Crude Oil Special: Anas Alhajji, Joe McMonigle, Dr. Ellen Wald

June 14th, 2018

Part 1 Ellen Wald

Erik: Joining me next on the program as our first feature interview guest this week is Dr. Ellen Wald, author of *Saudi Inc. – The Arabian Kingdom's Pursuit of Profit and Power*.

Ellen, I think even you have been surprised by how many people are talking about this book. It seems to be on everyone's mind. And I know the approach that you took was to try to explain to your readers not the outside perspective but the inside perspective on Saudi Arabia, how they think about the oil market, and what they think that things are all about.

So please give us the high level – unfortunately, we don't have time today to go into all of the fantastic detail in your book. But, at a high level, how does Saudi Arabia think about the oil market?

And particularly, help us understand – so many investors are confused. It feels to us outsiders like in 2014 they really shot themselves in the foot, basically, crashing the oil market, cutting off their own sources of revenue.

Was it really an act of incompetence as some people thought? Or did they just see things differently? What's going on?

Ellen: One of the things when I set out to write this book was that I really wanted people to understand the backstory to that decision in 2014 by Ali Al-Naimi. I would say the most important thing to understand – and that I discuss in my book at length – is that the kingdom of Saudi Arabia has always managed its relationship with Aramco like a family business.

They have two twin objectives: long-term profit and power. And when they look at Aramco, they're not concerned about meeting, say, what their quarterly reports are going to show or their stock price. They're looking at this in the long term, in a generational perspective.

And so in 2014 when it seemed as though oil production was increasing around the world – there was lots of other sources – not just shale oil production in the United States but we had really increasing from all over – they went into that OPEC meeting and everyone thought oh, they have to cut production. If they don't they won't maintain the price they need for the budget and this is what has to be.

Instead, they surprised everyone by basically walking out and saying to heck with it, we're going to produce as much as we possibly can. And the reason, it seemed to me, was very clear: They knew that no matter how low the oil price went it was going to be that much worse for everybody else and not as bad for Saudi Arabia.

Saudi Arabia had 800 billion dollars in the bank. They could withstand a period of low oil prices for a future with higher oil prices. Because they were looking at a much longer term, even if it took two or three or even more years. And I think that we're seeing that playing out now.

Erik: Now, Saudi Aramco, historically, of course, it was actually founded originally as an American company. But shortly thereafter, it was taken over and nationalized by Saudi Arabia. And the crown jewel of Saudi Arabia is Saudi Aramco. They've never had an interest before in sharing it with anybody else.

So the talk of the IPO of Saudi Aramco, some investors have interpreted it as, well, this must be an act of desperation, they must have no choice. Because we know they don't want to be doing this. And I think that you and other people have expressed a different view, that maybe there's more to understand here in terms of the background.

So what do you think led up to this IPO discussion? And how serious do you think they are about being in it for the long haul with the rest of their investors?

Ellen: I think one of the most important things to understand about Aramco when we're looking at it in this IPO period is how the Saudis acquired the company from the Americans back in the '70s and 1980. And that's that they bought the company. They actually went out and they negotiated to buy the company in stages.

And then even after they bought it they maintained it as if it was an American company, which, in fact, it was. It was actually registered in the state of Delaware for eight years, until the Saudis finally basically recreated it as a Saudi company.

And that gives you an idea of how the Saudis have seen their relationship with Aramco. They didn't want to touch it. They knew that it was an excellently run company.

When I was there I had the opportunity to visit Aramco. The people there are incredibly proud of that American heritage. They see their company like Exxon. And, in fact, that's really the model they are striving to work towards as they expand their downstream assets.

They see themselves as a major IOC, not an NOC. And I really think that that is, in essence, where this IPO talk is coming from. It does seem to originate with the Crown Prince and his desires.

But in another sense, I see this as a natural progression for a company that was an NOC but has always seen itself as really a major international oil company. And it's expanding its research, it's expanding its downstream operations, in order to have a profile similar to that of an IOC. They are very, very proud of the patents that they've acquired and they compare it to the number of patents that, say, Exxon gets. It's really very evident throughout this.

So I think that when we're looking at how the IPO is going to take place, we have to look at it in that respect. It's not entirely the same as an IOC; it is a Saudi company. They've issued a charter that is not really either articles of incorporation or – it's kind of like a conglomeration of that. There are differences.

But when we do look at the company and where it's going, we have to understand that they don't see it as just another national oil company. And it isn't really just a national oil company. It's something else entirely.

Erik: You mentioned Crown Prince Mohammad bin Salman. I want to come back to him for just a minute. There were a lot of outside analysts looking in who thought Mohammad bin Salman was crazy at one point. He was talking about his Vision 2030, which was in part to diversify Saudi Arabia's business away from oil into tourism and other things that some outsiders thought was kind of crazy considering the natural resource that they're sitting on top of.

And at the same time, I've heard other people – Marin Katusa, particularly, on this program told us that he thinks MBS is perhaps the most brilliant leader in Saudi history and that he's the guy who really understands how to take the country forward and be successful.

So I've heard these just radically diverging views. You've spent much more time really looking at this from the inside out.

Tell us your perspective on Mohammad bin Salman. Is he the young prince who doesn't get it, as some have accused? Or is he really the genius guy who's going to be the leader that takes the country into the future?

Ellen: I'm going to come down somewhere in between those two. He's certainly making a break with the previous generations of Saudi leadership. He's a lot more active, especially when it comes to Aramco.

