

## A new buying opportunity?

**Brent prices have collapsed 16% from their end-of-October highs. What are the reasons? What is the outlook for crude oil prices? Should investors see this as an opportunity or a danger?**

The International Energy Agency and OPEC (Organization of the Petroleum Exporting Countries) both estimated that the world's oil market was back in surplus and that this situation would last into early 2022. The measures taken to curb the spread of the Omicron variant raise fears of a drop in demand while the recent rise in prices should lead to an increase in non-OPEC+ oil production in the coming months. This should help to stabilise prices, but the balance of risks remains to the upside in the short term (winter) and medium term (end of 2022 and 2023). In practice, any weakness in oil prices should offer investors buying opportunities in oil stocks, oil ETFs and funds investing in the futures market.

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## The role of OPEC + in supply management

In February-March 2020, when the first lockdown and travel ban measures were implemented, oil prices collapsed. The fall was amplified by a price war between Saudi Arabia and Russia, which failed to agree on quotas to limit production. As the storage capacity was saturated, WTI (West Texas Intermediate) contracts for delivery in May no longer found buyers and negative prices (USD-37.6) were registered on the last trading day.

In April 2020, the 13 OPEC countries, plus Russia and 9 other oil-producing countries decided to cut oil production in May and June by 9.7 million barrels per day and in July by 7.5 mb/d out of a global total of nearly 100 mb/d before the pandemic. Since then, the strict management of supply by OPEC + has paid off handsomely, with Brent prices climbing from a low of USD20 in April 2020 to USD86.5 at the end of October 2021.

Faced with rising inflation, the Biden administration tried (with no avail) to put pressure on Saudi Arabia and other producers to agree that OPEC + accelerate the return to pre-pandemic production levels. In order to put pressure on prices, Joe Biden decided in November to draw 50 million barrels from the US strategic petroleum reserve. Remarkably, this was done in consultation with China, India, South Korea, Japan and the United Kingdom, which agreed to follow suit.

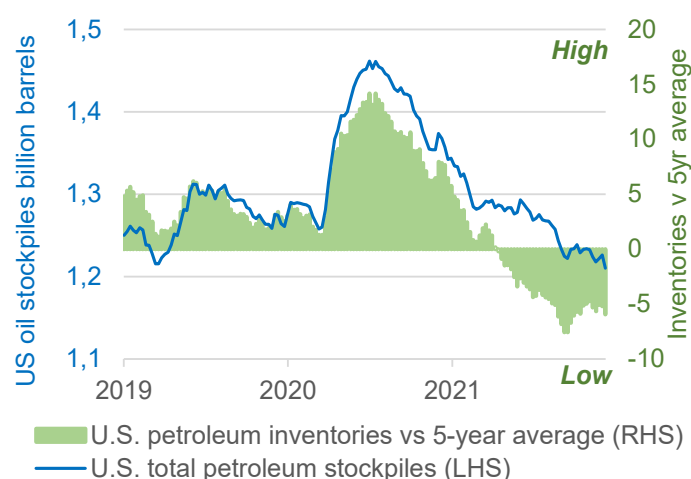
The announcement of the spread of a new Coronavirus variant on 25 November coupled with the immediate stoppage of air traffic with South Africa triggered a fall in crude oil prices.

On 2 December, OPEC + surprised the markets by announcing their decision to pursue its plan to up production by 400,000 barrels per day each month despite the uncertainties related to the Omicron variant. The markets were not expecting the alliance to announce a production increase from January 2022, in response to Joe Biden's initiative and the Omicron virus.

## Implications for the coming months

The OPEC + meeting in early December was preceded by intense diplomatic negotiations between the US and Saudi Arabia and other members of the alliance. The decision to continue to raise production despite the decline in prices (the Brent slumped from USD86.5 at the end of October to USD70) is both a sign of appeasement and confidence in the robustness of demand, which should lead to price stabilisation in the coming months, probably in the range of USD70-80 for Brent.

US CRUDE OIL STOCKS ARE WELL BELOW THE SEASONAL AVERAGE



Source: US Department of Energy, Bloomberg 13/12/2021

The downside risk is small because oil stocks are well below their 5-year average and OPEC + continues to argue that tighter supply restrictions are possible at any time. This aggressive tone by OPEC + should set a floor for the oil price even if the Omicron variant were to lead to a significant decrease in air traffic and travel in general.

On the other hand, barring exceptional circumstances, such as a very severe winter in the northern hemisphere, prices are likely to be pressured by an adverse seasonal effect in February-March and the expected increase in non-OPEC + production, in particular US shale oil. Overall, US production is set to increase from USD11.5 million to nearly 12 million barrels per day by mid-2022.

For the time being, the markets do not expect Iranian exports to resume because talks on Iran's nuclear power appear to be stalling. According to some diplomatic sources, an agreement does not seem likely before the US mid-term elections, but partial progress could lead to a reduction in sanctions to the tune of 500,000 barrels per day.

## Short-term risk: natural gas prices

In the short term, the main risk is a surge in natural gas prices that would favour a substitution effect (of gas by oil) in a number of industries. Today, natural gas prices in Europe are sky high for many technical, commercial and geostrategic reasons.

At the beginning of the autumn, gas inventories were lower than in previous years in Europe, Asia, but also in Russia (its own consumption). Added to this was greater demand for gas in China to satisfy its growing needs in industry and

to help it meet its pollution reduction targets. New gas pipelines are now making it easier for Russia to supply China. Russian exports to Europe fell while exports to Asia rose. Geopolitical tensions in Ukraine are not helping things along.

