AVALON Consulting | Cordence WORLDWIDE MEMBER

Oil Insights & a Contrarian Viewpoint

Raj Nair - August 2021

The Avalon Edge

E ntrepreneurship
D edication To Excellence
G reat Value Creation
E thical Approach

www.consultavalon.com

Sridhar Venkiteswaran I Chief Executive Officer
sridhar.v@consultavalon.com I +91 98119 37755

If I were to predict that oil prices will fall from the mid-$ 70s to below $ 60 per barrel by the end of 2021, the probability of being wrong could be 75% though past experience would suggest that oil prices normally dip after the Western summer and autumn.

If I am wrong, I will be in the august company scores of oil experts who got it wrong. It will not hurt their pride because that's the nature of this animal called oil, whose prices are best predicted one day at a time.

I am no Oil expert, but I still took a punt at predicting the price a year in advance in December 2020, because oil price is one of the many components that I need to use in my annual note about economic and business sector predictions for 2021. What prompted me to predict a drop in oil prices to below $60? Politics of course. But more on that later.

Since oil is produced only in a few pockets, almost 70% of it is traded. Anything that valuable and is traded across borders invites interest from politicians, business interests, transporters, investors, speculators and lastly users.

The moot point is that 'lastly' is apt tag for users as you will discover while reading this paper. In a way, oil is like gold, in that the value of both often rises when the dollar falls. In some ways, they are very different, gold has very little practical use in industry and is used in jewellery and coinage. It is stored without getting consumed whereas there is finite storage capacity for oil and all of it eventually gets consumed. Both evoke different levels of trading interest than do semiconductors, onions, real-estate, a whole host of products and agricultural produce which we use or consume and for which we are comfortable in predicting prices based on the demand-supply equations.

Oil is interesting because different factors impact differently in different years. 2020 was a very interesting year in which the impact of most factors can be witnessed. (See Charts 1 to 4)) in the same year.

Chart 1:

Monthly oil prices

Source: Bloomberg; World Bank.

- In 2019, Brent averaged $67 per barrel and ended with economic optimism: However, early in 2020, Covid19 struck. Oil ended 2020 at $ 50 and continued its climb in 2021. what happened in between the start and the end of 2020 is worth understanding

- By March 2020, prices headed South and OPEC+ talks to cut production had failed. Russia and Saudi Arabia competed, leading to a price war. Oil prices plummeted to a twenty-two-year low of $9.12 per barrel in April.

- On April 12, OPEC+ countries agreed to cut oil production by 9.7 million barrels/day during the next two months with Russia getting a grace period of two months to cut production. Oil price rebounded.

- But on April 20, prices of WTI futures (due to expire the next day) plunged below zero for the first time ever- minus $37.63 a barrel on the New York Mercantile Exchange. Because of the dramatic demand shrinkage during the Coronavirus lockdown, companies had filled their entire storage capacity with unused oil and were trying to get rid of expiring futures contracts.

- 2020 ended with hope of vaccines and with the US shale capacity battered, the crude oil price reached $52 per barrel.

To the casual observer, Oil prices may appear to have been driven individually and jointly, by classic factors like demand, supply, and global inventory levels (see chart 1 for prices movement and compare prices trends with changes in these factors in 2020 in Charts 2-4). It is easy to miss the highly exaggerated price response to even small changes in these factors which would suggest that there may be other more important factors in play.

Chart 2:

