

An Oil Minister's Lament

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Somewhere in the suburbs of Riyadh, a Saudi oil minister is roaming the kingdom's roads in his Mercedes sedan. He's undoubtedly relieved that oil prices have rebounded sharply from their shocking collapse earlier this year.¹ He may even smugly believe that the turnaround stemmed directly from OPEC's decision last spring to limit oil production through the summer.

This past weekend, he might have changed course, now encouraging his colleagues to begin opening the taps again; after all, the world's major economies are reopening, and consumption is beginning to rise again. He also recognizes, correctly, that this is an opportune time to squeeze leveraged American producers. All the same, he may not have a lot of confidence in his conclusions, because he knows that Covid-19 may yet force new closures and because the Americans can be both resourceful and unpredictable. In the back of his mind, he's also dimly aware of some long-term challenges lurking just beyond the horizon. In the comfort of his climate-controlled car, the minister may even notice fresh meanings in the old Jackson Browne CD he's popped into the car's infotainment system:

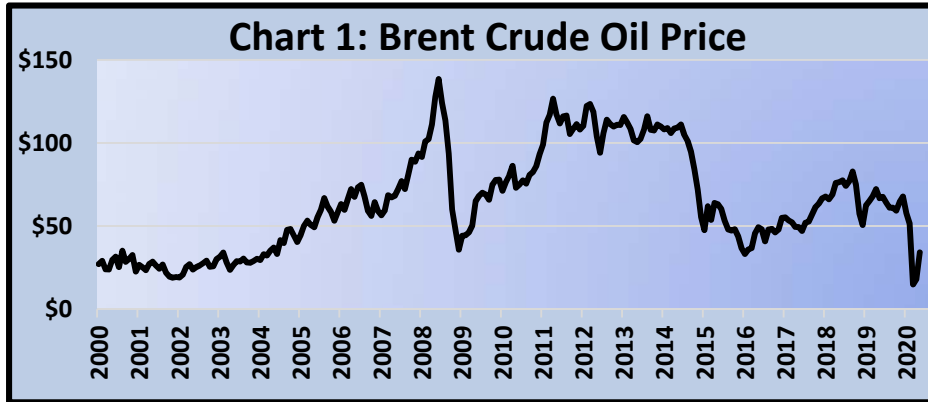
*Looking out at the road rushing under my wheels
Looking back at the years gone by like so many summer fields
In '79 I controlled the oil and called the world my own²
I don't know where I'm running now, I'm just running on
Running on empty, running blind
Running on empty, running into the sun
But I'm running behind.*

Forty years ago, OPEC effectively controlled the price and quantity of the world's crude oil, which left the United States and other Western countries vulnerable to economic and political shocks such as the second Arab oil embargo in 1979. That (along with misguided monetary policy) sent inflation spiraling upward; when new Fed Chair Paul Volcker fought back with double-digit interest rates, the U.S. plunged into a recession while OPEC countries prospered.

Today, OPEC is running on empty, its influence and profits greatly diminished by developments out of its control. Neither the 70% plunge in Brent crude prices earlier this year nor the rebound were primarily of OPEC's doing; indeed, the cartel would have preferred stable prices all along. Yet oil prices have been anything but stable in the past twenty years, as shown in Chart 1.

¹ He's especially happy because Saudi Aramco's stock price, after falling 21% following its IPO, has finally risen above its IPO price and has been touching new highs this week.

² OK, so he may have slightly misunderstood the original line, or perhaps it was the English-to-Arabic translation that was slightly faulty here.