The previous kings had really, almost all of them had operated with this idea which is best expressed in something that Ali Al-Naimi said. He had a meeting with the king at one point and he kind of said I'm running your oil company. And the king was happy to let him – let them run themselves because they were making a lot of money for the kingdom. Let them do their thing, run it like a business, and the king didn't really interfere very much in it.

And Mohammad bin Salman definitely has a different perspective. He's not wrong when he's saying, look, Saudi Arabia needs to diversify its economy, because it may very well be – it is entirely possible that within his reign because Saudi kings tend to live for a very long time, Saudi Arabia may run out of oil. It's entirely possible.

So he's looking at this through, I think, that kind of a lens. He says, we're not going to stop being an oil producer. And oil and petrochemicals are still going to be a major, major sector of the economy.

And in many respects, actually, Vision 2030 – Aramco is a participant in it. They see their diversification in bringing in new petrochemical facilities and things like that as them playing a role in Vision 2030. But he's not wrong to try to diversify the economy to bring more Saudis into the workforce.

Sometimes I question some of the methods that are very statist. In particular, everything seems to be very much based on money and grants from the state as opposed to encouraging, say, private business. But that may be my American ideas talking. So I would certainly say that he's definitely got a vision and he's pursuing it. And it certainly needed to be done.

I do think that maybe in the grand scheme of things he'll come down somewhere in the middle between a super-visionary or a complete fool. But he's trying. And there are a lot of people in Saudi Arabia who are very excited by this. They have national pride in what's going on, and they see a new future. That may be one of the most important things that he has cultivated, in fact, is this exuberance among the people of Saudi Arabia.

Erik: Now, one of the things that is going on with bin Salman's leadership, which is very different, is it seems in many ways like they're kind of modernizing and they're allowing women to drive for the first time. So it seems like they're making progress on a women's rights front on the one hand.

On the other hand, inasmuch as I know you were treated very well in your interactions with them, we're hearing recently in the news that women's rights activists in Saudi Arabia will be put to death for the crime of speaking out against what they consider – it's really the same thing as the 1970s women's movement. They're speaking out. We didn't put them to death for that in the 1970s. That's actually being contemplated there.

So as a professional woman, how does this come across to you? Because I know they treated you very well. Yet other women who are trying to fight for equality are facing a death penalty.

Ellen: I'll be very, very frank on my feelings about this. I'm an American and I believe in freedom and I believe in democracy. And Saudi Arabia is none of those things. I don't like to say everyone should have our system of government, and people need to do what they feel is right.

But I cannot help but look at that situation and feel this incredible sadness and frustration because many people are very excited about these new freedoms. And yet at the same time the message that's coming across from Mohammad bin Salman and from the Saudi leadership is we – as in the government and the monarch – are the source of all of your freedoms. And anyone who thinks differently, who says differently, or who wants to express their desires, is going to be crushed. That is the message they're sending. And that's incredibly, incredibly sad.

Because the people that I met, and the people there, they want a better future for them and for their children and for their country. And imprisoning these women and the other activists who support them – it's not just their own lives – but they have silenced so many people who supported them, who tweeted about them, who helped them in any way. Those people are terrified and silenced. They are losing those voices and those are the voices of the future. So it's something that I do feel very, very strongly about.

I had a wonderful time when I was there. I think it's a very interesting country. I enjoyed my experience immensely. I would love to go back. But this incident, it should remind us that Saudi Arabia is a monarchy. It is an absolute monarchy and there are no freedoms there.

Erik: Wow. On that note, let's come back to your book, because this has just gotten everyone's attention in the industry. Where is the best place for people to find out more about it? Is there a website? Is it just Amazon? What's the best place?

Ellen: There is a website. You can go to saudiincbook.com and you can learn all about it. You can see some of the reviews that people have posted, some of the different things that people have said about the book from all different perspectives.

One of the things that I really tried to do in the book was tell a good story. I wanted it to be entertaining, I wanted it to move. I really wanted to tell an exciting story, because there's a lot of excitement in Saudi Arabia. There are a lot of interesting characters you're going to meet – people from long ago and people who are still alive today.

You can definitely find the book on Amazon. It's now available in the United Kingdom as well. So you can get it on Amazon US, Amazon UK, and Amazon Canada as well. It's also in Barnes & Noble bookstores around the country.

Erik: Well, Ellen, I can't thank you enough for a taking the time to tell us about the book and about Saudi Arabia. So thanks so much for joining us. Listeners, we'll be back with Anas Alhajji and Joe McMonigle as MacroVoices continues right here at macrovoices.com

Part 2 – Anas Alhajji and Joe McMonigle

Erik: Joining me now as our second feature interview are Anas Alhajji, an independent energy market analyst, and our old friend Joe McMonigle who heads up the energy policy and geopolitics group at Hedgeye. Both Anas and Joe are must-follows on Twitter – both very prolific and both incredibly knowledgeable about energy markets.

Gentlemen, thanks so much for joining us. I think the first question on everybody's mind is: What the heck is going on here? It seems to a casual outside observer that a few weeks ago Saudi Arabia didn't want higher oil prices, then they did want higher oil prices, now they don't want higher oil prices.

There's obviously more to this picture than meets the eye. So what is going on here? And what's driving it? Joe, why don't we start with you?

Joe: I think the main thrust of what's going on now, that seems like people are sort of changing their positions, is the fact that the market has really accelerated into a more balanced picture quicker than (I think) most people thought. One of the main drivers is the very successful OPEC-Non-OPEC production-cut deal.

