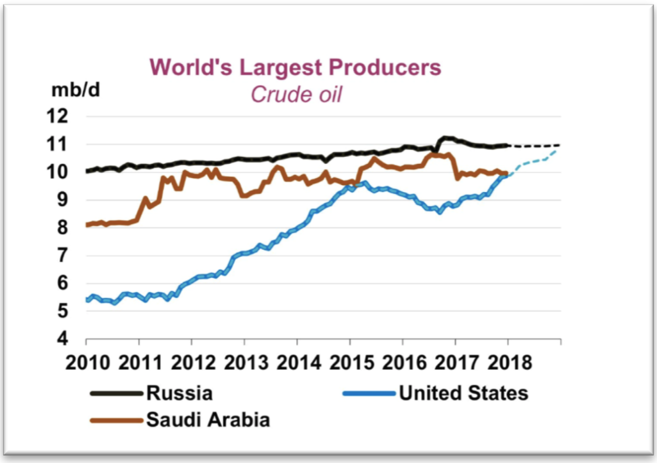
Lambert Commodities

Two Charts Worth Looking at to Understand Oil Prices Movements

January 2018

Source EIA



Source Bloomberg

Crude oil dynamics in 2017 are worth reflecting upon. Have a look at the left-hand chart. We notice two very interesting things

- One is obviously the rise of oil prices. After a year or so of fluctuation between 45 and 55 USD per Barrel (dpb) and within 6 months, Brent crude oil appreciated by not less than 55 pct!
- The second worthy information is the widening gap forming between the WTI and the Brent prices during these 6 months. Quite an unparalleled situation if looking back on prices since July 2015.

What happened and what does this tell us for the future? Lets' try to answer the easier question first (there are always smart explanations for past trends…).

The rise of oil price is the combination of three main factors:

- In November 2016, and under Saudi's drive, OPEC together with Russia decided, for the first time in eight years, to cut their production, to re-balance the market (largely oversupplied hitherto). For several months, this did not work, for two reasons: first, in the wake of talks about peak demand and anticipation for electric vehicles (EV) to conquer our roads, the market remained largely bearish. A stance that was reinforced by the shale oil revolution happening in the United States and the anticipated fast rise of production of unconventional oil as soon as prices would rise, thanks to the cuts.
- However – and this is the second reason, as the world economy started to improve across the board (45 countries responsible for 80 pct. of the world GDP are in growth mode, according to OECD), and whilst EV anticipations took a reality check (EV dominance will not happen overnight), markets started to embrace a more bullish stance about demand. Combine this with supply cuts and prices were bound to rise.

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- The third reason is found in the United States. Whilst shale oil is more nimble than conventional production (turning spigots on and off is much easier for the former than for the latter) and the number of wells kept rising throughout the year, production took time to accelerate as shale producers, after almost exclusively focussing on revenues, were now mindful of profitability.

What explains the rising gap between WTI and Brent, then? Again, the answer lies in the USA. WTI is more and more the reference price for US production only, whereas Brent is now largely seen as the main reference for crude, elsewhere. Shale production breakeven prices are in a 35 and 55dpb bracket, depending on producing areas in the US. This means that as soon as prices were getting close to 55dpb in the first half of 2017, the "shale boys" rushed to hedge their future production, thus locking in some profits or simply an acceptable breakeven. Hedging future sales is a sound strategy, unless prices turn against you… As oil prices started to climb from July onwards, the shale boys' hedges capped their selling prices at 55 for no less than 70 to 80 pct of their entire 2017 output… This means that as they could not benefit from the 2H2017 rally, the WTI future price got increasingly disconnected from the Brent which was not hampered by massive hedges.

What does this tell us for the future?

Put it differently, is the current rally sustainable? To try to answer the difficult question, let us look at the right-hand chart. What do we see? The unexpected just a few years ago: The Unites States are already matching/exceeding Saudi's production and will in all likelihood catch up with Russia as soon as the end of this year: they will become the largest oil producer in the world. Unconventional production (shale) is entirely responsible for the output rise in the United States and represents today 50pct of the country's output. Furthermore, the ill-timed hedges will soon lapse and, as very little of 2018 output is hedged, one can expect the WTI to catch up with the more attractive prices levels of the Brent, thus fostering the shale boys' appetite to turn more spigots on. All this means that unless we witness an unexpected surge in demand beyond the 99.1mbpd anticipated by the International Energy Agency for 2018, the surge of US production is likely to be overwhelming and to damp OPEC/NOPEC hopes that their cuts could sustain the current level of prices.

Many factors could interfere with this view, however. The unexpected, always the unexpected to paraphrase JM Keynes: a major geopolitical crisis; an environmental disaster in any of the shale production areas; an unexpected shortage of conventional oil production, this time due to the lack of investment since 2015…

What is unlikely to happen though is OPEC/NOPEC willingness to keep harming themselves and further cut their output out of despair. Unless unforeseen events occur therefore, we will not see oil price back at 100dpb anytime soon…

One last word of caution though: predictions tend to be wronged as soon as made, so a contrarian view to the above might be wise!

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