OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

Author

JEAN-PIERRE DURANTE
jdurante@pictet.com

SUMMARY

- It looks like our forecast of USD50 per barrel for Brent oil in 2020 set out in our last note on the oil market) will be close to the mark, with Brent stuck around USD60.
- Our concerns about geopolitical tensions triggering temporary oil price spikes proved overstated. Even direct armed confrontations in the Strait of Hormuz resulted only in a temporary rise of a few dollars in oil prices. The risks of a global recession have risen, adding to concerns of oil oversupply in 2020 due to increased US export capacity.
- The Brent oil price, which has become a sort of thermometer of global sentiment like manufacturing surveys, international trade and industrial production, is increasingly reflecting the impact of the US-China trade war on global economic growth.
- However, the oil price cannot be considered a reliable indicator of a global recession as, from time to time, price fluctuations may be dominated by supply factors.
- The medium-term outlook remains tilted towards weaker prices due to the prospect of oversupply, uncertain OPEC+ compliance with production limits and the global economic slowdown.
- We continue to expect the Brent price to drop to USD50 in early 2020 and remain close to this level for the rest of the year. Prices indeed are likely to move toward this level. Brent is expected to close 2019 at USD58 and WTI at USD55, with increasing US export capacity likely to narrow the gap between the price for the two types of oil.

Investors worried by the damaging impact of the trade war

Despite a tight oil market and geopolitical tensions, the oil price has remained weak so far this quarter. Brent oil has declined by USD4 since the end of June and more than USD12 since 25 April, when it reached USD75.2, the highest level this year. Two factors have contributed to this decline. The first factor, especially evident during the spring, was concerns over the risk of oversupply due to the dynamism of non-OPEC producers, the US shale oil industry in particular. The second factor —relentless Trump announcements of new tariffs— has risen steadily in prominence as investors have become convinced that the trade war will not be solved rapidly and that the uncertainty created by this new environment will have a cost in terms of global GDP growth and thus oil demand. Thus, while new tariff announcements have had a significant downward impact on oil prices, incidents in the Strait of Hormuz have barely added a transitory two to three US dollars, as investors have positioned for a long decline in oil prices.

OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

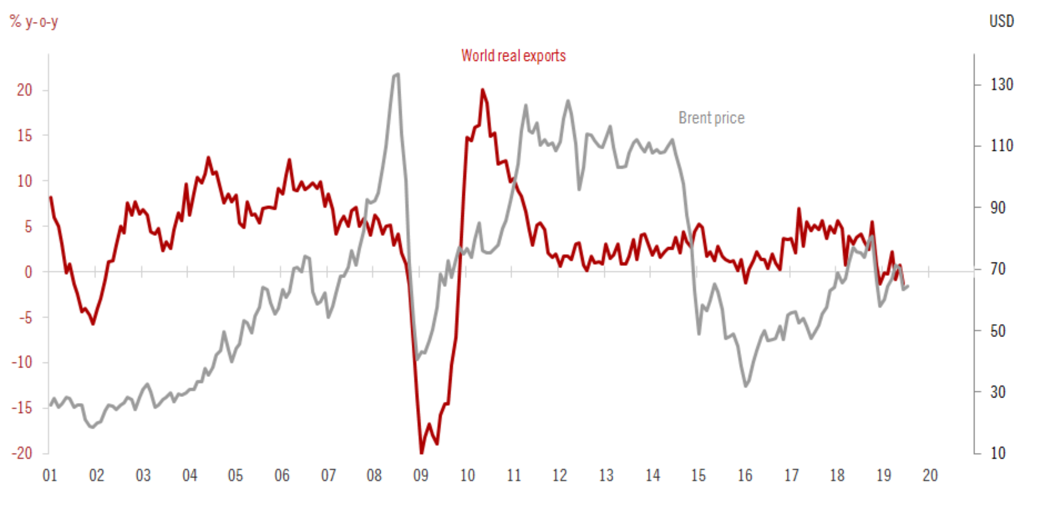
CHART 1: OIL PRICES

Source: Pictet WM - AA&MR, Thomson Reuters

Brent price as a thermometer of global sentiment

Historically, the relationship between oil prices and economic activity is quite loose, but since the beginning of the trade war, the oil price has become quite a good indicator of global activity. We can see a certain relationship between the Brent price and world real GDP growth as well as other indicators like purchasing manager indexes (PMI) for manufacturing. But the most obvious relationship is between the Brent price and international trade. Since early 2018, there has been a close correlation between the two.