But the bigger factor here is Venezuela and how quickly Venezuelan crude has come off the market. Venezuela was producing about 1.4 million barrels a day. It's probably 1.3 now, in June. Under the OPEC agreement, they could be producing close to 2 million barrels a day. So that's 600-700 thousand barrels extra that has really accelerated crude stock drawdowns and I think has really supported higher prices quicker than most people thought.

I was in the camp, and I think others were, that in the second half of this year we would be around between $70 and $75. Obviously, we got there pretty quickly at $80. And most of that had to do with Venezuela.

And then, of course, you had the Iran sanctions – which we've been talking about for a long time – that we expected to come. But there are a lot of people on the market that just didn't think Trump would pull the trigger on it. Well, he did. And so that really pushed things up to over $80. There isn't any crude yet coming off the market, but we certainly expect that there will be.

So I think that's the scene setter.

First of all, I have to say I don't think OPEC is going to give up that easily on higher prices. I think the Saudis are quite comfortable with prices around $80. They don't really see a production problem. The physical oil markets are pretty well-supplied, as I think Anas will talk about. But they really have a political problem instead of a production problem.

And the political problem is this: You know, higher prices, you've got some calls for action. Trump, of course, with his tweet a couple of weeks ago while the compliance committee was meeting in Riyadh I think really took them by surprise. I think there is kind of an implicit agreement to help because of the Iran sanctions. And that's something that Saudi Arabia and UAE and all the other Gulf countries support.

Then you have the Indian oil minister or energy minister [Dharmendra Pradhan] calling up Khalid al-Falih to say *We don't like these high prices, you've got to do something about it.*

Then you have Russia on the other hand, which has really been, all throughout the engagement in this production-cut alliance, always clamoring to review the agreement, raise production. They're under pretty considerable pressure from the Russian oil companies to increase production and exit the deal. They have major projects coming on line that make it difficult for them to stay in the deal.

And from the Saudi standpoint, I think they see the coordination with Russia being very critical, at least for the psychological impact on the market. You've got the two top producers who have the ability to coordinate market signals. They want to keep the Russians in the fold. So they didn't splash cold water all over this proposal a couple of weeks ago from the Russians to increase production by a million barrels a day.

But I think they've got a much lower number than the Russians do. I saw yesterday that the Russians are now adding 1.8 million barrels back to the market instead of a million barrels, basically going back to the pre-production-cut levels. I definitely don't think the Saudis are anywhere near that position. That story probably prompted a lot of " WhatsApp" texting among energy ministers over the last 24 hours.

So that's how I see the big picture of where we are, why we are here today. I'll let Anas offer some insights.

Erik: Before we go to Anas, though, I want to interject that we have a slide deck for our listeners. You can find the download link to the slide deck in your Research Roundup email. For any new listeners who are not registered yet, just go to Macrovoices.com and click on the red button that says Looking for the Downloads?

Anas, back to you. And feel free to reference your slides in the slide deck.

Anas: Joe is completely correct, especially on Venezuela and Iran. However, it is very clear that the market reacted strongly to what it perceived the Saudi position and the Russian position to be.

If we go back and look at every statement that Minister al-Falih or Minister Novak give to the press, or even sometimes privately, we see four key words in all those statements: stability, flexibility, coordinated, and gradual. Anything they are doing right now, basically fits those four key words.

We are talking here about market stability. Market stability requires flexibility. So there is no surprise here on the change in attitude or behavior, because it just fits with what they were saying and what is required from a swing producer.

Both of them emphasize the idea of coordinated – which means that they want all OPEC members and everyone else to participate in this decision, even if they cannot participate in terms of increasing production. Of course it's going to be gradual. And I think this is the most important point here.

Because if the Saudis decide to increase production it is going to be a small increase every month. We are not going to see a major increase in production all of a sudden. We already have seen some in May. Probably we will see the same level in the coming month.

But we also have to remember that we are coming into the summer demand. I'm not only talking about the driving season in the United States. We are talking about the power burn in Saudi Arabia and the rest of the Gulf countries and the rest of OPEC – North Africa and other places where demand for crude increases because of the cooling demand that increases with higher temperatures in the summer.

All of these factors together indicate that the issue is not that big in terms of the gradual increase in production. So the impact on price is still very limited, and the Saudis still want a higher price. At the same time, we have this higher demand that we have to meet.

And some of that demand is domestic demand. Therefore, we have to make a distinction between production – and production numbers that OPEC is going to announce later on – and net exports.

The reason is because we have large increases in domestic consumption in the summer within OPEC members. Therefore, if they increase production we want to know what percentage of it is going to go to exports. And therefore, the impact on prices, even with the increase in production, is really limited.

Erik: Why don't we talk next about the Iranian sanctions in particular? It seems like on May 8, when President Trump announced that the United States would pull out of the nuclear deal, that's where we saw the upside break out beyond the channel resistance line. It seemed like prices were headed to the moon. That lasted for a week or so.

And then, of course, we got the messaging out of Saudi Arabia and Russia. It seems like they wanted to put a stop to that rally. And, boy, did they ever.

Joe, why don't we start with your perspective? What is the real meaning and consequence? Is the market correctly discounting what the Iranian sanctions are going to mean? And how much does it mean?

Because I've heard a lot of conflicting opinions. Some people have said the re-imposition of sanctions on Iran changes everything. It's a complete game changer.

Other people have said Iran is going to keep exporting all the oil it wants to. They've got their own ships, they'll sell it to China and other countries that don't care what the United States thinks.

Joe, what's your perspective on the consequence and significance of the Iranian sanctions?

