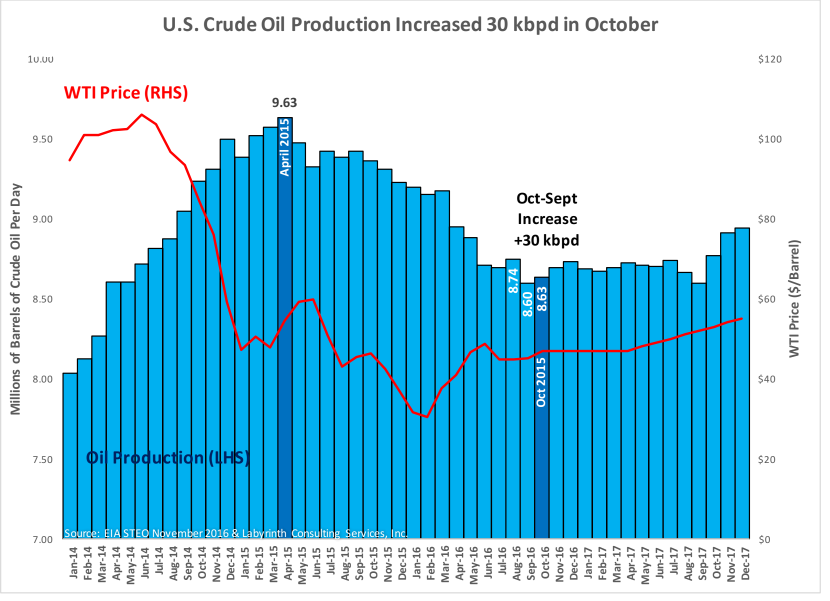
- The balance between production and consumption is only part of the story.
- Storage is part of supply.
- OECD inventories are 500 million barrels above late 2013 levels.
- That is the equivalent of almost a year of 1.5 mmbpd of surplus supply.
- Until inventories are drawn down ~350 million barrels, there is little possibility of a return to $80 per barrel oil prices.

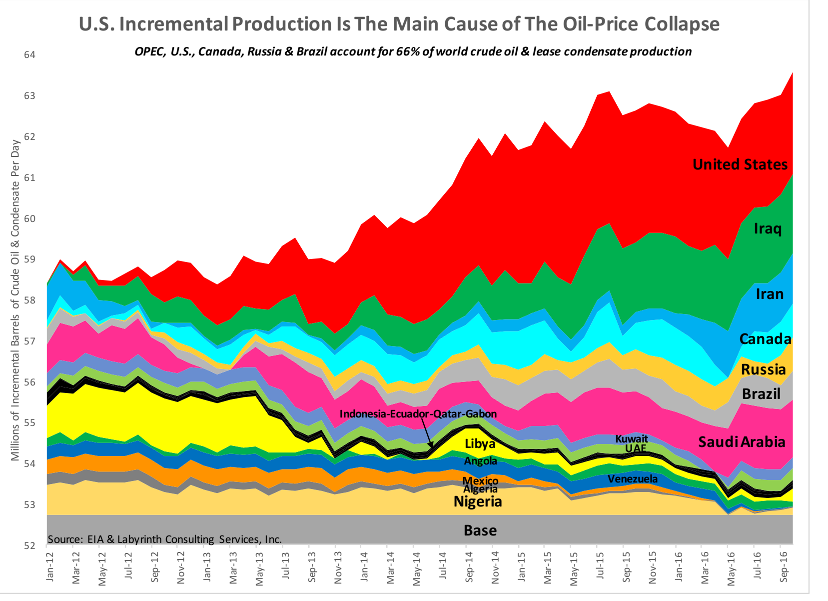
Reason 3: Demand Growth Is Weak



- Demand growth is at a 2-year low of 0.9 mmb/d year-over-year.
- That is the same level as during the quarter that prices collapsed in late 2014.
- Demand growth has fallen from 2.5 mmb/d a year ago.
- The 4-year average is 1.6 mmb/d.
- That is because demand is highly price sensitive in a weak global economy.
- Higher prices will further weaken demand growth
- This in no way supports “peak demand” forecasts.