Oil Production change trends in 2020

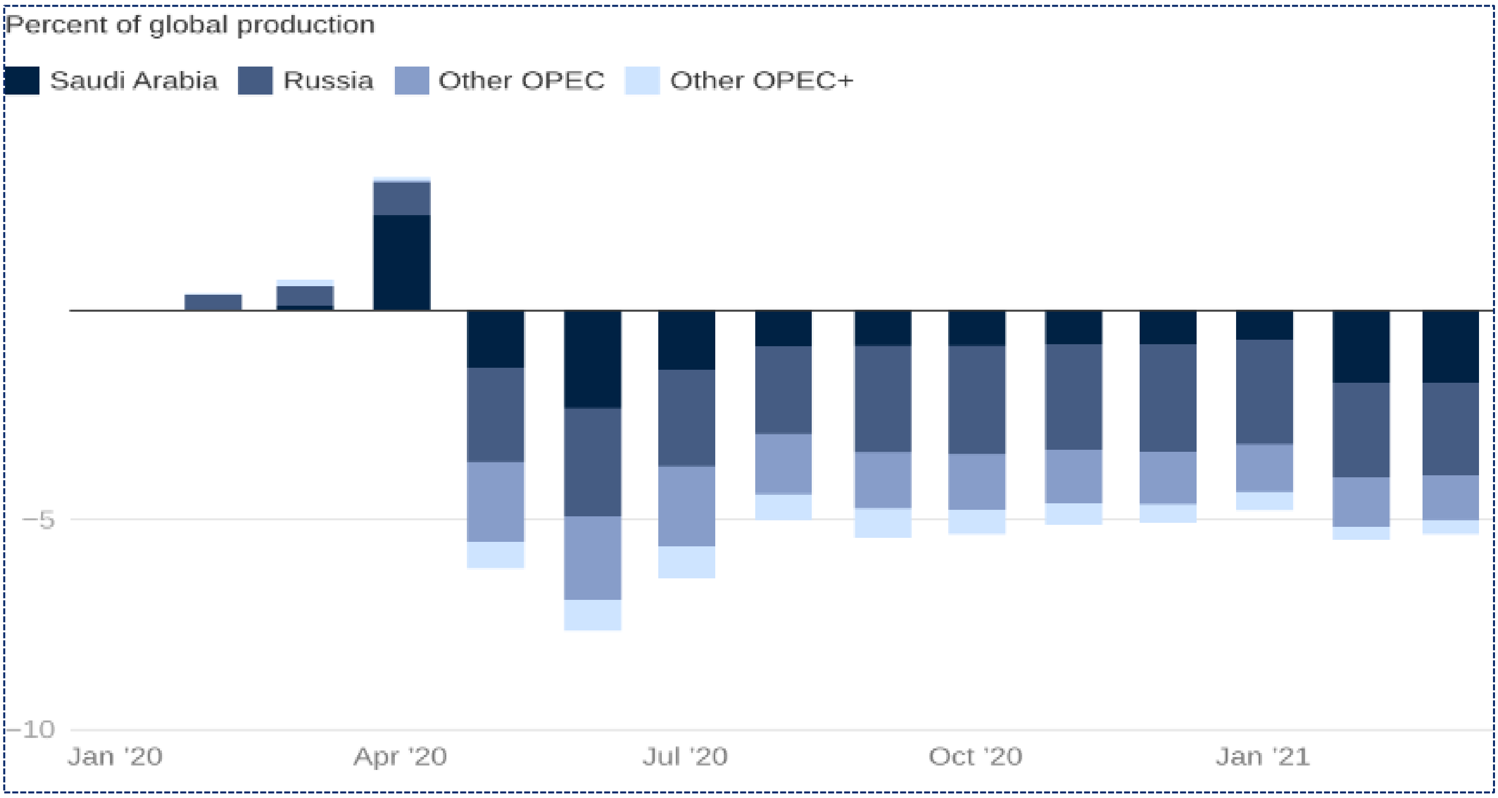
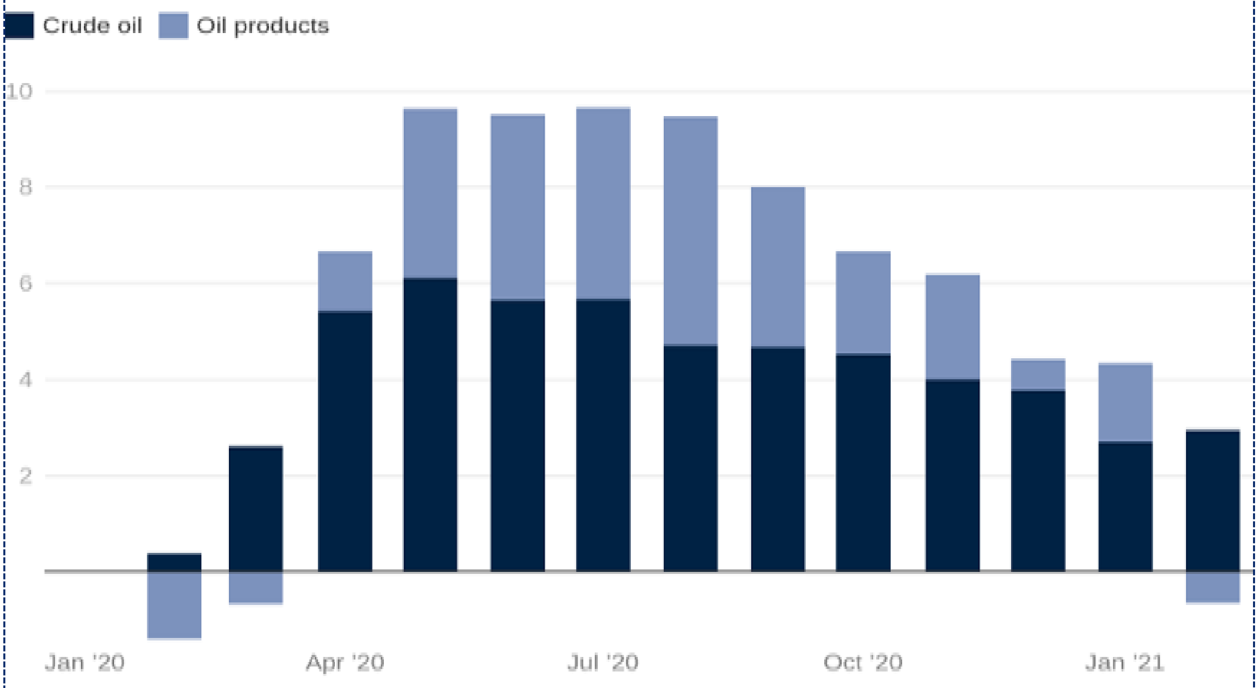


