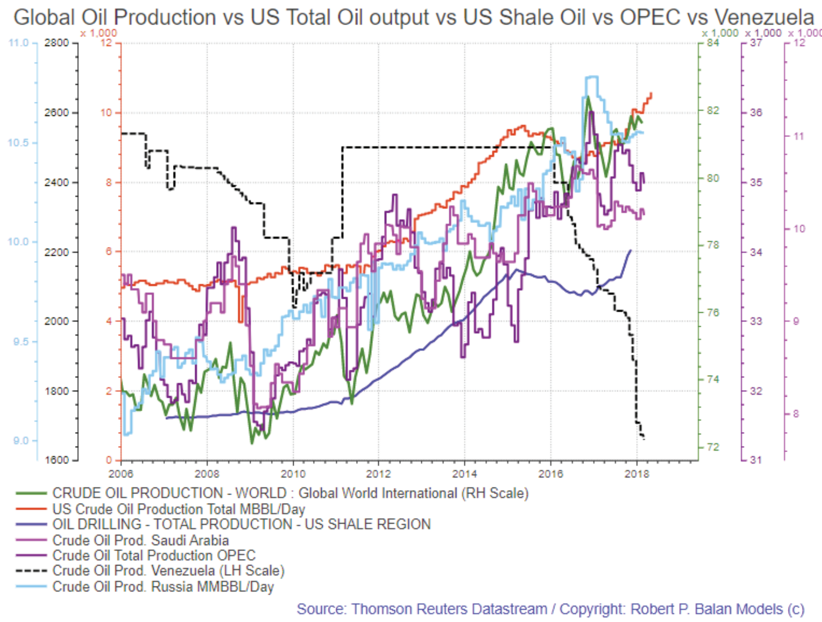
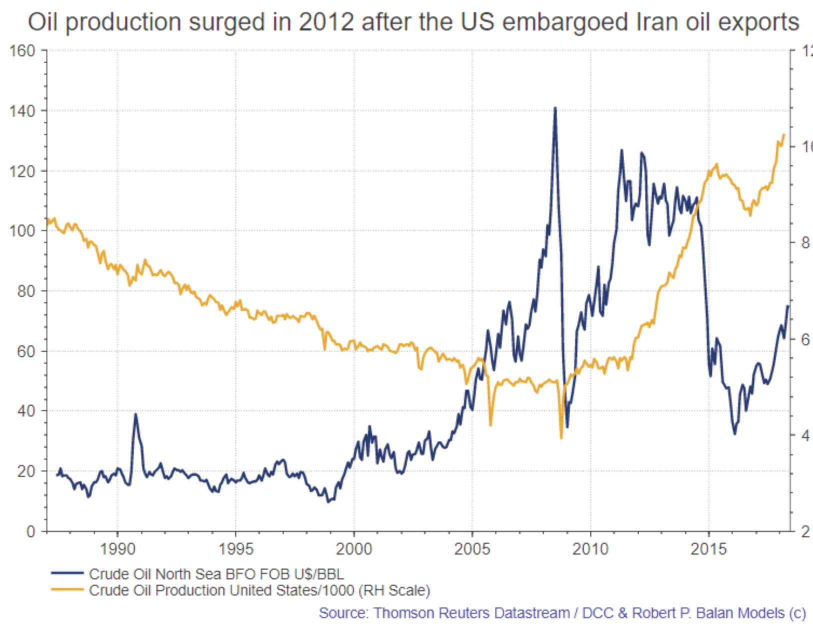
46 / Geopolitics faded out and oil fundamentals are back in the forefront, but the June 22 OPEC meeting could throw a Crude Oil curve ball

In last month's Capital Observer (May 2018), we noted that geopolitics and fundamentals were colliding in the oil price discovery process, and we asked rhetorically – which one will win? At that time, oil fundamentals have already become less price-friendly and it was just the slow simmer in adverse geopolitical events that was keeping sentiments of oil speculators still bullish. Then came the talk of OPEC potentially raising oil production by as much as 1 million bpd after global oil inventories have gone back to their five-year averages. Oil prices promptly collapsed, hastened along by a series of US inventory builds and a surge in US oil production.