Joe: I think the market has been really underestimating the impact of Iran sanctions, and even Trump's willingness to do Iran sanctions. I mean, leading up to the event – we talked about this the last time I was on – I've always been very confident that Trump was going to do this. It was just a matter of timing. And I think there are still people, even now, who think that the sanctions are not going to be implemented as advertised.

I had one hedge fund guy tell me this is really just a bumper sticker thing for Trump. You know, check a campaign box. And it's not, really, at all. He's very focused on curtailing oil revenues to Iran. And he's been focused on that for some time. I think that's important.

Now he's got a different foreign policy team working with him. It's no longer McMaster and Tillerson, who I think were more open to maybe working with the Europeans and might have been a little bit more flexible with waivers and implementation of the sanctions. Now he's got Pompeo and (John) Bolton, who not only agree with Trump on the policy, but (I think) are going to be much tougher on implementing sanctions.

So the Europeans are trying to keep the deal together, even without the US, and the Iranians have kind of given them two months, I think until August 1, to try to keep the benefits of the deal, meaning the oil revenue primarily. But you also have airplane sales, which is another huge issue for the Iranians. And Airbus would certainly be impacted by that as well.

The Europeans have got to try to deliver to keep these benefits flowing. If they don't flow, the Iranians are going to probably exit the deal themselves. I think it's very likely they will and go back to pursuing their nuclear program. At that point, you're going to have the EU have to make a decision whether they're going to join sanctions or not if that happens.

So I do think there is probably another shoe to drop here, because there are a lot of people who still believe the narrative that the EU doesn't support it. So the impact of physical oil being removed from the market is going to be much less.

I think the point here is that governments do not buy the oil. It's the energy companies that buy the oil. So, yes, the EU and France and Germany are opposed to withdrawing from the deal. But Total and Repsol and BP and all these other European companies have big operations in the US. And even if they didn't have big economic exposure to the US financial system – they've all indicated that, unless we get a waiver from sanctions, we're going to comply – and that means we won't be buying Iranian crude.

Europe alone is about 600 to 700 thousand barrels a day, depending on the time of year. I think all of that comes off the market. Iran has added about a million barrels to global markets since sanctions were lifted – I think the number is close to a million barrels a day. Consensus is it's probably a lot lower. 300 thousand, I think, is the consensus number. So I'm a little bit on the other side of that.

But you have South Korea and Japan, who are also big purchasers because of the North Korea situation. I see them complying with the US sanctions.

The wild cards here are China and India. And both countries have made noise about continuing to cooperate with Iran. The Iranian oil minister traveled to India and the Indian minister said we plan to cooperate with Iran in energy. And, maybe four or five days later, the head of Reliance, the big Indian refiner, said we are not going to be buying Iranian crude anymore because of US sanctions.

So the question is, do India and China sop up all this extra oil that would be available? And I don't see that happening. I think China will still be buying oil, but I don't see them increasing their purchases as a result of US sanctions.

I think there's a lot of political reasons not to do that. They certainly want to stand up to the US, but they don't want to poke Trump in the eye either on this. So I see them maintaining current levels. I don't see them dramatically increasing.

So I do see physical oil from Iran coming off the market, and I see it being closer to a million barrels a day. You're already seeing companies announce plans to do that. I don't think we'll know for a couple of months how much physical oil has come off.

And, of course, the sanctions don't actually go into effect until November. So we'll see, I think, an impact later in the year. And it will be something that OPEC will have to probably address at their November meeting.

I don't see them getting ahead of the game on Iran though. I know there's a lot of speculation that they've got to do something because of Iran sanctions. I think it would be very unusual of them to do something in advance of having an impact on the market. And so I would expect them to maybe address that at the November meeting, not at this June meeting.

Erik: Anas, we've got a series of four slides, Slides 2 through 5 in the slide deck, that you supplied, talking about the significance of what's going on between Iraq and Iran. Please explain.

Anas: I will go to that in a minute. I just want to emphasize the point that, when it comes to OPEC members, especially the leaders of OPEC, they really want an increase in oil prices based on fundamentals, not political events. And, therefore, we see the possible increase in production from Saudi Arabia and other Gulf allies, simply because they don't want the oil price to be political. Especially in an election year.

Generally speaking, I differ with Joe on this. I see that the impact is way lower than one million. Like he said, it's probably 300 to 400 thousand barrels a day. And I want to explain why.

The impact of the sanctions on Iran is more in the long run as their investment in upstream dwindles and cannibalizes the equipment and the spare parts they have. The fact is, the Iranians have perfected their own game under sanctions. If you look at the previous experience and see what they've done, we know for a fact that, yes, their exports declined a little, but not much. And here is why.

If you look at the first slide, on the left side we have Iran's oil production based on secondary sources (that's where companies and shipping companies monitor those shipments, and from satellite they monitor storage and other activities) versus what the Iranian government reported to OPEC.

And at the left side here, during the sanctions you see there is a big gap between the green line and the orange line. At the same time for the same period, you look on the right side, you look at Iraq, you see the reverse of that. There is a gap there. And the government numbers are way lower than what shippers show as Iraqi oil coming out of the region.

What that means is that Iran was literally shipping Iranian oil as Iraqi oil. It's not necessarily going through the Iraqi facilities. It's just the paperwork of the ships is Iraqi oil, as shown in the chart. So some of that crude – illegally, basically – was in the market as Iraqi oil but is really Iranian oil.

And therefore it cannot be a million. It has to be lower than a million.

And then, we have to remember that Iran today has a currency deal with Turkey, with China, and Russia. So they can circumvent the international banking system using local currencies, especially with Turkey and China. They can use gold, as we have seen in the past. And they can use cryptocurrency.