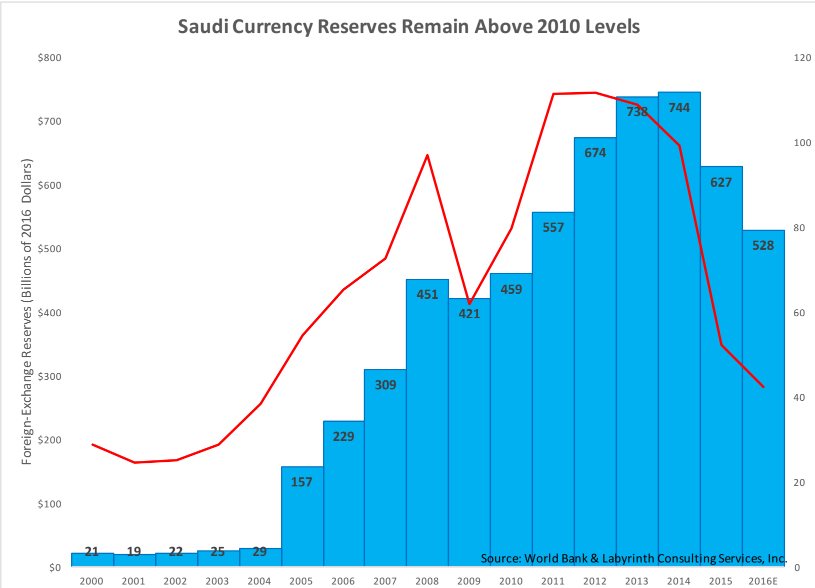
Reason 4: U.S. Production Has Started Increasing Again

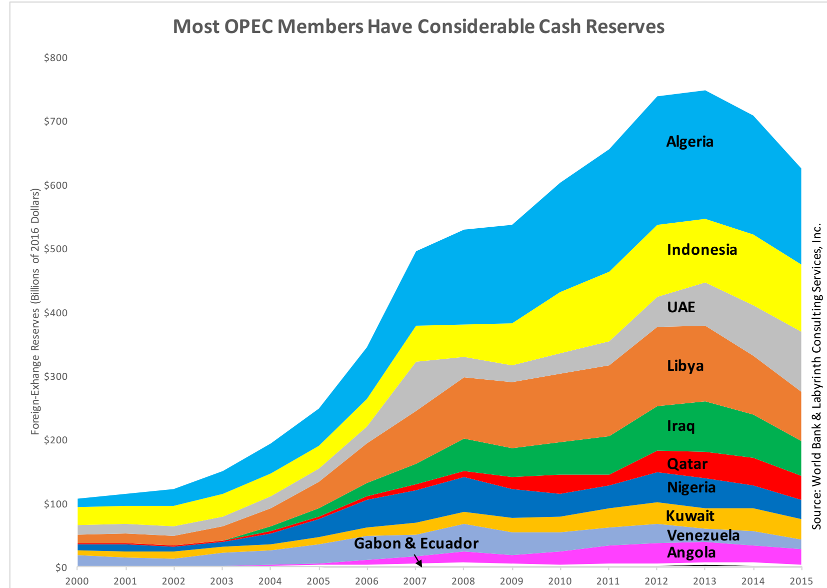




- U.S. oil production has already started increasing based on relatively stable prices in the mid-$40 range.
- U.S. incremental supply was the main reason for the over-supply that caused the price collapse in 2014.
- Higher oil prices will accelerate U.S. production additions.
- Iraq is a secondary contributor & Iran has increased 800,000 bopd since the end of sanctions.
- Overall, however, OPEC increases and decreases have balanced since 2012 except for recent additions by Iran.