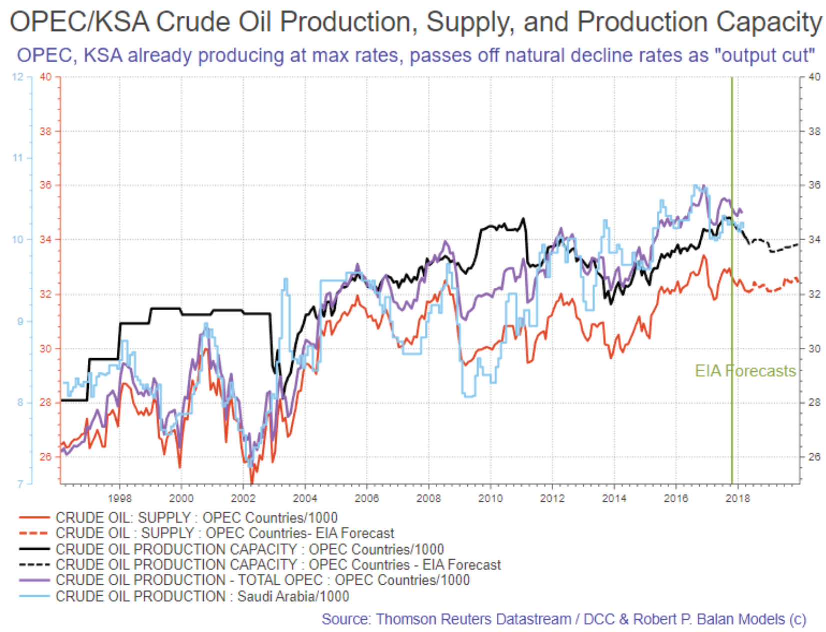


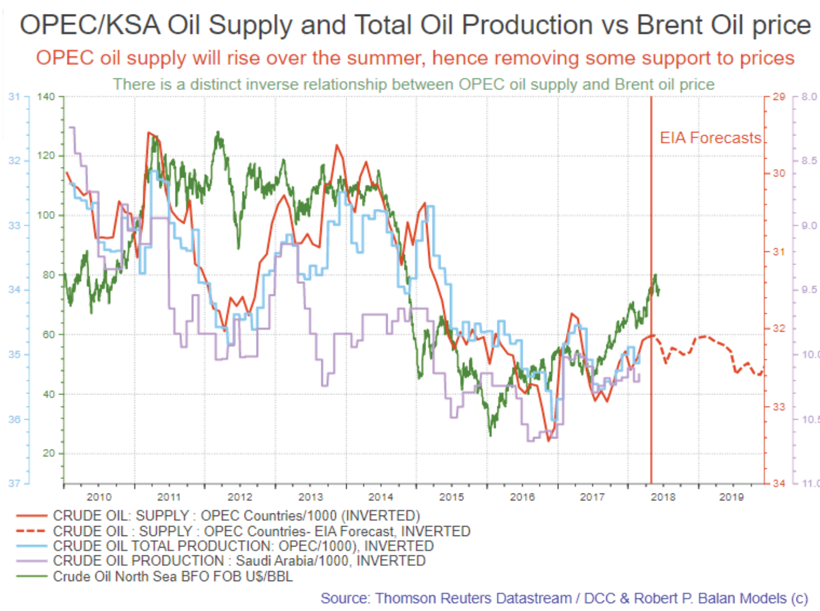


At crude oil's lowest point in the sell-off on June 5, WTI oil lost \$8.52 (from \$72.80 to \$64.28/bbl), which matches the Middle East risk premium of \$7.00 to \$9.00 per bbl. Why is this significant? Because removing that much from WTI oil price means that **the oil discovery process will now rely more on fundamentals than geopolitical events.** The current lower oil price is again open to a new series of Middle East political machininations, but nothing threatening is in the horizon, except for a quicker imposition of US oil embargo on Iranian oil exports. But that too has already been discounted by the market, especially after Saudi Arabia expressed willingness to make good any shortages caused by US action. The only event which one may call "force majeure" is a complete collapse in Venezuela's production. This slow-motion train-wreck has also been discounted by the market, as it is more than made up for by a new surge in US oil production, and higher Russian oil production, which already started ticking higher (*see first chart on this page*).

The most significant wild card facing the market is the June 22 OPEC meeting. It is shaping up to be a contentious one, after news broke that the U.S. government asked Saudi Arabia to increase oil production before Washington pulled out of the Iran nuclear deal. According to Reuters News, a high level Trump administration official called Saudi Arabia a day before Trump was set to announce the U.S. withdrawal from the Iran nuclear deal, asking for more oil supply to cover for disruptions from Iran. This has incensed Iran, and the apparent willingness of Saudi Arabia to comply with Washington's request has ignited furor from within OPEC.