So, in a sense, we are going to see Iran circumventing those sanctions. Will we see a decline? Yes. How big it is? In my guess, probably it will be 300 to 400 thousand barrels a day. That's the actual. However, we might see reporting of 800 or more, simply because those reports are not seeing the black market that Iran is using.

Erik: Anas, moving on to Slide 3 in the deck, titled "Oil Prices Increased at the Start of Disruptions, then Stabilized." Please explain. What's going on here? Why did they stabilize?

Anas: We got out of the financial crisis in 2012 with a very large spare capacity and we've seen OPEC cut at that time. That made the price jump from about $35 to about $75. When the Arab Spring started in February–March 2011, disruptions increased substantially. And, with it, we've seen increase in prices as we see in this chart.

But, as you see, prices peaked at the end of the first quarter of 2013, and then it relatively stabilized around $110–$120, but above $100.

The way to explain this is to look at what happened in terms of production and use of spare capacity. Moving to the following slide, really what mitigated the prices during the Arab Spring is US shale production. That yellow line is the same slide, I just added the additions from the US.

So that yellow line shows the net additions from shale from the United States. And you can see that it compensated for most of the disruptions that we've seen in 2011, 2012, 2013.

So US production was a factor.

Now we have to remember that at that time we did not have US oil exports. Now we are exporting, and exports are going up. And production continues to go up. So that trend, that yellow line, we are going to see it again once we have more disruptions from Iran and Venezuela.

Move to the next slide, and this is a very interesting slide because it plots the same disruptions against the spare capacity. As you can see, that line that represents spare capacity – that's global spare capacity, mostly in OPEC and mostly in Saudi Arabia. With the increase in disruption, that spare capacity declined.

And here is the interesting part, related to today's events and OPEC meeting next week. That flexibility of Saudi Arabia and Russia just mimicked what happened at that time. If we are going to have disruptions, OPEC members are going to use their spare capacity like they did in 2011 and 2013, and spare capacity will decline.

The question is, do we have enough spare capacity? Well, yes, we do. In fact, if you look at the disruption, at the peak of that disruption, you see it's about 3.6 million barrels a day at that time. And spare capacity was about 6 million. And then it declined to about 3 million.

So at the peak of the crisis, spare capacity was around 2.8 million but the disruption was about 3.6 million. Right now, the disruption is only 1.6 million and, according to the IEA, the spare capacity is about 3.6 million.

Now, if you don't believe in it, just take 1 million out of it – probably we have about 2.6 million. But, based on market fundamentals, we are way better off than where we were in 2012–2013, simply because we still have about 150 million barrels in commercial storage. That is above the level we had in 2014 and before.

We still can use the SPR. We can release 1.5–2 million barrels a day of SPR for at least three months without any problems. And then we have the flexibility of OPEC members to produce more.

So it's very hard to see a crisis similar to what we had in 2012-2013. And, therefore, it's very hard to see prices above $100, even with the loss of Venezuelan and Iranian oil.

Erik: Let's talk next about the range of possibility for what might happen going into next week's OPEC meeting.

I've heard every perspective possible, ranging from people saying the writing is on the wall, Saudi Arabia and Russia both want higher production. They're going to completely nix the production cuts. That's going to be cancelled, over and done with. And it's going to be a free-for-all from here.

Other people are saying the exact opposite, which is no, it's not a done deal at all. They were just messaging things to get the froth out of the market. It's very likely that we'll see a continuation, now that they've adjusted the market as they wanted to. They probably won't change anything.

Joe, why don't we go back to you for your perspective first. What do you think the range of possibility is for next week's OPEC meeting?

Joe: I think, as I said when we opened, I really see a more modest production increase. Not the million barrels that the Russians floated in St. Petersburg. And certainly not the 1.8 million barrels that they floated this week. And so I see something more symbolic coming out of this OPEC meeting.

Notwithstanding the fact that a lot of OPEC countries in particular – I'm not talking about the Non-OPEC, which is a probably most of them probably clamoring to increase production – but the OPEC members themselves are probably not very supportive of doing something that's going to depress prices. So we're already seeing disagreements.

Some of it is political, with Iran saying that they didn't want to see any kind of unilateral action. The Iraqi minister basically said that ministers should not be exaggerating the need for more oil and also said they didn't support unilateral action – almost echoing the exact messaging from Iran.

But you have other countries – Nigeria, Algeria, and others – who will be opposed to increasing production. And I really don't think the Saudis want to do it, but I think they feel like they have political issues they have to address.

Now, as Anas pointed out, they have already raised production by about 200 thousand barrels, but that's really to meet summer domestic demand for energy. So they've already raised – you know, it's being used, I think, to say, no, we're interested in increasing production. So it conveniently allows them to have some dual messaging. But it's something that they probably would have done anyway.

I guess the bottom line is I don't think that there is an option for no action or maintaining the status quo at this meeting. But certainly not a million barrels a day. And after that messaging in St. Petersburg at that conference that both the Saudi and Russian ministers spoke at, that's when you had the sharp drop in oil prices, based on a million barrels a day.

So anything short of a million barrels, I think, is probably bullish for oil prices. Even if they do five hundred thousand, which I think would be the high end of any kind of move. As Anas pointed out, probably with Venezuela you've got another half a million barrels coming off the market there.

By the end of the year, we're going to see some impact on Iran. We obviously disagree on how much. But even if it's not a million, if it's 500 thousand, that's another million barrels. So even if OPEC adds production, I think it's going to be pretty bullish for oil prices.