CHART 2: INTERNATIONAL TRADE AND THE OIL PRICE

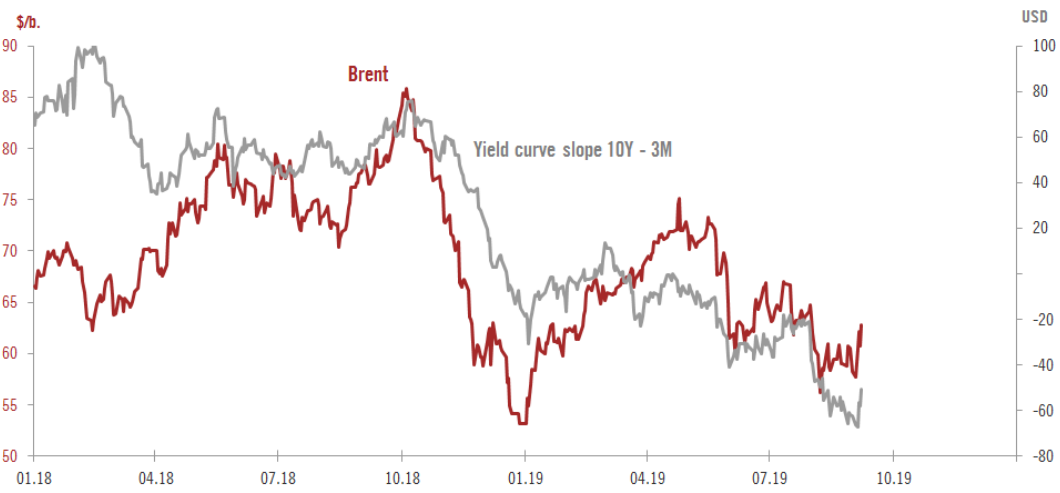


Source: PWM - AA&MR, Bloomberg

OIL MARKET
ARE OIL PRICES CALLING A RECESSION?

As a result, the oil price has become a sort of thermometer of investor sentiment on global activity, reacting in tandem with traditional indicators like the US yield curve and the S&P500.

CHART 3: BRENT OIL AND THE US YIELD CURVE

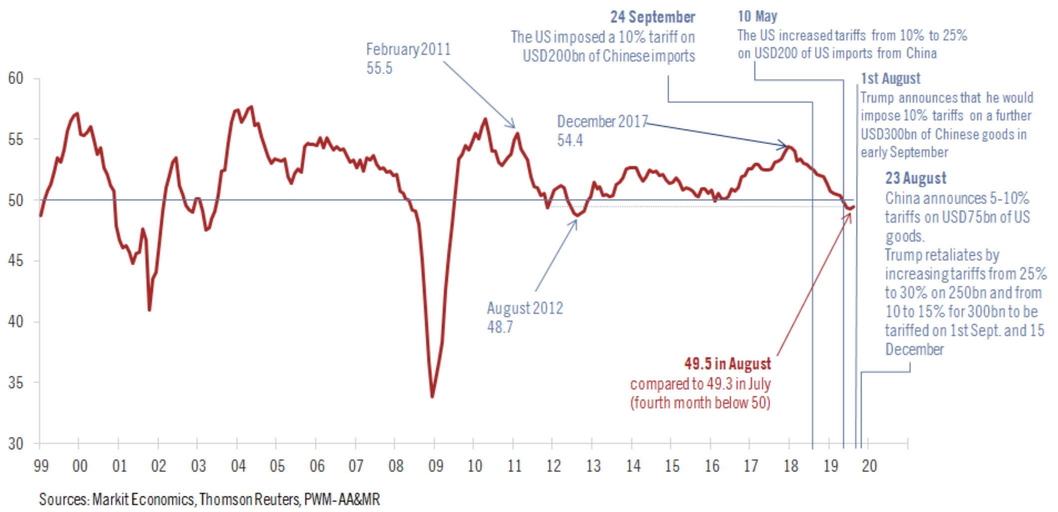


Source: PWM - AA&MR, Bloomberg

Latest tariff increases are likely to weigh on sentiment in H2 2019…

Although the deterioration in global sentiment started before the escalation of global trade tensions, the uncertainty created by tariff announcements has surely been a major factor behind the longest deterioration in manufacturing sentiment on record (15 months in a row up to July). The scary aspect of this is that the August announcements of new tariffs by the US and China are not visible yet in surveys or statistics. This means we can expect further deterioration in manufacturing confidence in the months ahead.

