EPG
ENERGY POLICY GROUP

Oil markets in 2020:
fundamental drivers and geopolitical uncertainties

Radu Dudău and Andrei Covatariu

January 13, 2020

The fundamental market drivers are pointing at a balanced oil market in 2020, with a Brent price mostly within the $60-70 a barrel – unless, that is, a massive escalation of the geopolitical tensions occurs, following the targeted killing of Iranian general Soleimani, causing large and indeterminate oil supply disruption.

With the international oil markets still reeling from the geopolitical shock of the targeted killing of Qassem Soleimani, the high ranking Iranian general, on January 3, the Brent crude jumped on January 6, more than 5% since the air strike, reaching $70 a barrel. One week later, the Brent price came back to $65 a barrel.

It was the second time in the past three months that the international oil benchmark surpassed the $70 threshold, the previous time being the aftermath of another military attack: the mid-September drones and missiles hit in Saudi Arabia, supposedly under Iranian planning, of the world's most important oil processing plant in Abqaiq, and of facilities at the Khurais oil field.

Strategists are fretting over the rising tensions between Iran and the U.S., exploring possible consequences of multiple orders for Middle East's security environment and the world's economy.

However, to estimate the likely effects on the global oil markets, it is useful to remember that the price spike caused by the September attack on Saudi Arabia faded out in less than two weeks, confirming a structural robustness of the price corridor of $60-70 a barrel of Brent that has been manifest in the second half of 2019. The price fall after last week's spike suggests a similar evolution

Price of the Brent oil benchmark, H2 2019 ($/bbl)

Source: Marker Insider, January 2020

Of course, under the current geopolitical uncertainty, there is no guarantee that the market will stay calm. Still, we argue that, short of massive military escalation in the coming months – the like of an Iranian attempt to seal off the Hormuz strait, through which 20% of global oil is transported, which would double the oil prices for many months, with devastating effects for the global economy – the underlying market drivers keep pointing at a balanced market for 2020, likely to stay, most of the time, within the same $60-70/bbl Brent price corridor, with probable short-lived deviations contained in the $50-80/bbl price range.

The determinants shaping the oil markets are a slowing global oil demand, a slowing U.S. shale output, and a narrowing space in the market for OPEC production. Let us discuss them in turn.

Slowdown in global oil demand

In 2019, oil demand was affected by the U.S.-China tariffs war, which topped a preexisting tendency of tepid global economic growth, after almost a decade of economic expansion. The marked economic slowdown of India, a major global offtaker of oil, has only compounded the slowing demand. As estimated by *Petroleum Economist*, oil demand is expected to grow by 0.8mb/d y-on-y in 2020, almost half the average growth of 1.5mb/d in the past five years. Still, growth there will be, nearing an unprecedented daily output of 100mb.

Slowdown of U.S. shale oil output

U.S. shale oil production has been, for the past several years, the main contributor to the growth of global oil output, mainly based on production from the Permian Basin. To sustain the pace, oil pipeline capacity to the Gulf Coast has been increased by about 2mb/d in late 2019.

However, as noted by *Financial Times* „the small independent companies that still dominate the sector are finding it increasingly difficult to raise money and struggle to generate free cash flow consistently." The drilling activity is slowing down, with the horizontal rig count down 23% in 2019. Thus, for 2020, analysts expect a flatlining of U.S. shale output, at best.

Narrowing space in the market for OPEC

In spite of the somewhat low spirits about the shale outlook in 2020, the non-OPEC production is set to remain robust, mainly on account of robust growth from Norway's Johan Sverdrup field in the North Sea, expansion of Brazil's production in the pre-salt Santos Basin of the Southern Atlantic, and Guyana's start as an offshore oil producer.

Against the backdrop of slowing demand, the space in the market for the OPEC producers is diminished. However, the U.S. sanctions on Venezuela and Iran (and possibly on Iraq too, depending on how the situation will evolve after the Iraqi Parliament voted on ousting the American troops) will cause deep cuts in these countries' oil outputs, thus easing the burden on the other OPEC members, with an overall cut of just 0.2-0.3 mb/d in 2020, according to Petroleum Economist. The cartel's own projection for the 2020 production is 29.6 mb/d.

In the larger OPEC+ framework (i.e., OPEC and Russia), another joint production cut was agreed on in December, in the attempt to avert an oversupply in H1 2020, and thus keep the Brent price above $60 a barrel.

EPG
ENERGY POLICY GROUP

Now, the interplay of these three drivers can be easily upended by the rising geopolitical tensions, considering the potential of the latter to escalate and get out of control. Yet, as noted by Goldman Sachs market analysts, the risk premium presently included in the oil prices is already too high, so that consistent price increases could only be caused by actual supply disruptions. In other words, while assessments of increased geopolitical risks normally lead to self-correcting behavior – e.g., U.S. and allied vessels should better stay clear of commercial shipping in the Persian Gulf – in case of renewed Iranian attacks on Saudi oil facilities or/a and military blockade of the Hormuz Strait, the supply disruptions will be substantive and durable.

There are other factors too influencing the oil market in 2020, such as President Trump's insistence that the oil prices stay low, as part of his economic promise to the voters, especially in this electoral year. He repeatedly enjoined Saudi Arabia, OPEC's de facto leader, to pump sufficient oil to keep a lid on the prices – a policy that, as underlined above, stands in obvious contrast to the Saudi coordination with Russia to keep the Brent prices above $60/bbl.

But a more consequential and long-standing factor is the increasing stringency of environmental and climate regulations and norms that affect the behavior of investors, financiers and consumers worldwide – and especially in the European Union.

The fossil fuel divestment – i.e., institutional divestment of financial assets connected to fossil fuel companies – added up to more than $12trn in December 2019, as underlined by *The Guardian*.

The European Investment Bank (EIB), the world's largest development bank by capitalization, decided to stop financing any sort of fossil fuel asset as of 2022, while the new head of the European Central Bank (ECB), Christine Lagarde, stated in December that the institution should adjust its monetary-policy strategy to take into account the impact on climate change.

As noted by *The Economist*, „the Bank of England requires banks to have a plan of dealing with [climate] risks. The Network for Greening the Financial System (NGFS), a group of 51 central banks and supervisors, collates guidelines for regulators and disseminates scenarios to help analyse potential losses to the financial system."

Insurers and pension funds seem to be the most exposed, because of their holdings of corporate bonds and equities, with potential losses of up to 10%, according to a stress test conducted by the Dutch central bank in 2018.

Expert groups around the world are working and contending to elaborate taxonomies of clean energy technologies, to serve as basis for „sustainable financing" procedures and mechanisms.

Although this tendency is not yet generalized, there is a foreseeable risk to the O&G industry of being perceived, a few years down the line, just as the coal industry is being seen today, to the effect of restricted and more expensive access to capital.

As this environmental trend is gradually becoming a „new normal" in corporate financing, the O&G companies are best advised to begin serious strategic planning about climate change and, accordingly, engage sooner rather than later in the clean energy transition.