What the Energy Tug of War May Mean for Investors

On the one side: A potential global oil glut. On the other: geopolitical tensions that could choke off key supply. We drill into the future to sort it all out.

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Chart 1. Reflecting Geopolitical Turmoil, Crude Oil Prices Have Had a Bumpy Ride Year-to-Date

Per barrel price of West Texas Intermediate grade crude oil, for the 12-month period ended July 16, 2019

Source: International Energy Agency. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results. Past performance is not a reliable indicator or guarantee of future results.
In Brief

- After U.S. president Donald Trump made a pledge on April 22, 2019 to drive Iran’s oil sales to zero, forcing trading partners to choose between Iran and the United States, crude oil prices surged.

- But the bull was sidetracked on July 12, 2019, when an analysis of various forecasts showed major surpluses and not the supply shortfall that was expected to perpetuate the rally.

- Barring any major disruptions of a geopolitical nature, lower crude oil prices will prevail heading into the new year, given current macroeconomic and production trends, according to Giulio Martini.

Note: This is the first in Market View’s Sector Spotlight series, offering a periodic examination of conditions in key investment sectors and related investment insights.

After U.S. president Donald Trump made a pledge on April 22, 2019 to drive Iran’s oil sales to zero, forcing trading partners to choose between Iran and the United States, crude oil prices surged. With potential supply disruptions in the offing, many market participants were expecting oil prices to experience a bull rally this year and eventually through to 2020. Data from the International Energy Agency (IEA) show that the price of West Texas Intermediate (WTI) crude oil rose to $65.07 on April 22, 2019 from a low for the 12-month period (July 16, 2018-July 16, 2019) of $42.53 on December 24, 2018. (See Chart 1.)

But the bull was sidetracked by a countervailing development. In a report released on July 12, 2019, the IEA provided a preliminary analysis of various forecasts showing major surpluses and not the supply shortfall that was expected to perpetuate the rally. Rising U.S. shale production, a slowing global economy, and the prospects of an escalating trade war between the United States and major trading partners (mainly China), have all placed downward pressure on prices in recent weeks. WTI ended the period (July 16, 2019) at a price-per-barrel of $57.62, according to IEA.

The recent weakness in pricing comes despite such supply-constraining developments as pipeline infrastructure issues in Russia, the impact of U.S. sanctions on Iran and Venezuela (see Chart 2), and elevated tensions in the Middle East, all of which definitively cut oil output levels.

On the demand side, news that the International Monetary Fund cut its forecast for China’s economic growth in 2020 to 6%—the slowest pace since 1990—has also weighed on sentiment. Given that China has long been viewed as the engine of demand for commodity markets, this potentially does not augur well for the oil market.

While experts see crude-oil oversupply next year, they are not in agreement as to its severity. S&P Global Platts estimates the surplus in 2020 at approximately 400,000 barrels per day (bpd). The Energy Information Administration of the U.S. Department of Energy sees a 100,000 bpd surplus, while consultant Energy Aspects sees a stock-build of 500,000 bpd. Finally, and most alarmingly, IHS Markit is expecting a total surplus of 800,000 bpd next year.

But these bearish forecasts must be considered in the context of the unique vulnerabilities of the global oil market. Much of world supply comes from politically unstable regions, where sudden policy, infrastructure, or military developments can throw a wrench into the most carefully constructed projections. For example, news about a June 13 attack on two oil tankers in the Hormuz Strait—the world’s most important oil chokepoint which accommodates nearly 40% of seaborne trade—caused...
oil prices to jump 2.0%-4.5% intraday before paring losses, Bloomberg reported. A longer term concern: coming changes in fuel requirements for oil tankers could sideline a portion of the global fleet starting in 2020, according to a CNBC report.

**Drilling Into the Future**

Our international economist, Giulio Martini, Lord Abbett Partner and Director of Strategic Asset Allocation, believes that, barring any major disruptions of a geopolitical nature, lower crude oil prices will prevail heading into the new year, given current macroeconomic and production trends.

On the demand side, slower economic growth outside the U.S. and peaking (or declining) auto sales in the United States, China, and the euro zone will continue, he believes, to hold oil prices down.

On the supply side, production from low cost shale continues to grow rapidly – over 1.5 million bpd in the United States alone. Although lower prices have moderated drilling activity a bit, production cuts haven’t been nearly enough to adjust to weaker demand.

While falling prices is good news for consumers, at some point the downward trend will discourage capital spending, resulting in caps on production, which in turn, could, eventually, pressure prices higher.

But Martini believes that lower, not higher, prices are in the forecast for the foreseeable future. “Investors should not underestimate the overhang of supply that exists in Iran, Libya, and Venezuela. Eventually,” Martini says, “while higher output in these countries is not imminent, when the supply from these big oil producers is back on the market, the price of crude oil is likely to decline sharply. And we may never see $100 a barrel again (as we did in June 2014) unless a major shock, such as another oil embargo, causes a temporary price spike.”

**Chart 2. Sanction Shock: Oil Output Plunges in Iran and Venezuela**

*Combined crude oil production for Iran and Venezuela, June 30, 2014–June 30, 2019*

Source: Bloomberg. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results.

*Past performance is not a reliable indicator or guarantee of future results.*
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