CHART 4: WORLD PMI – MANUFACTURING: THE DAMAGES CAUSED BY ONE YEAR OF TRADE WAR



OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

…and to dampen hard data

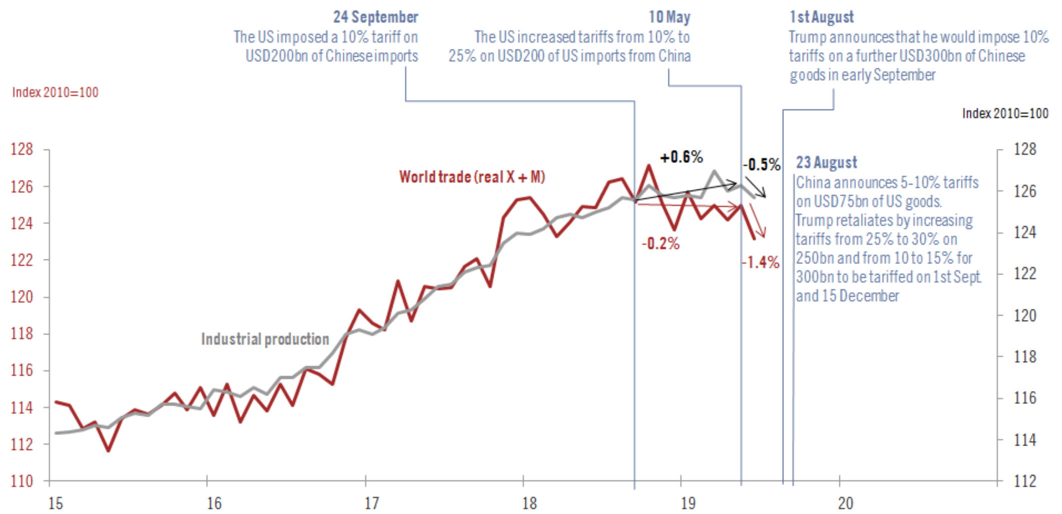
Events since Trump first threatened increased tariffs in 2017 provide a textbook example of how tariffs affect international trade. First, the uncertainty they create hurts sentiment. Then, as uncertainty lasts, investments are postponed. Indeed, we are currently seeing a progressive decline in new orders, industrial production, an increase in inventories and, ultimately, a reduction in investments.

All this process takes time. Hard data remained resilient for nine months. but the first signs of capitulation are now appearing. International trade weakened by only -0.2% between September 2018 and May 2019, but it dropped abruptly by -1.4% month on month (m-o-m) in June. One sees a similar pattern in industrial production, which actually increased by 0.6% between September 2018 and May 2019 before falling by -0.5% m-o-m in June.

These developments tend to confirm our ideas about the sequence of events. A trade war is the kind of shock that takes time to impact economies. At first, the direct impact is quite negligible (10% tariffs on USD200bn = 20bn or 0.1% of US GDP), but the longer the uncertainty lasts the harder the indirect impact through the transmission mechanism described (sentiment impacted first, then orders, inventories, then production and eventually investment).

All this is worrying, as it means that we are only at the beginning of the deterioration process. The impact of the most recent tariffs is not yet visible in trade and industrial production data. Accordingly, data releases in the months to come are likely to reflect the impact of the latest round of the trade war, with damaging consequences for international exchanges and industrial production (see also World GDP growth revised down to 3.1%).

CHART 5: INTERNATIONAL TRADE AND WORLD INDUSTRIAL PRODUCTION



Source: PWM - AA&MR, CPB, IMF, Thomson Reuters

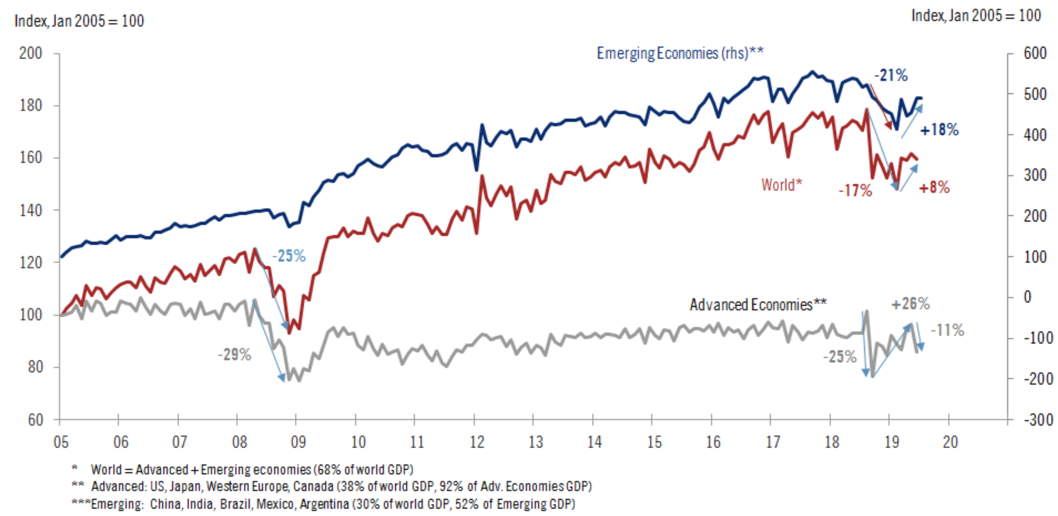
OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

