Focal Point
The oil price plunge will reshape the energy market

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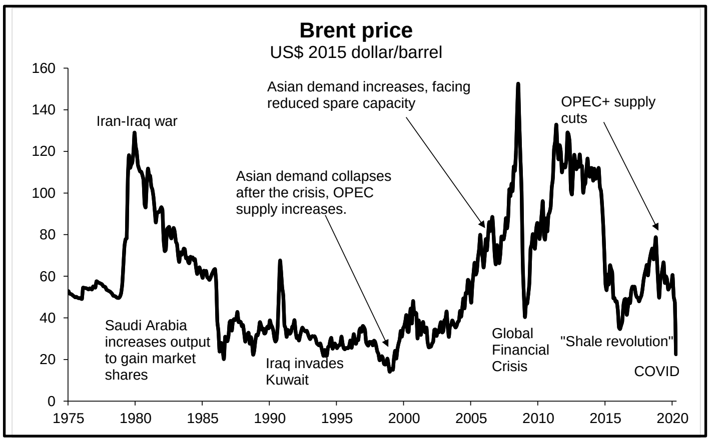
- The unprecedented drop in demand hit an oversupplied oil market, pushing prices to a 25–year low. They should remain below 35 US$/barrel for the rest of the year, and accelerate to 40-45 US$/bbl by the end of 2021.
- Global inflation will likely slide below 1% this year. A spillover of low oil prices into inflation expectations could complicate central banks' work.
- In the medium term, big, low-cost supplier like Russia, Saudi Arabia and UAE could gain market shares, but in Gulf countries, fiscal and external balances may come under stress if the oil price remains unsustainably low for a prolonged period.
- Highly leveraged US shale producers face a deep restructuring; surviving firms will benefit from the expected demand bounce back thanks to their flexible production process. Short term, yet, investment cuts will weigh on US growth.
- Energy companies' stocks remain depressed by weak oil prices and the prospects of greatly reduced dividends. Low oil prices are also putting additional pressure on an already vulnerable US HY market.

The temporary drop of the US oil price into negative at the end of April has been the starkest indicator of the stress energy markets are exposed to because of the COVID-related collapse in demand. The recovery in oil prices will be slow and possibly characterized by bouts of volatility. The industry structure will undergo some deep changes, favoring larger and low cost producers through M&A and production closures. This Focal Point describes our outlook for oil prices and the main economic consequences. We also sketch some financial market implications, leaving a more detailed analysis to a fortcoming article.

Oil prices at their lowest in more than two decades

Adjusted for inflation, at the end of April oil prices were not too far from the though reached at the beginning 1998. The current situation shows some similarities with what happened back then. In 1998, global demand had collapsed following the Asian crisis, but OPEC continued to increase supply in order to expand its market share.

In February, OPEC+ (OPEC, Russia and other smaller producers) unwound the supply cuts enacted in 2018 and ramped up production to crowd out higher cost US shale producers. As transportation (which accounts for around one-half of oil demand) was curtailed as the first response to the COVID outbreak, the global oil market found itself with an unprecedentedly high level of unwanted stocks. Gloomy expectations on global demand gave the final push to prices. In April OPEC, Russia and other producers quickly reached an agreement to cut global production by just below 10%, but this pales in comparison to the projected 30% collapse in demand.



Gradual price recovery in 2020…

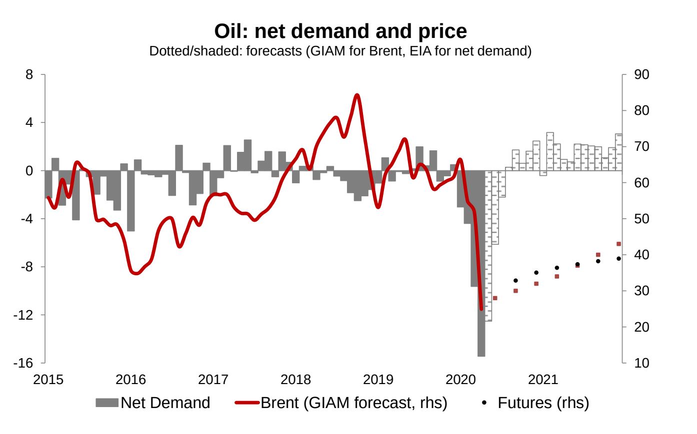
Assuming that producers comply with the announced cuts and that economic activity starts recovering during the summer, the oil market will stage a rebalancing.

Yet this will not, in our view, lead to a sharp bounce back in prices, as net demand is likely to recovery in a slow and uncertain way. First restrictions on travelling will be lifted well after those on other activities. Second, unlike the 2009 crisis, Emerging Markets are being hit hard. Economic activity there is much more oil intensive than in developed countries and this will slow down demand. Finally, it will take time to mop up the high level of inventories that has built up since the beginning of 2020. As a result we expect a Brent price in the 30 to 35 US$/bbl range by the end of the year.