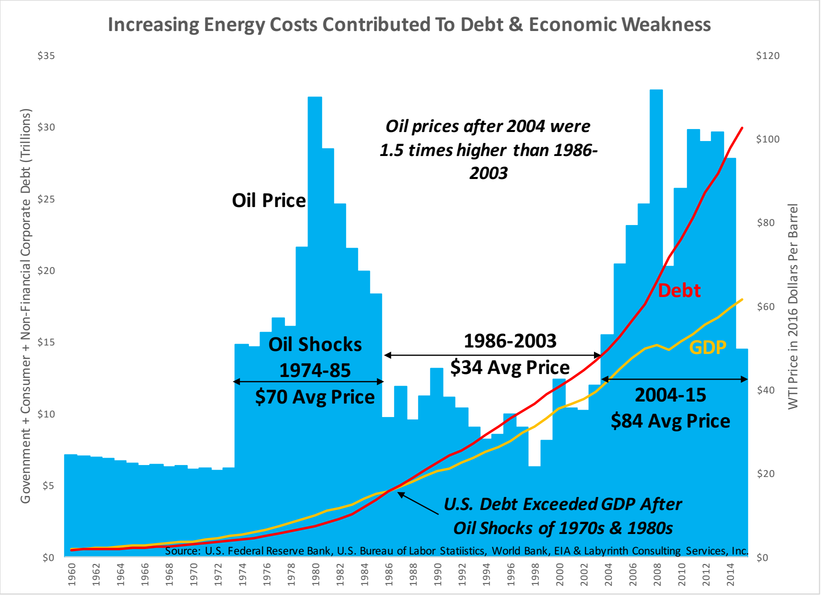
Reason 5: OPEC Is Not As Desperate For Higher Prices As Many Believe…Yet

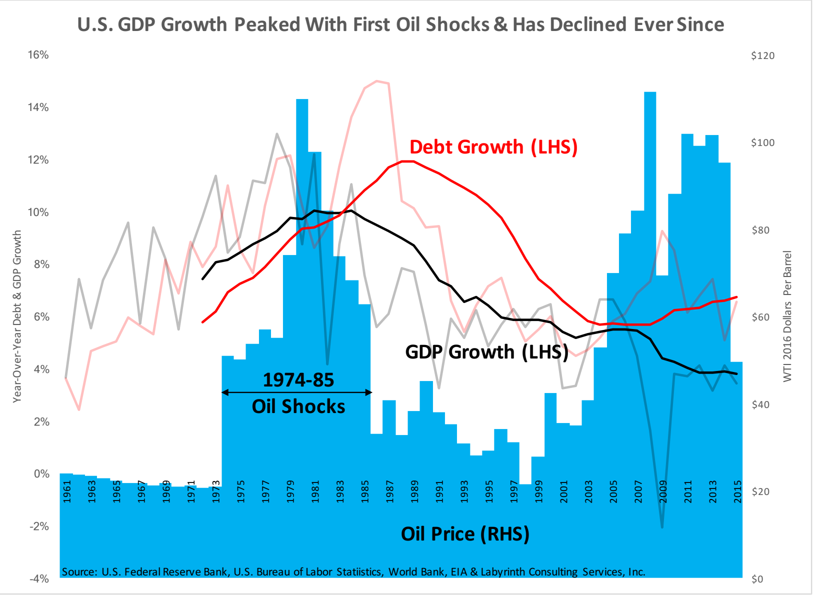




- The press gives the impression that Saudi Arabia and most OPEC members are desperate for higher oil prices.
- In fact, Saudi foreign currency reserves are still above 2010 levels despite drawing down almost $220 billion since 2014.
- Many other OPEC countries have considerable cash reserves: Algeria,Libya and Iraq are surprisingly strong (Iran is unknown).
- Nigeria, Venezuela and Angola are certainly in trouble but because of more fundamental problems than just low oil prices.