Car industry contribution to the downturn

Sentiment was already declining among manufacturing companies before the beginning of the trade tensions in 2018. Apart from the tariff announcements, one of the main factors behind the dramatic collapse in manufacturing sentiment has been the crisis in the car industry. Dieselgate and more generally the change in consumer tastes away from diesel have badly affected car sales. In September 2018, car registrations collapsed -25%, a one-month drop comparable to the fall registered during the whole Global Financial Crisis in 2008 (-29% over seven months)! The deterioration in car sales in emerging economies has been of comparable magnitude (-21%) but less violent, as it has been spread over six months (between August 2018 and February 2019). Since then, registrations have rebounded significantly (+8% worldwide), but the latest data are not encouraging, with registrations in advanced economies dipping again in June. It is clear that on top of the uncertainty created by the trade war, the car industry's troubles have had an impact on global manufacturing sentiment, inventories and production.

CHART 6: GLOBAL PASSENGER CAR REGISTRATIONS



Source: PWM - AA&MR, National statistical offices, Thomson Reuters

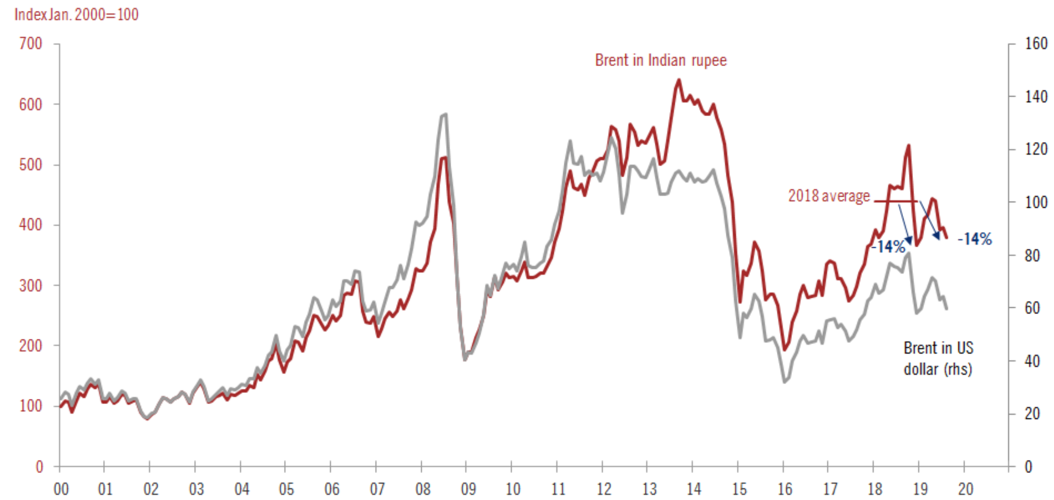
Good news! Oil prices are low!

Beyond all the worrying news, there is at least one positive development. Low oil prices offer some support to global activity and consumer demand. World GDP is dominated by oil-importing economies. As a result, low and stable oil prices tend to favour economic activity and investment as well as provide purchasing power to consumers. Despite recent volatility, we observe that the price of Brent in Indian rupees (other currencies could equally be used for comparison purposes) is still 14% below the 2018 average.

OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

CHART 7: BRENT IN US DOLLARS AND INDIAN RUPEES

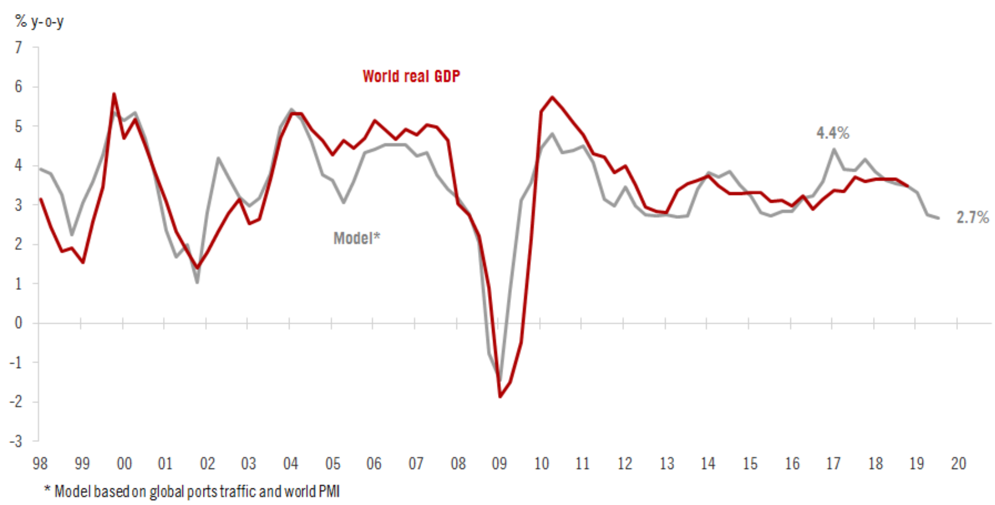


Source: PWM - AA&MR, Thomson Reuters

Towards weaker global GDP growth in H2 2019

Combining different information, we see that there is a marked risk of a deceleration in world GDP growth in the second half of this year. According to one of our models, based on international trade and manufacturing PMI, real global GDP growth could slow to 2.7% year on year (y-o-y) in H2 2019. This would imply growth of 1.5% q-o-q, annualised, followed by 2.4% q-o-q, annualised. World GDP growth below 2.5% is traditionally considered a global recession.

CHART 8: WORLD REAL GDP GROWTH



Source: PWM - AA&MR, IMF, Markit Economics, Thomson Reuters

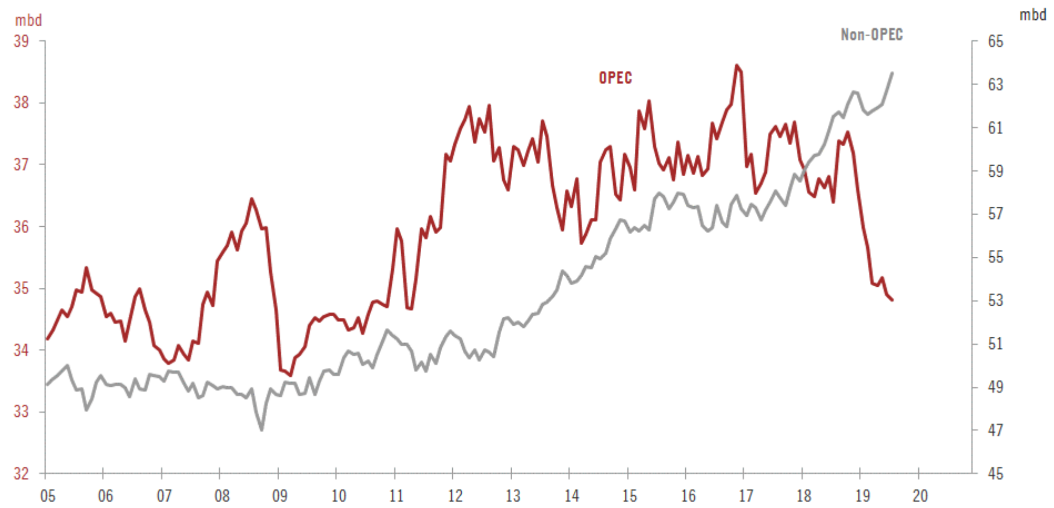
OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

OPEC's travails to support prices

This gloomy world economic scenario tends to increase the risk of crude oil oversupply in the medium term. OPEC output has collapsed by 1.8 million barrels per day (mbd) since the end of 2018, in part due to OPEC+'s self-imposed production limits and in part to the problems being experienced by some producers (Iran, Venezuela, …).