Chart 3:

Change in OECD Oil Inventories in 2020

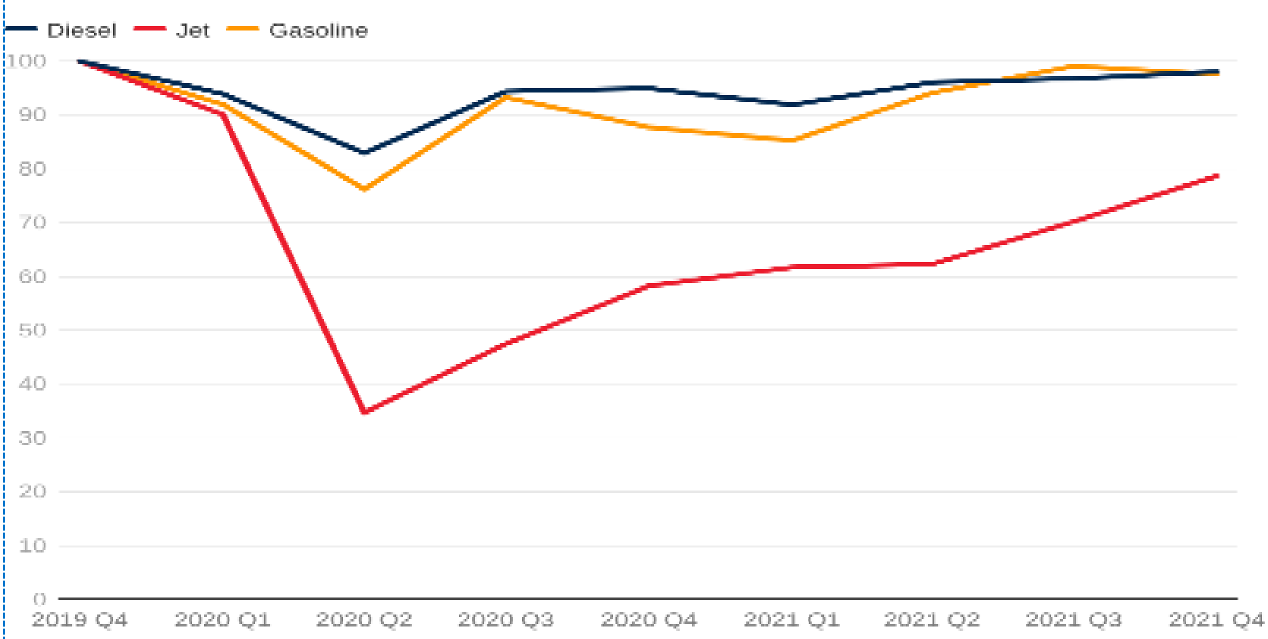


Change in oil inventories relative to their January 2020 level.