And just to quickly hit on the spare capacity issue, I think the EIA number for 2018 is just below 2 million barrels a day for OPEC surplus crude oil capacity. At least according to the latest short-term energy outlook.

So if you add production now that number is going to narrow, go down, which is sort of a mixed message to the market, I think, in terms of whether adding production is bullish or bearish. I think that's something to keep in mind.

The EIA is forecasting spare production capacity for OPEC at about 1 million barrels in 2019. So that's becoming tighter and tighter. And if you do have some big geopolitical event, you don't have a lot of cushion there. Although you do have the strategic petroleum reserve and of course some IEA action. But that's really last resort type of activity that you would see.

So I think that markets are going to be concerned about spare capacity decreasing as we move forward.

Erik: Anas, what's your take on potential outcomes from the OPEC meeting?

Anas: Generally speaking, it is very clear that the Saudis want a complete success of the agreement. Complete success of the agreement requires certain steps. And, of course, flexibility is part of it. So the expectation is to maintain the agreement. And it is very clear that all members want to maintain the agreement. So there is no end to the agreement, even by the end of 2018.

But we are going to end up with lower compliance. The issue here is, what is lower compliance? And I think that's where most of the discussions are going to be. And the best way to explain it is this: We have a ceiling, and you can lower compliance by either lowering the ceiling or increasing production.

Remember that, historically, OPEC made decisions to legitimize existing cheating. In essence, what they did is they raised the ceiling to match the production. Now we might see the opposite, where they want to maintain the idea and the appearance that the agreement is working by showing a very large compliance, despite the increase in production over the summer. So we might end up with people calling for lower ceiling.

So that 1.8 cut is going to be lowered while we see higher production. And therefore, we are at 100% any way you look at it.

Or we maintain the 1.8 cut, but we increase production to compensate for Venezuela, and others maintain 100% cut.

So the bottom line is: Maintain the agreement with lower compliance. The language could be surprising, that they are going to come up with, because they have done this in the past.

I just would like to comment on the 1 million barrels out of St. Petersburg, the one that I mentioned earlier, about the 1 million barrel possible increase in production. There was no mention of timeframe.

And we also heard from them that they will increase production "if needed." Those two words were dropped from several media stories. So, in a sense, like Joe said, it's going to be a gradual increase but not a big one. And it is very clear that we might end up with 1 million, but over a longer period of time.

Erik: Let's broaden this conversation out now to the bigger, longer-term picture. Some people are saying that we are at a crossroads in history here, where the US dollar is losing its prominence as the global reserve currency. The Shanghai yuan-denominated oil contract is certainly evidence that there are efforts afoot by some countries trying to displace the dollar as the standard of oil commerce.

I've heard other people say this is nothing more than a symbolic gesture. It's meaningless and it doesn't change anything.

If we look at the big picture of Saudi Arabia, its relationships with Russia – which is becoming so much more important in recent years – and China. And, also, what the heck is going to be the future of Venezuela? Because that is a hugely, hugely important oil-producer in terms of its potential, even though they're only producing a little over a million barrels a day now. That country could produce 4 million barrels if their government had their act together. So, at some point, I would hope that that's going to come back on line if we see a new regime in Venezuela.

What's your long-term outlook for the geopolitical interactions? And what are the most important things for investors to be paying attention to as this geopolitical story unfolds? Joe, why don't we start with you again?

Joe: I think we're yet to see the potential, if there is potential, for the alternative currency models for oil prices. But it's definitely something to keep an eye on. And maybe as sanctions get implemented, maybe we start to test whether there will be a more expanded use of alternatives to the US dollar.

You really hit the main focus, I think, for oil markets. Venezuela is kind of the key driver. It's creating so much geopolitical risk in the market now. It's really, as I said, accelerated the fundamentals to increase prices and has accelerated drawdowns in crude stocks.

Our forecast is it's basically another 500 thousand barrels by the end of the year. Based on that, this year they've been losing about 50 thousand barrels per day per month. I think there is a risk now that the country could totally go into chaos and you wouldn't just lose another half a million, you could lose all of it. And that would be, obviously, a big issue for oil prices.

Also, because the global refining sector is very dependent on the medium to heavier crudes – it's not really the light crudes that the US is producing here. So if you had a big heavy crude producer go down like Venezuela it would have major implications for the market.

But I think, also, as you point out, it has tremendous capability. That country, it's such a shame the oil riches that they have and the conditions in that country now are just horrible. I was just in Colombia this past week and there are tons and tons of Venezuelan immigrants in that country, and it's just so sad to see.

But if there is some kind of political change, and you could have a new government, I don't think it would take long for them to increase production. Part of the reason the production is gone down is the army is in control of production now, and you just don't have as many rigs operating right now.

I think if you had a new government that was at least more competent, you could see that production rise quite quickly. And, of course, that would have the opposite impact on the market.

So I think Venezuela is the key driver here. Non-OPEC production is forecast to rise over, I think, 2019. And so I think you could see the call on OPEC oil actually be lower in 2019. So I think that's another reason why OPEC may not want to get ahead of itself here and prematurely raise production, until they see what the market conditions are.

Erik: Anas, what's your take?

Anas: Generally speaking, when we talk about the yuan-denominated contract in China, we have to distinguish between pricing in dollars and getting revenues in dollars. All we are seeing here is we are seeing a price in China that is highly correlated with other prices. So the pricing remains in dollars. There is no independent pricing in yuan.

And I think this is going to continue, no matter what. Oil will be priced in dollars. But we might see revenues collected in other currencies like we've seen historically with Iraq, Iran, and other countries like Venezuela now.

