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TRENDMACRO LIVE!

On the Doha Oil Freeze Failure

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Michael Warren

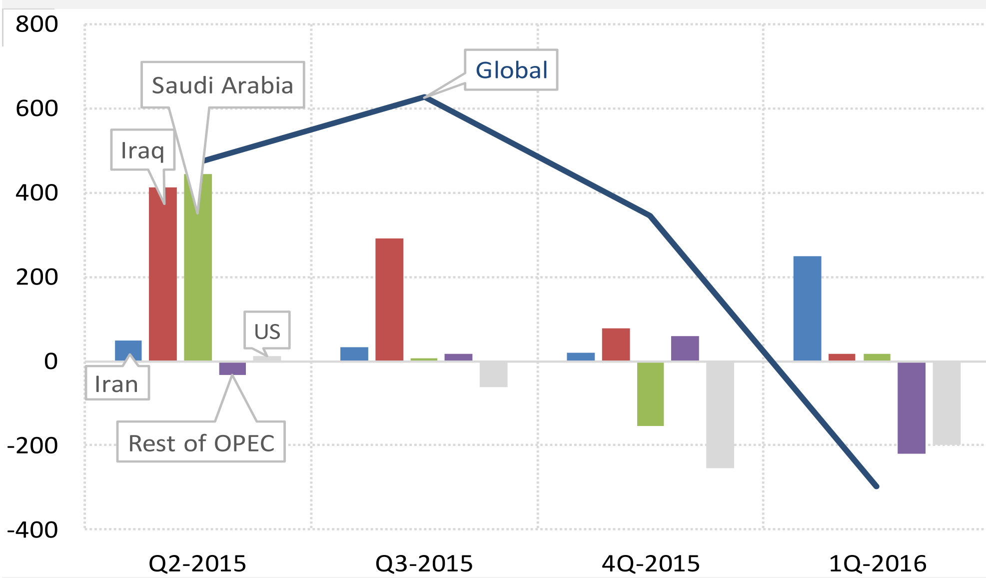
No deal. No surprise. No importance. Too-low prices have already cut global production.

As we predicted (see "Oil's Bull Market in a Month" March 15, 2016), the Doha negotiations among major oil producers to freeze production have collapsed without an agreement. The reason for the collapse is exactly what we expected (see "PIF the Magic Aramco IPO" April 4, 2016) – that Saudi Arabia would insist that Iran join in the freeze before recovering its production from years of sanctions, which inevitably Iran refused to do.

If this news – which should not be news at all – drives much of a correction in the oil price, we would see it as a buying opportunity. All the more so because the Doha headlines are masking other more bullish developments in global oil markets, to which we will turn shortly. We reiterate our call for oil to trade in a range from $45 to $60 in the back half of this year.

- While the markets have been obsessing over a possible production *freeze* among select nations, we have already seen an actual *drop* in world oil production of 299,000 barrels per day in the first quarter, from its prior-quarter peak (please see the chart below).

Change in crude production Millions barrels/day



Source: OPEC, TrendMacro calculations

Update to strategic view

OIL: If the failure of the Doha negotiations to freeze oil production drives a major correction in the oil price, we see it as a buying opportunity. A freeze was a non-starter from the get-go. Too-low oil prices have already done the work of a deal anyway. World production is off 299,000 since peak in Q4-2015, led by a 700,000 drop in the US since peak in April 2015. With further global and US drops forecasted, the question is how expected growth in global demand can be satisfied, especially with what we expect will be increasing social upheavals in oil-producing welfare states – such as Kuwait, where a strike has reduced production by 60%. Saudi's bragging that it can increase production by 1 million b/d is not a bear-case for oil – it's a hedge against today's glut catastrophically flipping into tomorrow's shortage. We reiterate our call for oil to trade in a range from $45 to $60 for the back half of this year.

