Daily Note

OIL – SHALE REALITY

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- **US shale in transition from 'growth at all costs' to sustainable expansion**
- **OPEC's tightening bias raises the risk of a price overshoot later this year**
- **Oil equities to play catch-up with crude as the forwards curve shifts higher**

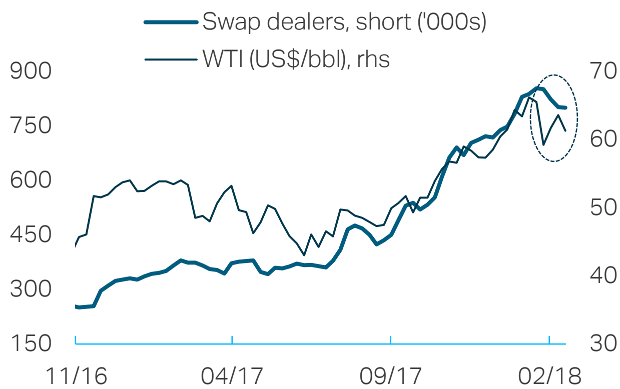
February's sell-off took some froth off the oil market. But it was also a reminder that abrupt shifts in interest rates and risk sentiment can trump fundamentals in the short run. As the dust settles, prices and spreads are back to roughly where they started the year, only with somewhat higher volatility attached. Is the market just taking a breather, or will the ongoing acceleration in US tight oil supply keep prices on the back foot?

Besides their conviction on sustained demand strength, investors are gradually coming to terms with the fact that the second wave of the US shale revolution (since late 2016) is qualitatively different from the first (2011-15). While US shale oil undoubtedly remains in a growth phase, there is a shift from 'growing at all costs' to achieving sustainable expansion. The 2014/15 downturn exposed the industry's vulnerability to sharp falls in oil prices, providing a valuable lesson for both producers and their financial backers. With prices having recovered, investors are now paying more attention to returns and the balance sheet. The new buzzword is discipline, on both supply (to prevent another glut that saps margins) and capital (as Goldilocks gives way to tighter financial conditions). The operating environment has become tougher, too, challenging the view that the US shale supply response is 'linear'. Oilfield service costs are rising and Trump's steel tariffs could end up boosting them further. Capacity constraints (e.g. pipelines/sand/crews) have started to bite and, with the best drilling locations in North Dakota and South Texas largely already tapped, growth is increasingly dependent on the Permian basin.

US producers' latest earnings calls sent the same message. Output was robust in Q4, yet several companies have dialled down their (still strong) guidance for this year, with supply bottlenecks pointing to backloaded production in H2. Budgets are pencilling in WTI at around $50-55/bbl, consistent with a growing focus on higher dividends and buybacks.

Hedging takes a breather

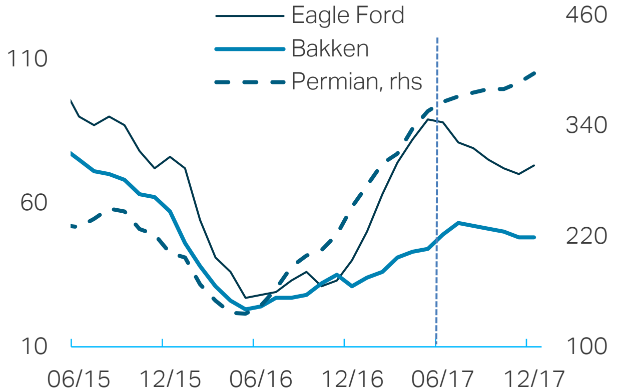
CFTC Nymex crude oil contracts



Source: CFTC, Bloomberg, TS Lombard

All about the Permian

Operating oil rigs



Source: Bloomberg, TS Lombard

Will oil prices stay high, supporting US shale's transition? The big picture remains bullish, underpinned by solid fundamentals. The inventory glut has shrunk meaningfully and OPEC+ is determined to do whatever it takes to avert a relapse. US drilling activity is picking up, with the EIA expecting production to average 10.7mb/d this year, on course to overtake Saudi Arabia and Russia. Yet strong oil demand from Asia and EMs in general is keeping the market sanguine about quicker shale output growth. Foreign demand for US crude is soaring. Surging export volumes have effectively raised the speed limit on US output implied by domestic consumption and refineries' need for heavier grades (the legacy of US reliance on imported Saudi crude). A weak dollar does no harm, in this regard. Meanwhile, declining output from Venezuela and geopolitical tension in the Middle East continue to pose upside risks for prices.

Near term, however, oil prices are facing headwinds. Successive upgrades for future US crude production, higher financial market volatility and escalating protectionism, combined with softer PMIs, are keeping investors nervous, at a time when speculative long positioning is stretched. After a strong nine-month run, the drawdown in US crude inventories is also starting to show signs of exhaustion – not least as we are entering a period of seasonal weakness (refinery maintenance). With US output on course for a strong H2, the pressure on OPEC to prolong the supply cuts – even as it sees its market share erode – will rise going into the cartel's June meeting. Any chance of the alliance winding down the output reductions hinges on (1) global oil demand re-accelerating, and (2) non-OPEC output growth disappointing. Both seem like a tall order. The IEA sees Chinese oil demand cooling, leaving India to pick up the slack. Non-OPEC supply is also expected to match nearly all incremental global demand in the coming years. This leaves little room for the cartel to step back from supply cuts anytime soon.

Oil at around $60/bbl strikes a good compromise between satisfying OPEC's fiscal needs, incentivising investment and keeping a leash on US shale expansion. But with Aramco's IPO in the offing, the risks look asymmetric: OPEC is more likely than not to err on the side of tightness and keep the rebalancing objective alive for longer. We have long argued that, as the market moves closer to balance, the strategy of OPEC+ will morph into an open-ended 'put', i.e. a commitment to lean against persistent deviations from (an evolving definition of) price stability. Recent official remarks seem to confirm this view.

As it becomes clearer that OPEC+ is veering to a lower-for-longer supply policy and there is more evidence of balanced US shale growth, investors could start treating $60 as a price floor – so long as consumption remains healthy and (as we expect) the dollar stays weak. With oil stabilising at higher levels, the propensity of US shale producers to continue aggressively hedging future output should also ease somewhat. After all, hedging into rising prices entails an opportunity cost; and higher volatility will act as a dampener. As such, a scenario in which the forwards curve stays in backwardation with the back end gradually shifting higher seems increasingly plausible.

Importantly, high and rising prices *along the curve* would go a long way toward allaying concerns about the industry's future profitability, paving the way for higher stock prices. Coupled with friendly tax policy and a dose of deregulation, US energy shares could start closing the yawning gap with crude prices that has developed since mid-2017. After all, valuations are relatively attractive and late-cycle dynamics tend to favour commodity assets. Not to mention that higher multiples would serve the objectives of both Riyadh (eyeing a successful Aramco IPO) and US shale companies (enhancing shareholder returns) well.

Overall, 2018 still looks to be a sweet spot year, even if, with US output on the rise and OPEC+ supply strategy approaching a crossroads, the sweet spot is maturing. Looking through any near-term weakness, the bigger risk is that OPEC's tightening bias stokes a price overshoot above $70 that triggers a stronger response from non-OPEC suppliers, short-circuiting the rebalancing of the market and raising the stakes for both oil producers and consumers.