However, we have to emphasize the role of exchange rates and the role of the appreciating dollar today. And the Saudi decision and the Russian decision to increase output, if they increase it, of course, officially in the next meeting. Simply because, aside from the political issues, the most important factor impacting demand right now around the world is the appreciating dollar. Simply because it's making fuel more expensive in various places around the world.

Looking at India specifically, since India was mentioned several times on this show, the reason for the increase in India, or why India is really worried about the impact of higher oil prices, has nothing to do with OPEC and the increase in oil prices. It's really the heavy taxation of petroleum products since 2014. I think they increased taxes five times in only four years on petroleum products.

If they are really serious about mitigating the impact of high oil prices, they should lower taxes. They can use fiscal and monetary policy to mitigate that as they've done in 2006, 2007 and early 2008. But the higher dollar is not helping them. Every time the dollar increases, they get more pain in India.

So the bottom line here is that exchange rates matter, no matter what.

Erik: Gentlemen, what I'd like to do next is go back to our slide deck. Looking at Slide 6, I've got a chart here of continuous contract front-month WTI crude oil prices.

And I apologize, listeners, for the noise in this chart. There's every moving average known to man shown in this chart. For the purposes of our conversation, we don't really care about that. What we care about is the purple channel, the two parallel lines where the price has mostly been moving between them. And the dotted orange vertical line indicates the point at which Donald Trump made the announcement that the United States would pull out of the Iran nuclear deal.

And after that announcement, we see prices break out above that purple resistance line. We're kind of hugging along on the top of the line there. It seems like maybe we're getting ready for an upside breakout.

And that's the point where Russia and Saudi Arabia decide to, at least for a while, put a blanket over this party and make their announcement that they are both considering increasing production. That's where we see the collapse about ten days after President Trump's announcement, where front-month prices fall all the way down below the lower support line, the lower purple line. And now they're just hugging the line there.

It feels to me, if I look at this chart in isolation, it seems like we're hugging along on the bottom of that channel bottom support line. Maybe we're about to climb back up into the channel. Maybe the market is just waiting for confirmation from the OPEC meeting and we're headed higher, is the sense I get from this.

But the thing is, a lot of analysts consider backwardation as a very strong leading indicator of what's going to happen next in front-month prices.

If we move on to Slide 7 – and I really want to give credit where it's due because, Anas, I think it was the day of the president's announcement about pulling out of the Iran deal, Anas tweeted, saying backwardation is going to be much less. And quite a few people, myself included, responded to that saying, Anas, what are you talking about?

Backwardation normally indicates tightness in the market. Iran coming off line because of sanctions can only mean more tightness. It shouldn't mean less backwardation. It should mean more backwardation.

And Anas very confidently replied, no, this business about leaving the Iran deal was priced into the front of the curve but not the back of the curve. And what you're going to see next is the back of the curve is going to adjust. And that's going to result in a reduction of backwardation.

Well, holy cow, Anas, I've really got to hand it to you. Look at just two days after you said that, this chart on Slide 7 is showing us backwardation. This, specifically, is the degree of backwardation in 2019. It's a measure of the difference between the December 2918 delivery contract and the December 2019 delivery contract.

Now, on this chart, we go through that lower support line. But we don't stop there. The price has outright collapsed down to that lower orange line, the 200-day moving average. It looks like it's consolidating there and trying to decide what to do next.

So this really, to my mind, begs a question. If backwardation is often a sign of what could be coming next in front-month prices, this chart, if I look at it without considering any other factors, seems like it is predicting an outright collapse of oil prices. So I want to get your perspective on that.

Before I do, in the interest of time we're not going to be able to get into all of these charts.

Moving on to Slide 8, for any listeners who are not familiar with this concept of backwardation, backwardation refers to each successive delivery month contract. So each of these yellow dots that you see depicted on Slide 8 is the price of oil in a different delivery month. The first one is July of 2018, then August, then September, then October and so forth. And this chart goes all the way out to 2026.

What we're seeing is this downsloping condition of lower prices over time. It's called backwardation. The light yellow in the background – that's what the curve looked like back on May 10, two days after President Trump's announcement. There was a very steep backwardation. Higher front-month prices, lower long-dated prices.

What we've seen in the last month – from May 10 to June 11 is the brighter yellow color – not only has the front-month price dropped dramatically, but normally if the front-month price goes down dramatically we would expect the back-month prices to go down in sympathy. They went the opposite direction. Back-month prices are going up even as front-month prices are going down.

So as Anas predicted so presciently, what's happening here is the market is discounting in the effect of the Iran sanctions and causing those longer-dated prices to move higher.

That's depicted also on Slide 9. What you see here in the bar chart is the front-month futures contract in a continuous contract format. Then all of the other lines below it are individual contracts going all the way out to 2024, showing us what each of those contracts did.

And you see those very steep increases in price, right after the Iran nuclear announcement, are so steep at the back of the curve. It's because, just as Anas predicted, the long-dated prices are adjusting dramatically upward in reaction to the Iran announcement, even as, in some cases, the near-dated prices are moving down at the same time.

I'm going to save the rest of the deck for now. We'll come back to that later. But I want to go back to Slides 6 and 7, because you guys are both experts on this. I think there's more to the equation than just backwardation.

If I look at this dichotomy, Slide 6 suggests to me that the prices may be about to recover to the upside. Slide 7 seems to predict, if you believe backwardation as a predictor, that prices are about to crash.

How do you guys see this? Where do you think that front month price is headed? And where do you think that this trend in backwardation is headed? Joe, why don't we start with you again?