But this is not a special case, and there is no surprise that Saudi Arabia is just too willing to go along with the Trump administration. Anything that can financially hurt Iran, and slows down their capability to produce a nuclear bomb, will always be welcome in the Kingdom. Moreover, there is historical precedent. The last time the U.S. government pressured OPEC into adding supply, it was also over Iran. The Obama administration wanted the cartel to offset disrupted Iranian production, after an international coalition put stringent sanctions on Iran in 2012. Roughly 1 million barrels





per day were knocked offline, and OPEC finally made good the shortfall after oil prices run-up to $125.00, and triggered a severe global growth slowdown which just stopped short of a recession. That US oil production became almost exponential from late 2011 also held oil prices in check, and that helped convince the OPEC to leave Iran to its own devices (*see 2nd chart on previous page*).

Iran, and now, Venezuela wrote to OPEC members, asking them to denounce U.S. sanctions. But the OPEC steering committee rejected Iran's request which will be the likely fate of Venezuela's entreaties as well. Venezuelan oil minister Manuel Quevedo wrote: "I kindly request solidarity and support from our fellow members. The group should discuss the constraining effects of unilateral sanctions imposed by the United States of America, which represent an extraordinary aggression, financially and economically, for our national oil industry's operations and the stability of the market." (Reuters). Nonetheless, the fact that two founding members of OPEC are rocking the OPEC boat suggests that the June 22 meeting will be contentious. It suggests that a good portion of the cartel could line up against any move to increase production. It could set the stage for a heated meeting in Vienna and OPEC watchers are already suggesting it might be one of the worst OPEC meetings since 2011. At that time, Saudi Arabia wanted to increase production to ease triple-digit oil prices following the conflagration in parts of North Africa and the Middle East during the Arab Spring. The Saudis were overruled. And they may yet again be overruled come June 22, if the Saudis propose increased output, which is not yet clear at this time if they intend to do so.

There is a lot of farcical overtones into discussions going into the June 22 meeting, as the OPEC+Russia consortium's pact to limit output is a sham, for lack of better word to describe it. We have seen the power of any hint to increase production – the price of oil promply tumbling down sharply. Aside from Iran and Venezuela's grip about the US "unilateral" embargo, **there is little incentive to increase production from OPEC. Just about every OPEC member outside of the Gulf is unable to increase production anyway, so it is of little surprise that they are, and will be, opposed to higher production**. Venezuela, Angola, Libya and Nigeria don't have official limits on their output as part of the OPEC deal, so there is little upside for them in supporting production increases from other countries. And they won't. Even the Gulf producers are already at maximum output, and they have gone to calling natural decline rates as "output cut" (*see 1st graph on this page*).

Russia (Rosneft) has already started raising production; and on Saturday (June 9) Russian news agency Interfax reported that Russia's oil production, the world's biggest, had risen to 11.1 million bpd in early June, up from slightly below 11 million bpd for most of May, and well above its target output of under 11 million bpd as part of the deal. OPEC oil supply has also started rising, as extraneous output goes into storage. Effectively, OPEC supply has bottomed in May, coinciding with the top in oil prices. OPEC supply will rise going into summer, and that will remove some of the support for prices**. There is a distinct inverse correlation between OPEC oil supply and price, so going into the June 22 meeting, this might pressure prices further** (*see 2nd graph on this page*).

This could also be a significant development as further declines, after a circa $9.00 price declines in just a month, could harden the attitudes of the major producers. **We expect OPEC to reject any proposal to lift output soon, and the cartel will likely opt to let the agreement run as originally crafted.**

Summary:

This will likely provide another upwave to Crude Oil's bull run. A new rally in oil prices should in fact coincide with, and support, a new bull market in equities up to an expected July-August peak. However, the rally should be tempered by increasing US oil production during H2 2018. Demand is also expected to moderate somewhat, so there could be a test of the previous $72.80 top, but the calls for $80.00/bbl oil are unlikely to materialize. This theme is confirmed by a simple price model using the variance between global oil comsumption and global supply (*see 1st chart on this page*). The model shows that an oil bottom is likely in June followed by a moderate rise in price.

A pick up in H2 2018 is also supported by seasonal tendencies for oil demand and consumption to rise until Q3, this year and most years (*see 2nd graph on this page*). This tells us that the bottom we expected for equities and bond yields by the 3rd week of June, may be the same period when oil prices bottom and go on to retest the previous top.