[Strategy dashboard]

- The drop has been led by the US, where production has fallen nearly 700,000 b/d from its peak in April 2015. OPEC has increased production by only 61,000 b/d over the past two quarters, despite Iran having added nearly 250,000 b/d of incremental supply since sanctions were lifted.
- *Even if there had been a Doha deal, what would it have added that too-low market prices haven't already achieved?*
- For what it's worth at this point, even if Iran had played along, there was never much a deal on the table. Text of a draft agreement circulated to the press would have held the signatories' oil production to January's levels until October, when another meeting would take place to plan action going forward. There were no enforcement provisions. At best it would have had some symbolic value, being the first time in 15 years that OPEC and non-OPEC nations cooperated to jointly attempt to lift prices.
- But at this point such attempts fundamentally run counter to the Saudi position taken in November 2014 to allow markets to set prices (see "Saudisfaction Guaranteed" March 13, 2015), a position confirmed three weeks ago in Saudi Crown Prince Mohammed bin Salman's extensive interview with Bloomberg (again, see "PIF the Magic Aramco IPO").
- Indeed, Prince Mohammed bragged on Saturday that the Kingdom could easily *increase* production by a million b/d virtually immediately. Surely this was a deliberate slight to Iran whose oil minister Bijan Zanganeh had once claimed that Iran could increase production by 1.3 million b/d within three months of sanctions being lifted (the reality has been less than 20% of that).
- There is another interpretation. Zanganeh's latest version of his production promise is that Iran can add another 750,000 b/d by March 2017. Even if true, that won't even offset the US Department of Energy's latest estimate for an 890,000 b/d decline in US production by that same date, by which time it forecasts global demand will have grown by 1.2 million b/d. So maybe Prince Mohammed's seeming braggadocio is really to let markets know that Saudi has the spare capacity to supply the world – and, at the same time, supply its own ambitions to increase its market-share (see "Market Share for Cannibals" June 8, 2015).

Saudi's ability to supply the world means much more than its geopolitical rivalry with Iran, or its industrial rivalry with US frackers. Saudi stands as the world's best bulwark against increasing instability in OPEC supplies. We have argued for some time that, in the great bear market for oil that began in June 2014, markets have mistakenly turned a blind eye to geopolitical risks (see, among many, "Oil: Priced for Perfection in an Imperfect World" January 20, 2016).

- These risks are not only driven by the usual exogenous political factors – now exacerbated by the Iran nuclear deal – but also by endogenous social factors within oil-producing countries whose welfare states are fundamentally threatened by a future of lower oil prices (see "The Recession Caused by Low Oil Prices" January 8, 2016).

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- A salient example crowded out of the headlines this weekend by the Doha failure is the recent labor discord that has cut Kuwait's production by 60%, or 1.6 million b/d. Striking unions are protesting cuts to spending and benefits designed to plug a huge gap in state finances.
- Various oil-producing welfare states have different labor market structures, so the timing and nature of actions that express worker dissatisfaction will be highly diverse. But the trend is clear: the oil-producing welfare states that can't "make it up in volume" face disruptions, if not downright upheavals.
- Saudi Arabia is not entirely immune, but is relatively well situated. Prince Mohammed has signaled a new comprehensive plan to guide the Kingdom through a post-oil era (again, see "PIF the Magic Aramco IPO" April 4, 2016.) There will be cuts in state largesse to government and oil industry workers, which will no doubt be rationalized as requirements for the eventual IPO of Saudi Aramco.
- *At least Saudi has options to manage the pain of transition. And the greater its neighbors' pain, the less its own. If Prince Mohammed is right, Saudi can grow its production as disturbances in other nations decrease their production – thus improving the Kingdom's cash flow and market share, without driving prices lower.*

Bottom line

If the failure of the Doha negotiations to freeze oil production drives a major correction in the oil price, we see it as a buying opportunity. A freeze was a non-starter from the get-go. Too-low oil prices have already done the work of a deal anyway. World production is off 299,000 barrels/day since peak in Q4-2015, led by a 700,000 drop in the US since peak in April 2015. With further global and US drops forecasted, the question is how expected growth in global demand can be satisfied, especially with what we expect will be increasing social upheavals in oil-producing welfare states – such as Kuwait, where a strike has reduced production by 60%. Saudi's bragging that it can increase production by 1 million b/d is not a bear-case for oil – it's a hedge against today's glut catastrophically flipping into tomorrow's shortage. We reiterate our call for oil to trade in a range from $45 to $60 for the back half of this year.