There are downside risks to our 2020 forecasts. On the demand side, further waves of infection may prevent the much-awaited pick up in global activity. Concerning supply, the sharp degree of demand compression will need full compliance on the planned cuts and probably some extra effort. This may be difficult to enforce for technical and economic reasons. Large cuts in output by traditional producers may entail some physical disruption to wells, possibly leading to permanent output losses. Some countries may find slashing production too risky. Secondly, budget worries may force some governments to continue extracting to support fiscal revenues.

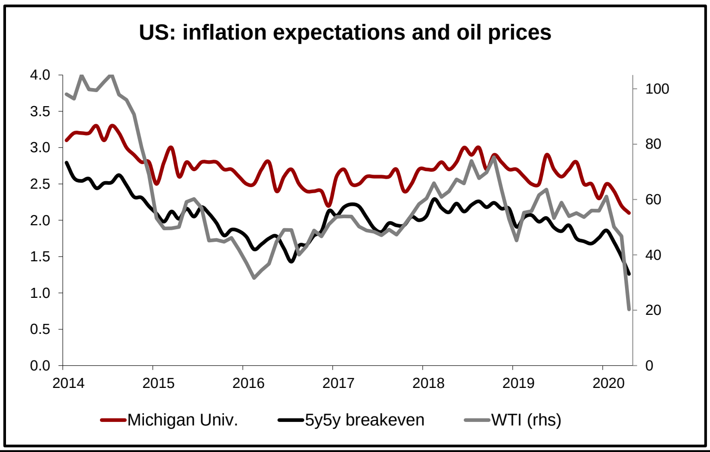
…with some upside risks for 2021

Prices will then continue to drift up in line with net demand. However, the Brent price should not exceed 45 US$/bbl by the end of 2021.There are upside risks to the medium term forecasts, and the possibility of bouts of volatility. The sharp contraction in production and the cut in investment may limit the flexibility by traditional producer to meet smoothly the increase in demand. Shale producers may play a smaller than usual role in rebalancing the market, as the sector will be undergoing a big restructuring (see below), with priority shifting from revenues to profitability.

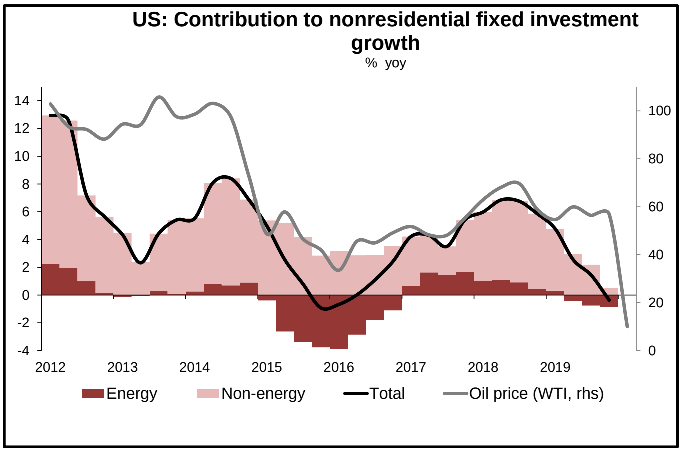


Inflation and capex under pressure

The oil price slump is already having a big impact on consumer prices, with global inflation likely to dip below 1% this year. Longer-term, the negative impact persistently low oil prices may have on expected inflation is troubling. It would be difficult for central banks to reverse it given that they have already deployed a lot of firepower to cushion the impact of the health crisis on growth and will likely have to step up efforts on that front. Moreover, monetary policy had lost effectiveness already very low before the crisis.



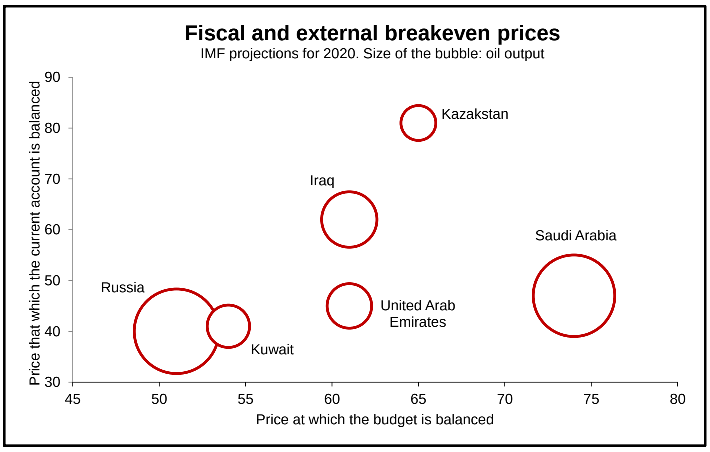
With consumption restricted by lockdowns, low oil prices will not stimulate growth in the euro area and other energy importers but will have a net negative impact on US growth. The shale sector will have to reduce supply to support prices and will find it much harder to get external financing. Moreover, produces will have to put profitability before output and market shares, given their high leverage. This will result in an immediate and sharp contraction in capex. In 2015 and 16, reacting to WTI plunging to below 60 US$/bbl, shale oil companies undertook a massive cut in investment which was responsible for the slump in US private sector capex. In the current situation, given the very low level of prices and higher industry leverage, a much larger investment cut appears inevitable. This will probably extend for a few quarters, weighing on the H2 recovery.



