macro scan

<u>Monday, September 16th, 2019</u>

- ***WTI has a bullish narrative ex-Saudi pipeline attack – wait for the dip to engage***
- ***Prism's PCA tool indicates: higher oil -> higher inflation expectations -> higher 10yr nominal yields***
- ***Fed is unlikely to respond to supply side pricing pressure which will keep core FOMC dovish (pegged front end)***
- ***Rising WTI not as positive for the US economy at this stage of the global economic cycle –keeps the Fed dovish***
- ***Deferred WTI spreads providing attractive 10%/yr carry, also emboldens the case for curve steepeners***

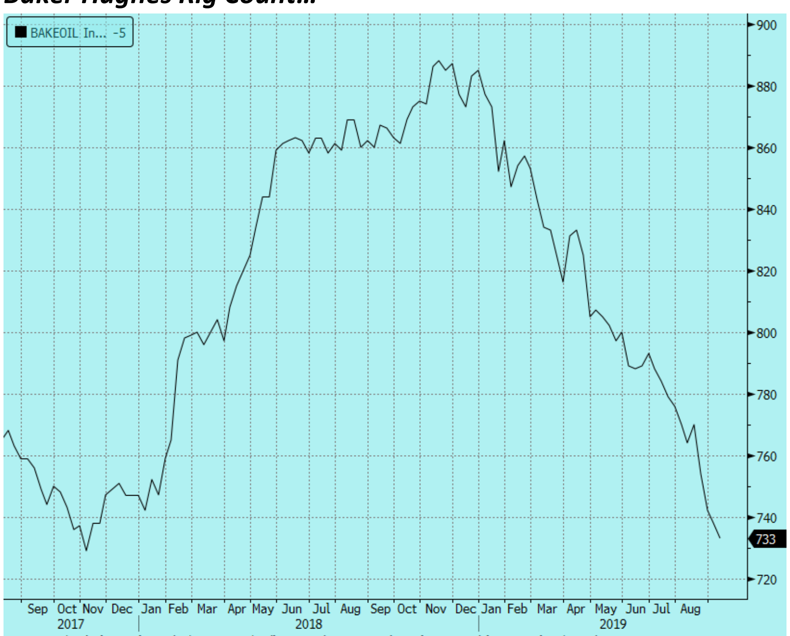
The weekend news obviously centered on the Saudi oil pipeline attack. Just to make sure we are all up to speed:

- 5.7m barrels/day (lot of that precautionary) of production taken offline = ~5% of global supply
- Around 1/3 likely to come back online within the next day or so
- Trump indicated the US could release supply from the SPR if needed (we know he prefers lower prices)
- The Saudi pipelines that were hit were of the light sweet kind which US easily produces so not a "heavy" crude problem which the world is a bit short of
- Risk off as tensions between US/Iran increase

Oil prices obviously jumped 15% higher on the open and has since given back 5% as fears of long-term disruption fades. Prices should continue to recede as production comes back online and we are likely to see a 50 handle on WTI relatively soon.

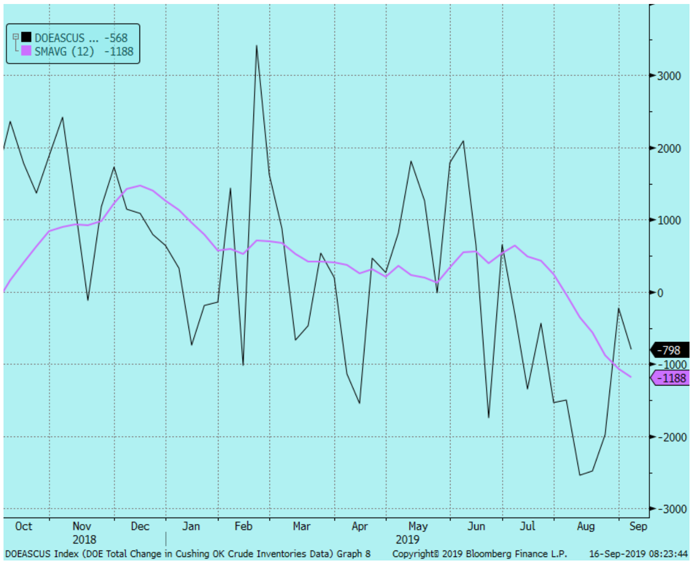
The key point I would make this morning is putting aside the strike on Saudi pipeline, there is scope for oil prices to remain firm going forward. That is due to the natural response of lower prices due to lower demand which is lower production. This can easily be seen in the rig count data which has been in a precipitous decline all year.