Source: IEA; World Bank

Chart 4:

OECD oil product demand in 2020



Source: IEA; World Bank.

The factor that overrides all the classical economic drivers is Futures & Options (F&O) in Oil, which is part of a basket of commodities that are 'traded' but seldom delivered. More than 95% of F&O trade is settled by paying the difference in price at two dates (contract signing and expiry) and not by physical delivery. The F&O price trends largely reflect the direction in which the three classical economic drivers point to and rarely the opposite - but F&O exaggerates their impact. Since there are people with different levels of price expectations, F&O thrives. Oil is the hottest commodity in Futures and Options contracts. Brent Oil and Texas Oil are the no 1 and no 4 largest F&O commodities out of the Top Ten items. Taken together, these two dwarf all other commodities. Once all traders start thinking alike about the future of Oil and differences in price expectations reduce, speculation will collapse and so will the pumped up prices. In the long term, Oil will move from being a fuel raw material catering to consumers, to a real B2B2B product catering to the chemicals and plastics industry which will force Oil of the future to behave like metals. There will be fluctuations and spikes from time to time but not like the Oil of today. EVs and renewable energy will together, hasten that shift in the medium to long term. Speculators and oil exporters want to make the most of the short to medium term opportunity making 2020 to 2025 very interesting.

Is there a rising tide since the pandemic began?

So, it seems given that

- US pumped in $1.8 Tr in 2021 in addition to $ 0.9 Tr in Dec 2020. Totally 12.6% of US GDP! Other major countries too contributed. Interest rates still ultra-low. Money started chasing riskier assets than uninteresting Debt?

- The number of Unicorns shooting through the roof since 2020; timber prices quadrupling, steel price booming, equities too shooting through the roof in 2020. Naturally, Oil too.

Oil and F&O are on steroids

Total **F&O contracts** up by 35.6% in CY 2020 of which **F** up 32.7% to 25.55 billion & **O** up 39.3% to 21.22 billion. **Open interest** - the number of outstanding contracts a record high, reaching 1 billion contracts, up 9.7% from December 2019.

Equity-related derivatives were majority of the increase in trading activity in 2020. F&O on equity indices, was the largest category of the listed derivatives markets by volume, up by 49.3% from 2019. **Energy F&O rose 24%** while **agricultural** F&O rose 45.4%. In both, the biggest growth was on Chinese Exchanges where speculation thrives even at the best of times

This tide has reversed for timber - a huge crash from the peak. Steel too, is headed South. What about Oil? Goldman Sachs expects an increase to $80.

Why would I expect prices drop when OPEC+ is actually planning to extend the supply cut beyond April 2022?

That's precisely why; a new kind of Politics is playing out right now. The potential end of unity in OPEC+ is in sight. Saudi Arabia and the UAE are likely to stop bottling up their simmering rivalry. The Saudi sponsored extension on oil output curbs beyond April 2022 is probably just the proverbial last straw for the UAE. This coincides with Saudi Arabia's ambition to attract investments, trade, and tourists away from the UAE. Relaxations on social restrictions in Saudi Arabia to make it liveable, the pressure on foreign companies to open head offices in the Kingdom if they want to do business with the Government and their decision to start a new airline to compete head-on with the Emirates & Etihad and to take transit passengers away from Abu Dhabi and Dubai could herald economic trouble for the UAE which badly needs more oil dollars to invest in diversifying its economy away from dependence on oil. If OPEC+ breaks, the resultant supply surge could bring prices down below $ 60 per barrel. Matters could come to a head in the next few months even if there is a patch-up of sorts up in July 2021. Russia and Saudi Arabia are trying hard to prevent a slide in Oil prices. Both desperately need a $60+ price but are not greedy for $80 which will help US shale to thrive. Very few Western countries want to feed Russian excesses by providing her $ 60- 75 oil prices. One cannot say for sure that the oil price drop will happen by December 2021; it could even be delayed by a few months. The cleavage could be exploited by Oil Importing Countries including India by negotiating prices and volumes with the two or three resultant splinter groups. When that happens, oil speculators could send price tumbling, just as rapidly as they took it up.