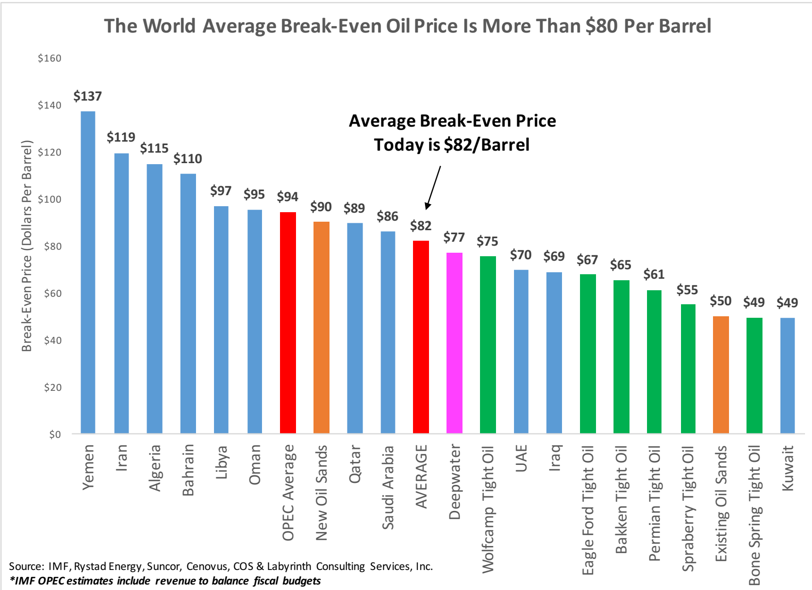
Reason 6: It's The Economy Stupid

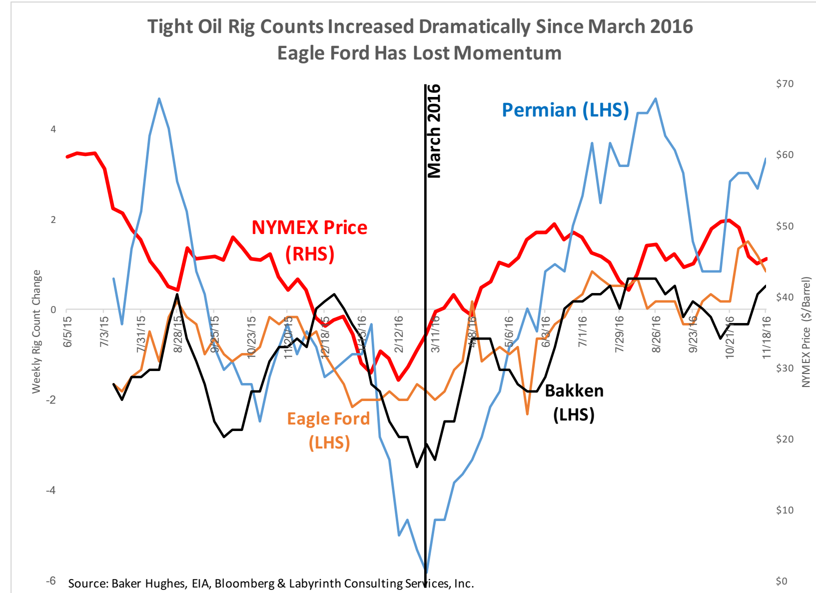




- The reason for low oil prices is more fundamental than market balance: it's the weak global economy.
- High oil prices from 1974-1985 structurally altered the global economy and led to increasing debt.
- U.S. debt exceeded GDP in 1986 after the first oil shocks.
- GDP growth has declined ever since.
- The U.S. is not the world but it leads all economic trends.
- Energy is the economy. Money is a call on energy. Debt is a call on future energy.
- The second oil bubble lasted from 2004-2014, only briefly interrupted by the 2008 Financial Collapse.
- U.S. debt reached 100% of GDP in 2012.
- Today's depressed oil prices are 40% higher than 1986-2003 in 2016 dollars.
- The oil-price collapse of 2014 is about affordability.

Conclusions





- Debt requires cash flow and zero-interest rates drive capital toward U.S. oil stock yields.
- Any increase in oil prices increases the flow of capital in a race to the bottom.
- More capital for drilling is followed by increased production.
- An OPEC cut will accelerate the self-destructive process.
- Saudi interests are focused on an Aramco IPO in a year when cash reserves may become critical.
- It has become increasingly clear that Saudi Arabia must bear a disproportional share of any production cut.
- A deal may result from today's OPEC meeting but I suspect that the real action will be later on after this effort fails following an initial boost in oil prices.