Baker Hughes Rig Count…



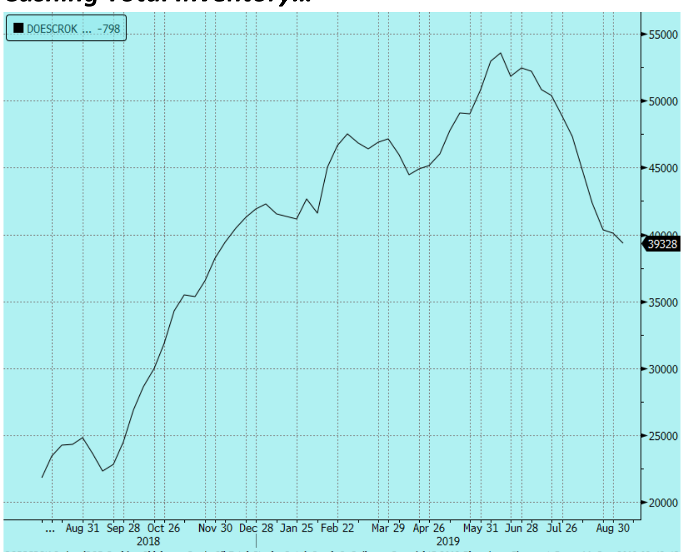
With this lower production, you have seen a "tapping" of supplies. As you can see here, since October 2018, Cushing Inventories on average (purple line) have shown builds but since Early August of this year; has flipped to draws.

Change in Cushing Inventories (black) with 12w moving average (purple)…

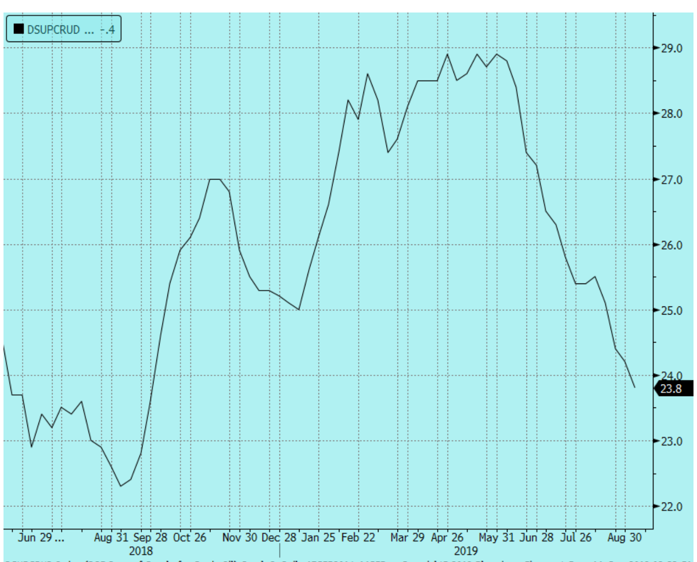


Thus we have seen inventories start to decline and retrace almost 50% of the past years gains.

Cushing Total Inventory…



Which obviously also means that the days of oil supply has been falling sharply.



That becomes more of an issue if the Saudi's continue to have production issues (attacks) that means the US need to make up for that Saudi supply loss.