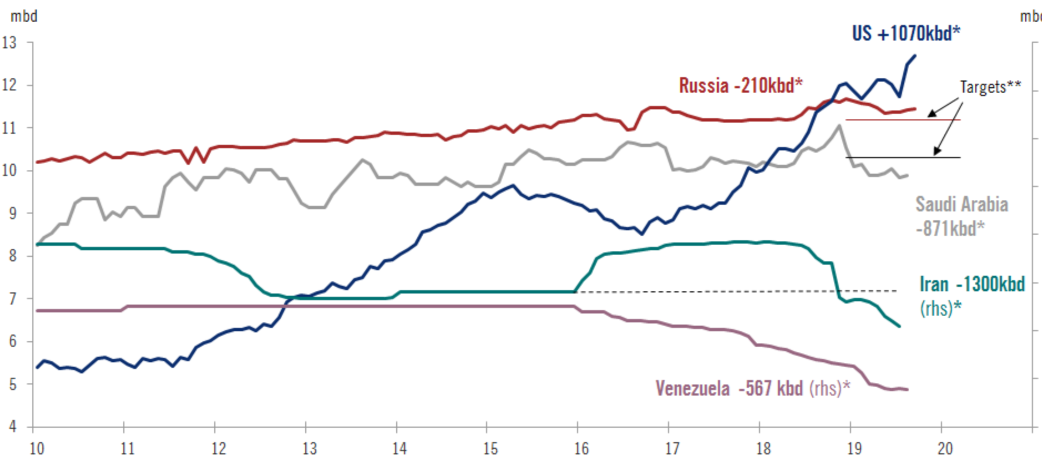
CHART 9: OPEC AND NON-OPEC OIL OUTPUT



Source: PWM - AA&MR, Energy Intelligence, Bloomberg

By contrast, non-OPEC production remains buoyant (+1.9mbd since February), in large part due to sustained increases from unconventional US production.

CHART 10: BIG OIL SUPPLIERS



* Since October 2018 ** as of OPEC+ 7 Dec. 2018 agreement, extended on 2 July 2019

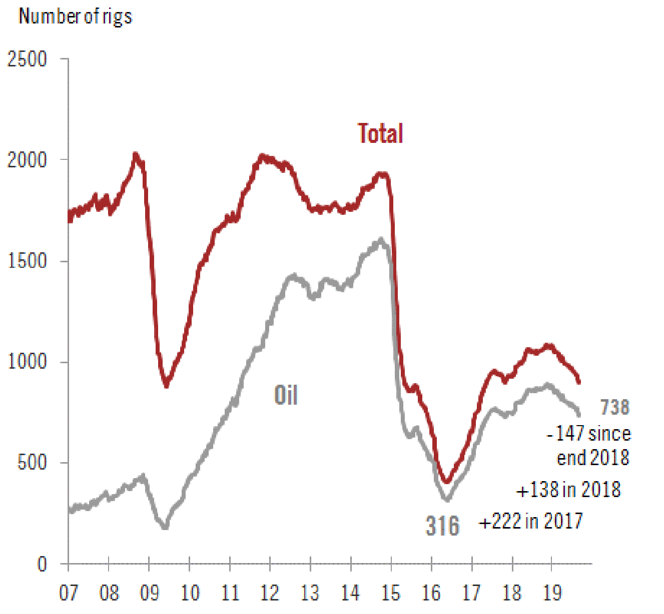
Source: PWM-AA&MR, US Energy Information Administration, Thomson Reuters

OIL MARKET
ARE OIL PRICES CALLING A RECESSION?

US increased export capacity

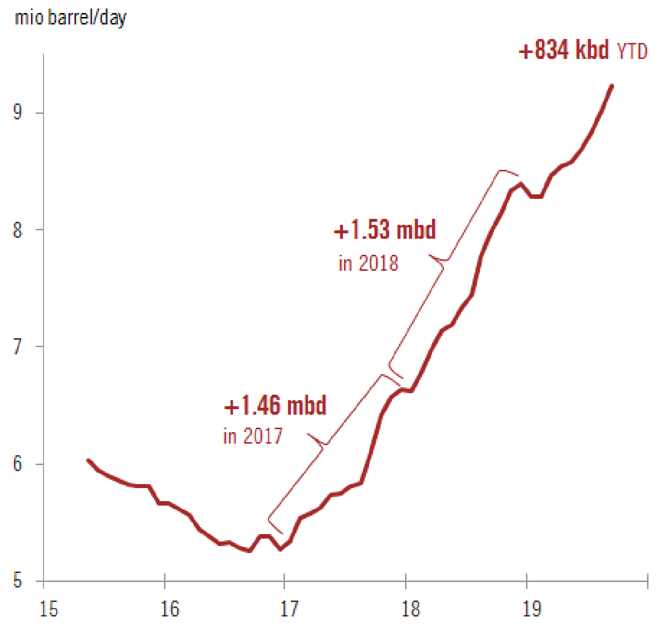
Despite declining drilling activity and ongoing pipeline constraints, US shale oil production has increased by 0.8mbd so far this year. Further increases in US export are looming as new pipeline capacity comes progressively on stream before year's end.