Winners and losers

A prolonged period of low prices will inevitably force changes in the market. In terms of countries, much will depend on extraction costs and the importance of the oil industry in the economy. The deterioration in the outlook for some countries is already evident. Mexico has been downgraded twice (by Standard and Poor's and Fitch) since the second half of March, as the vulnerability coming from the heavy reliance on oil revenues to sustain growth and fiscal receipts adds to political instability and the collapse in global trade.

The situation for larger players appears less problematic. Russia has relatively high production costs (17 US$/bbl, versus 10US $/bbl for Saudi Arabia) but a rather diversified economy reduces the importance of oil prices for the budget and the balance of payments. This shows up in a lower breakeven prices, i.e. the price level needed to balance the budget or external accounts. Saudi Arabia, on the contrary, seems worse positioned in the short term. The large gap between expected oil prices and the breakeven levels would require fiscal retrenchment, which will further depress growth. Yet public debt is low (40% of GDP) and foreign exchange reserves are large enough to cushion the impact on the balance of payments if prices do not remain at this depressed level for too long. With stable or even mildly increasing oil prices, fiscal and reserve buffers will allow the kingdom to continue its limited production cuts strategy aimed at maintaining and possibly increasing its market share. Other big producers, like the United Arab Emirates are in a similar situation, enjoying low extraction costs and a buffer from the large endowments of their central banks or sovereign wealth funds.



Once prices are back to more sustainable levels, bigger, low cost producers, such as Russia and Saudi Arabia may emerge stronger and with a bigger market share. OPEC may end up regaining some power in anchoring prices.

As said, another important consequence of the post COVID oil order will be a large restructuring of the US shale sector. The price level needed to cover production costs ranges from 23 to 30 US$/bbl, while drilling new wells is profitable for WTI prices above 45 US$/bbl, corresponding to a roughly 47 US$/bbl Brent price. Therefore, expanding capacity is not feasible in the short run and, more importantly, the industry is set for a deep consolidation. Surviving firms will be able to enjoy significant economies of scale. Additionally, the flexibility of the fracking production process will allow them to adapt quickly to the increase in demand, helping to stabilize the market in the medium run.

In principle, low oil prices may dampen demand for renewables, resulting in another unfavourable long-term consequence of the pandemic. It need not be so. First of all the supply of energy from renewables is not very responsive to prices; investment plains involving large sunk costs have already been planned or implemented, and therefore will lead to increased production regardless of the relative cost competitiveness. Secondly, renewables are mostly used for electricity generation (contributing to 20% of the total production), while oil is devoted to transportation, accounting for less than 10% of power production. Therefore, a growth pattern less dependent on travel and transportation will not necessarily depress demand. According to the International Energy Agency (IEA) in Q1 2020 global energy demand dropped by 3.8% yoy, but that for renewable energy increased by 1.5%; this was largely driven by the additional wind and solar projects that started operating in 2019 and the priority given to renewables in most power sectors. Finally, a country's energy mix is to some extent a political decision that overlaps with other priorities (e.g. acquire some energy independence). Therefore, political choices will be crucial. There are already positive signs in this sense: 8 % of South Korea's $38 billion stimulus package and about 40 % of China's $586 billion infrastructure plan were allocated to sustainable energy investment.

Equity and credit implications

We will soon devote a Focal Point to the impact of the oil plunge on financial markets. Here we just sketch what we expect on equities and credit.

Energy sector stocks lost 40% year-to-date, underperforming the market by 20%. The sector looks extremely cheap on the surface, but persistently low oil prices and the risk of deep dividend cuts lead us to adopt a neutral stance in out short- term portfolio allocation.

Trailing dividend yield is 2.9x the market and the 10-year median is 1.6x. However, Shell reduced its dividend from 47 cents to 16. Should the whole sector opt for a dividend cut of the same magnitude in the next months, it would only yield 1.06x the market. Energy will then become much less appealing in relative terms, especially given that investors usually look at the sector for its high dividends. Before COVID, the breakeven oil price for the largest companies (after capex and dividends) was around $ 50. Companies have reduced capex by 25% -30%; this will move the breakeven into the $ 35 area. The gap over the 25-30US$ bbl price range expected in the short term appears manageable given their solid balance sheets but still representing a big hurdle to a possible outperformance.

In the US, oil companies (mostly shale producers) account for nearly 11% of both the IG and HY markets. The default rate for the industry has been one of the highest since the 2015 commodity price bust. Some companies defaulted immediately but it took several years for some others. With the current level of oil prices, we expect the default rate among US oil HY sector to jump possibly above 20%. More broadly, surviving companies will face a severe rating deterioration, given also their high leverage. Loans to oil companies are mostly securitized via Collateral Loans Obligations (CLOs), which have rating constraints. Should a significant number of B-rated companies be downgraded to CCC, CLOs could become forced seller, possibly finding no buyers. This would in principle amplify financial distress, but the recent decision by the Fed to extend bond purchases to "fallen angels" reduces tail risks.

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