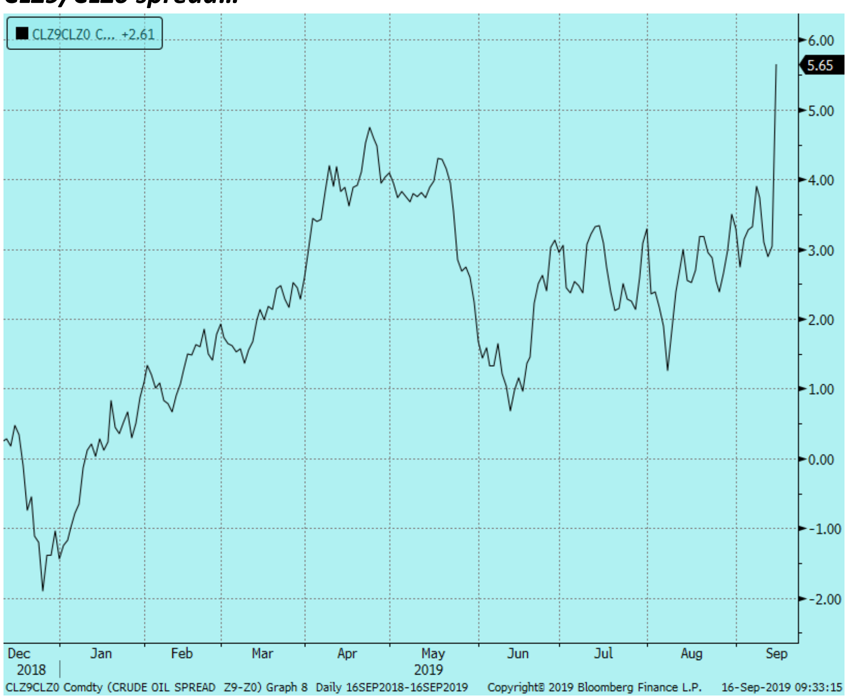
Further, my long time readers will recall my big bull call on oil in mid-2017 on rising production issues. You are once again hearing very similar problems in the Permian:

- Pioneer Resources noting the best of times are over for the Permian:
    - *"Rig count and Tier 1 acreage is being exhausted at a very quick rate"*
    - *"Convinced the Permian will reach 8 million barrels a day <u>at a much slower pace</u> with the Midland Basin as the only growing basin in the U.S. past 2025."*
    - *Some of the wells drilled in 2017 were a "train wreck" with underground pressure causing problems and delaying operations.*
- Concho Resources noting a growing problem of wells packed too closely which caused production issues and disappointing drilling results.

Both of those E&P companies (outside of today's pop on the Saudi story) have seen sagging equity prices as analyst have become acutely aware of these issues.

One other incremental positive for WTI is rising time spreads (Dec '19/Dec '20 spread = \$5.60). To say it differently for those fixed income minded, buying deferred crude contracts have very attractive carry (~10% per annum as of today).