CHART 11: US CRUDE OIL RIG COUNT



Source: Baker Hughes Inc., Pictet WM - AA&MR, Bloomberg

CHART 12: US SHALE OIL PRODUCTION



Source: Rystad Energy, Bloomberg, Pictet WM- AA&MR

Specifically, two new major pipelines began operating in August: Plains All American Cactus II (capacity of 585kbpd) and the EPIC interim line (capacity of 400kbpd). Moreover, the Gray Oak pipeline (capacity 900kbpd) is expected to start up in the coming months, with at least half of its potential capacity in use by the end of the year.

OPEC+ agreement to be tested

In the space of a few years, the US has become a major player in the oil market. It is already the world's biggest producer, outpacing Saudi Arabian production in 2017 and Russian output last year (even when taking account of these two countries' self-imposed production limits). But the largest impact on the global oil balance comes from the US's shift from being a massive oil importer (more than 13mbd at end-2005) to becoming close to a net exporter. In fact, US crude exports have jumped to 2.9mbd this year, a marked increase from 1.7mbd just one year ago.

OIL MARKET

ARE OIL PRICES CALLING A RECESSION?

CHART 13: US GROSS OIL TOTAL IMPORTS

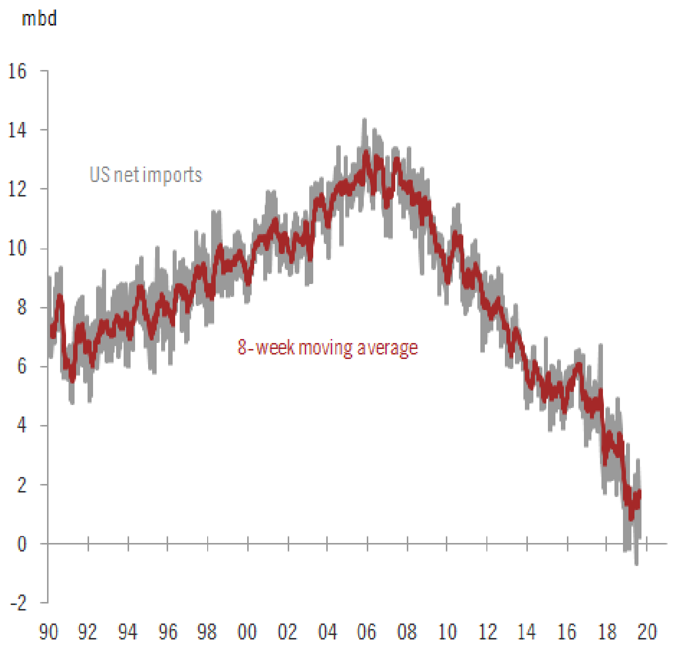
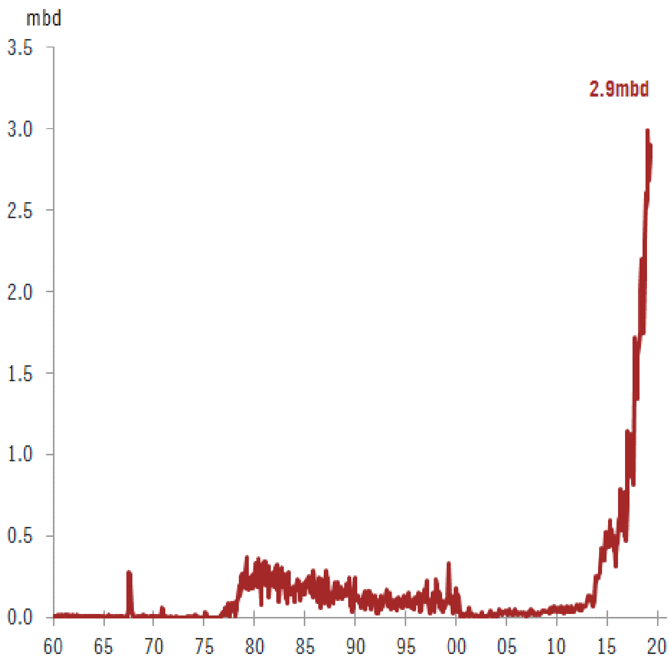