Joe: I don't see a crash coming. I think there's just so many fundamental factors pointing to increased demand and so many geopolitical events removing physical oil from the market that we're about to enter, I think, a very tight oil supply/demand phase.

The other factor here that we haven't really talked about is there hasn't really been a lot of capital investment in new supply. Mainly because prices until the last couple of months have been kind of depressed. And so I think companies are now thinking about some of these capital investment projects.

I think we need to see some big offshore megaproject type investments. There are a few oddballs throughout the world, but you haven't really seen Exxon or any of the big oil majors announce some big projects. And, until we start seeing more investment in further supply, I think we're going to be in a period where oil prices are going to be tight because of the supply/demand picture.

And, absent some kind of recession, I don't see any kind of relief coming here. I think prices are heading higher. I don't see them heading lower in the near term.

Erik: Anas, let's go to you. Why don't we start with front-month prices on Slide 6. Where do you see things headed from here?

Anas: Erik, if people want to know the importance of OPEC meeting next week, they should look at your two slides and your explanation of them. And how one of them tells that prices are going up and the other one is going down.

This is really what the significance of this OPEC meeting is. It is a very significant meeting because it is going to determine whether prices will go back to that channel or they are going to decline.

Probably, by now, you are already aware of President Trump's second tweet about OPEC. And I think that means the political pressure is still on. And we will see how OPEC officials are going to respond to his tweet today. But it is very clear that we are in an election year in the United States. No party and no president want higher gasoline prices, and they want to give at least lip service to the voters. How would OPEC react to that is going to determine, really, what is going to happen to the front-month.

I like what Joe said, that the reaction is going to be mild. It is part of the policy to have a gradual increase in production. They can satisfy Trump on one side and satisfy their needs on the other. So the idea of prices collapsing is not in the picture right now.

But, at the same time, it is very hard to see a large increase immediately. But, once we come to July and August, I think we are going to have a completely different picture. The whole chart is going to look different by then, simply because we have the domestic demand in the oil-producing countries usually in the summer.

At the same time, what people ignore is the fact that those oil-producing countries have extra money for the first time in about three years. And that's going to show. So we have more economic activity in those countries. Between the weather and the economic activity, we are going to see higher domestic demand in those countries. And it is very hard to see a decline in prices.

Erik: And since you so brilliantly called this collapse in backwardation which began on May 10, what do you see from here? Is this ending? Has it got further to go? Is the 200-day moving average that we see as the yellow line at the bottom of Slide 7, is that going to contain it? Or do you think that maybe we've got further to go?

Anas: It all depends if we are going to have a big political surprise or not. And that's really an issue. Of course, we have Venezuela. We don't know what is going to happen. Now we predict a decline in production in Venezuela.

But what about unpredicted? And that's where the issues are.

For Iran, what if there is something cooking for Iran. In essence, what if all this increase in production is really coordinated because there are more than sanctions and even more stringent policy toward Iran than what even Joe mentioned earlier? So it is really those surprising political events that are going to determine that. A big surprise is going to make backwardation probably worse than before.

Erik: So, potentially, it goes to higher than it was before. And, without surprise, do you think it stays where it is? Do you think it can collapse further? What's the other side of the coin?

Anas: I think the curve is going to flatten. Especially once we know the impact of the sanctions and what is going to happen by that time. Because people will start reacting to the long term by that time rather than just front month.

Erik: So a continued flattening of the curve in absence of geopolitical surprise and, potentially, a return to even greater backwardation than we saw at the peak in the event of that geopolitical surprise. So it's very much dependent in your eyes on where the geopolitics take us next.

Anas: Correct.

Erik: Fantastic. Well, gentlemen, I can't thank you both enough for a fantastic interview. In the interest of time, we're going to have to leave off the end of the slide deck.

For our listeners' benefit, starting at Slide 10 I've broken out this trend in backwardation by year on Slide 10. Then on Slide 11, I take it into 6 month intervals, and then quarterly, and eventually we get down to monthly on the final slide.

And it's very interesting to see how the various geopolitical events, the Iran announcement, have been turning points and some kind of mysterious behavior on a couple of months.

Particularly, I'll just ask you this Anas. If you look at Slide 14 in the deck, we see that September–October of '18 and also August–September of '18 – those two monthly contracts seem to have just completely departed from the rest of the pack and they're off on their own, rebounding dramatically. Almost as if the market is expecting some tightness event immediately after the OPEC meeting.

Any insight on what might be going on there?

Anas: Generally speaking, there were many media reports talking about the collapse of the meeting, they are talking about the collapse of the agreement. The Russians had a statement a few hours before the meeting indicating the possibility of the collapse of the agreement. And then the result was exactly the opposite.

Erik: Okay. So it sounds like you think that these changes that we're seeing in the term structure are reactions to the news flow about what may be happening in next week's meeting.

We're going to have to leave it there in the interest of time. Before we go, though, for people who want to follow your work, what is the best way for them to do so? Joe, let's start with you.

Joe: I'm on Twitter, @joemcmonigle is my Twitter handle. And, of course, if you are a subscriber of Hedgeye, all my stuff is available there. I'm occasionally on The Macro Show, that I think a lot of your listeners know, that's hosted by Keith McCullough. We talk about OPEC and oil prices quite a bit because it's really, as you know, part of the big macro picture.

Erik: And Anas.

Anas: Twitter account is @anasalhajji and you can find that on the chart on the slide deck. And on my website anasalhajji.com there are many what I call timeless articles you can pull at any time, and they can look like they've been written yesterday.

Erik: Gentlemen, thank you so much for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.