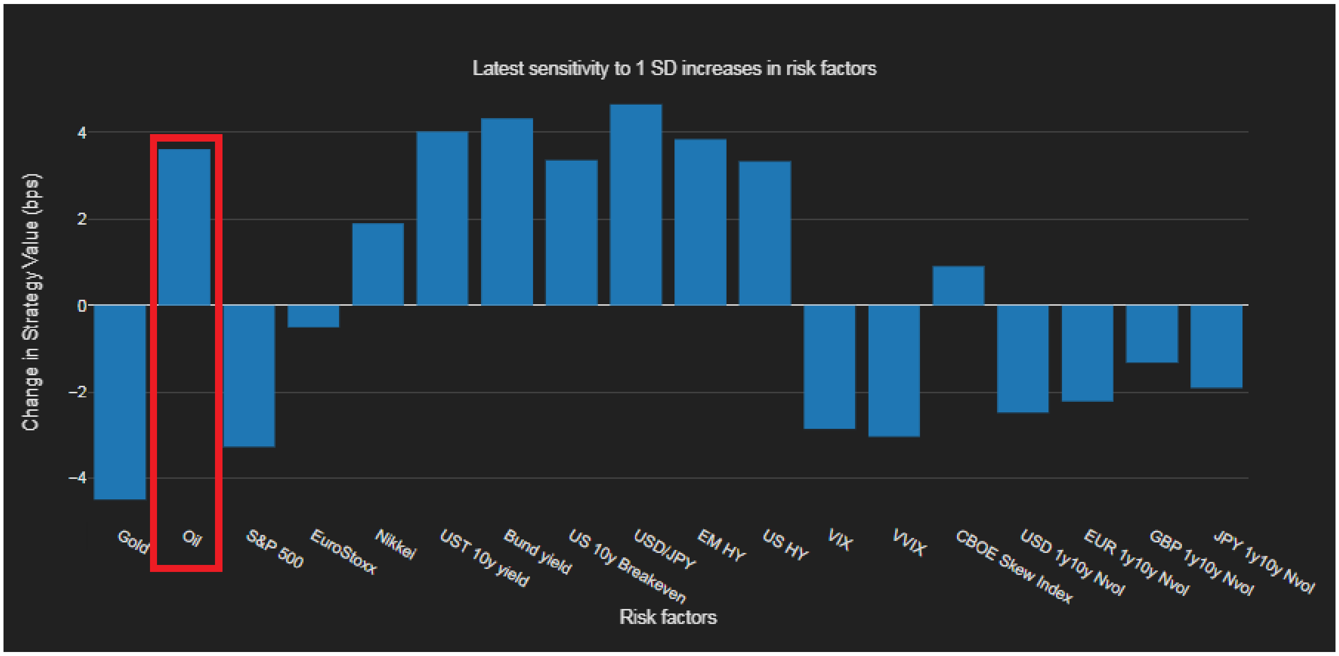
CLZ9/CLZ0 spread…



Again, throwing aside the Saudi news, there is a renewed bull case for WTI once the geopolitical bid fades – ie: you will want to buy the dip eventually, not today.

Why is all that micro oil background important?

It should lead to higher inflation expectations. Higher inflation expectations lead to higher nominal yields. Looking at Prism's PCA macro tool (throwing out some of the Capt. Obvious factors like Bunds), we can see that oil is one of the largest drivers of 10yr yields…



Is the Fed likely to respond to higher oil prices?

Highly unlikely. The Fed is already going to have to start dealing with firmer core inflation due to tariffs and now there is potential of higher oil and its effect on inflation. It is important to realize both of those are really coming from the supply side which the Fed will want to write off as "transitory" due to "international risks."

If anything, these rising prices come at the inopportune time of a deceleration in the labor market which means the consumer will be more exposed to rising costs.

That means the effects of rising prices (driven from supply side) will affect the long end more than the front end. The front end will be more driven by weakening global growth which was solidified over the weekend with another round of poor data out of China (weak Industrial Production, Retail Sales).

Also recall this new core of the Fed is AIT obsessed. Meaning they want to see average inflation above 2%. Over the last 24 months, 18 of those months (75%) has seen inflation below their mandate. So they will need to see many months of +2% Core PCE before they react.

Higher oil has been a positive for the US economy previously (because of how big US oil production has become). Does that still hold true?

Not so much anymore. That is due to:

1) As shown above, there won't be a massive ramp up in the Permian going forward due to production issues of having wells too close together which will lead to less capex going forward.
2) The global growth slowdown story has been driven mainly by overseas weakness. The strikes this weekend on pipelines will do no wonders to global manufacturing confidence.

That means the effects of higher oil prices will be less positive on the US economy and will help keep the Fed dovish despite firming inflation.

There are a couple trades that are therefore attractive based on the above analysis:

1) Deferred crude contracts will be attractive once you get the post-Saudi pipeline attack dip. If the market narrative that led to a fixed income bloodbath over the last two weeks has been that the US economy is going to trough; then buying deferred WTI contracts and rolling up 10% per annum makes a ton of macro sense.

2) Curve steepeners – something we have been discussing for a while gets emboldened. Again the idea that the Fed will stay dovish as global growth sags and (average) inflation remains below their target into the face of a weakening domestic labor market (please note that ISM-Non Mfg report that got the market into the "everything is ok" mindset had a much weaker employment component).

I continue to look for 2s10s to normalize to the 25bps level. The technical playbook is a consolidation into a bullish inverse head and shoulder pattern. Also notice that Breakevens (dotted in orange) correlate well and can lead 2s10s (using it as a curve proxy) higher.

US 2s10s vs. 5yr breakevens (dotted in orange) – consolidate down to form right shoulder of a bullish inverse head and shoulder pattern. Target 25bps…

Kind Regards,

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