The commissioning of the Nord Stream 2 gas pipeline is facing political and commercial difficulties. European countries fear that the opening of Nord Stream 2 pipeline will lead to a closure of the gas pipeline which goes through Ukraine. The new German foreign minister, Annalena Baerbock, said that her government was in talks with the US with a view to delaying works ahead of the pipeline coming on stream, in the event of heightened tensions in Ukraine.

In addition, Europeans do not agree with Russia's proposal to set long-term tariffs to replace the current system based on spot prices.

In Europe, natural gas prices peaked in early October and subsequently dipped following President Putin's reassuring comments that Europeans did not have to fear supply disruptions during the coming winter. Geopolitical tensions have caused them to surge again in recent days. They are currently 470% more expensive than at the beginning of the year.

In the US, the situation at the end of the summer was completely different. Pre-winter stocks were at normal levels and prices lower. Although new liquefied gas export capacities have been built, they are not large enough to have an impact on European prices. In addition, in early autumn (no longer the case today) Asia was paying more for liquefied gas than Europe, leading LNG exporters to favour Asia.

## The balance of risks remains skewed to the upside

At the time of writing, the economic impact of the Omicron variant cannot be estimated because its danger still needs to be determined. But with each new wave of contaminations, the impact on oil demand was smaller and the subsequent recovery faster.

Thanks to the progress of medicine, it is reasonable to expect oil demand to return to pre-pandemic levels at some stage during 2022. With the recent price hike leading to an increase in the supply of non- OPEC+ producers, there

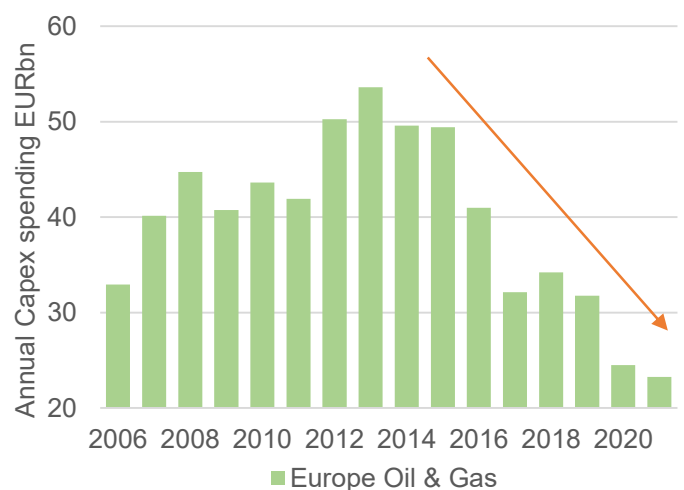
should be no major concerns in the first half of 2022. So everything will depend on the strength of demand.

According to economists' consensus, global growth is expected to reach 4.4% in 2022, well above the average of 3.4% observed between 2014 and 2019. Oil demand could exceed 100 million barrels per day, especially if the situation in emerging countries improves. The question is: will production be able to keep pace?

Since the collapse of oil prices in late 2014, the decline in investments in exploration and development of conventional oil fields has been significant.

We can already see that a number of OPEC countries (Nigeria, Angola, Algeria) are not in a position to produce as much as the higher quotas authorising them to. In fact, the surplus capacity of OPEC+ is concentrated in Saudi Arabia, Russia (from 2023), the United Arab Emirates and Iraq. But even in these countries, the surplus capacity could be lower than announced as some investments have been delayed in the wake of the pandemic, new oil fields are facing geological woes, infrastructure has aged and become less reliable due to the lack of investments of late.

### EUROPEAN OIL & GAS INVESTMENTS HAVE FALLEN SHARPLY SINCE 2015



Source: BNP Paribas, Bloomberg

## The effects of the energy transition

More and more analysts and strategists believe that the peak in supply could occur before the peak in demand in

view of the energy transition. A sharp expansion in investment in the exploration and development of new oil fields is unlikely, owing to shareholder pressure in favour of decarbonisation and the lack of visibility on the long-term profitability of such investments.

The impact of vehicle electrification on oil demand is expected to be felt in 2025 at the earliest. The risk of prices exceeding USD100 per barrel by then is very high.

As far as natural gas is concerned, there should be no supply issues, but demand could spike at times when gas needs to take over when the wind doesn't blow and the sun doesn't shine, especially in the winter months. The situation of inventories at those times could significantly influence prices.

## Conclusion for investors

We forecast Brent prices to stabilise at around USD70-80/barrel in the first half of 2022, and potentially USD80-90 in the second half. If, as we believe, global economic growth slows but remains above trend growth, Brent could exceed the USD100 mark in 2023-24.

For investors, low crude oil prices in the coming months should provide opportunities to reinforce positions in both oil ETFs/funds and in shares in oil companies.

The structure of oil prices in the futures market remains in backwardation (i.e. the further away the expiration date of the futures contract, the lower the futures price). In other words, ETFs and funds investing via futures benefit from an additional return generated by the rolling of mature contracts into a longer-term one. This return, known as the roll yield, is currently 4.5% in 1 year for Brent and 4.9% for WTI (as at 15/12/2021).

In equities, we like European oil companies, which are cheaper than their American counterparts. Moreover, their investments in alternative energy are not (yet) valued at the same level as those of producers of exclusively alternative energy. Finally, they generate substantial cash flows and pay high dividends.

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