CHART 14: US EXPORTS OF CRUDE OIL



Source: DOE, EIA, Bloomberg, PWM - AA&MR

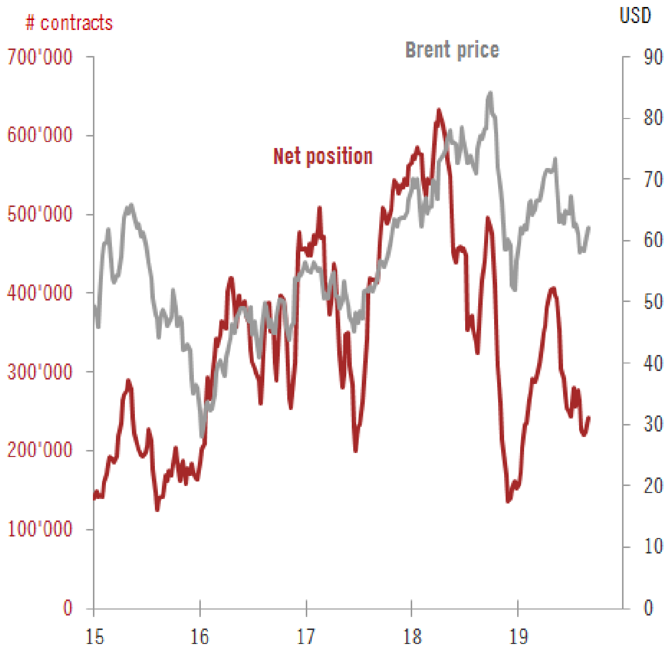
The Saudis are betting that US shale oil production, due to its unconventional nature, will not be sustainable. Meanwhile, they are sticking to their traditional role of stabiliser producer by limiting output to support oil prices, even if this is costly and painful in the short term. This strategy will be sorely tested at the turn of the year when new US export capacity arrives on the market. But what alternative do the Saudis have? Pumping more in order to defend their market share – as they did in the 1990's – will certainly cause prices to tumble (the Brent price more than halved between October 1996 and December 1998, to USD10 per barrel, when the Saudis last flooded the oil market). Since the Russians are less inclined to self-sacrifice, the solidity of the OPEC+ agreement is likely to be tested in 2020. This prospect is likely to encourage investors to bet on tame or even weaker oil prices, adding to the existing downward pressure.

On this point, the recent replacement of the Saudi energy minister is probably more related to the Aramco IPO (the state oil company) than to OPEC+ policy. In our view, the new incumbent is unlikely to drastically overhaul OPEC+ policies of recent years.

OIL MARKET

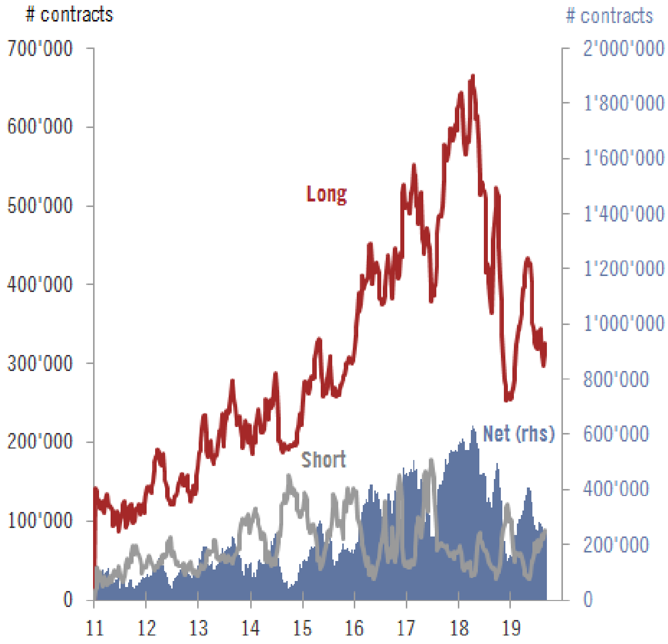
ARE OIL PRICES CALLING A RECESSION?

CHART 15: BRENT BETS – MONEY MANAGERS NET-LONG POSITION AND BRENT PRICE



Source: PWM - AA&MR, ICE, Bloomberg

CHART 16: BRENT BETS: MONEY MANAGERS LONG-SHORT POSITION



Source: PWM - AA&MR, ICE, Bloomberg

Brent towards USD50 in 2020

All in all, we are sticking to our existing scenario. Geopolitical tensions (US-Iran) and the threats to production in some countries (Venezuela, Syria, Irak, Angola) could resurface and trigger temporary price spikes. However, the medium-term outlook remains tilted to weaker prices because the oil market risks being oversupplied as a consequence of US increased export capacity, the fragility of OPEC+ compliance with production limitations and the global economic slowdown. All these factors will encourage investors to bet on lower prices. We continue to expect the Brent price to reach USD50 in early 2020 and remain close to this level for the rest of the year.

The oil price looks like converging towards these levels as we near the end of 2019. The Brent price is expected to close the year at USD58 and the WTI at USD55 as additional US export capacity compresses the spread between the two types of oil.