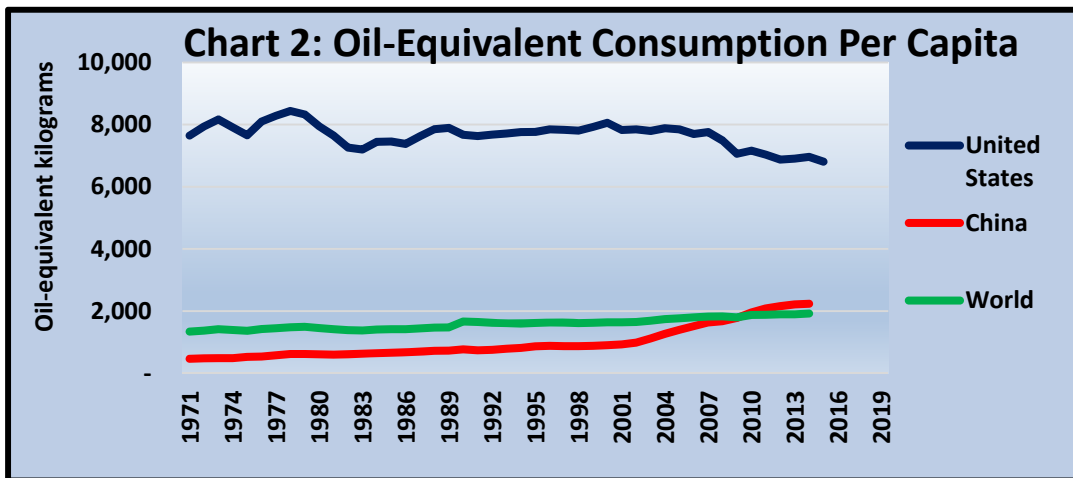


Source: Federal Reserve Bank of St. Louis

Saudi Arabia and other oil-producing countries still rely on steady crude production and stable prices to fuel their domestic economies. The wild swings seen in Chart 1 are visible evidence of tectonic change in the energy industry over the past few decades: Slowly, gradually, and inexorably, OPEC has lost control of oil prices; it’s not just Covid-19 that has upended the cartel’s influence. This has had profound implications for the U.S. economy and for our securities markets as well.

Both demand and supply factors are driving this tectonic shift. Together, they suggest that the world may hit “peak demand” for oil before reaching “peak supply” – flipping the conventional wisdom on its head and completely scrambling the economics of the oil industry.³

From a demand perspective, the conventional wisdom has been that rapidly growing international demand for oil will overwhelm slowing American demand. That’s been true in the past, as shown in Chart 2; global per capita demand was still rising through 2015 (the most recent year for which figures are available), even as American demand was shrinking.



Source: World Bank

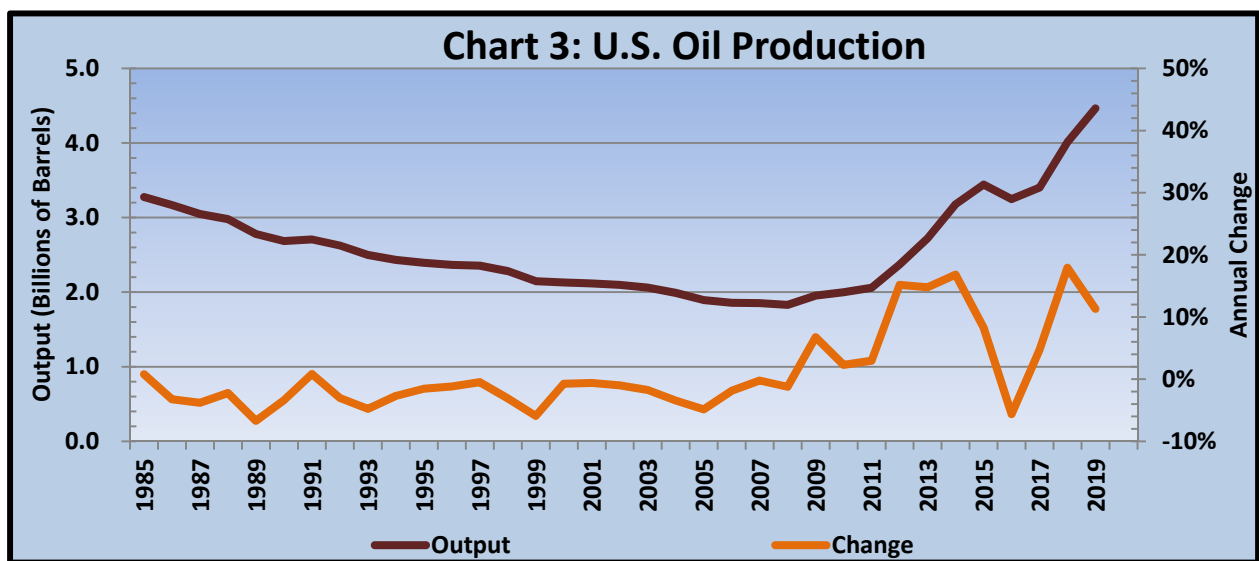
³ It scrambles the politics, too, as countries reassess whether access to Middle East oil is still a strategic imperative, but that topic is beyond the scope of my ambit.

The long-term trend is ominous, however: the fall in American per-capita demand has accelerated due to the emergence of economically viable substitutes at every stage of energy use. The decline from 2007 through 2015 in Chart 2 was largely because electric utilities shifted from oil to gas and renewable sources of energy. Since then, further reduction in demand has come from mass market acceptance of electric automobiles and from significant energy efficiency improvements in mass transportation and construction.

The shrinkage in demand isn't just an American phenomenon. Other major Western nations are seeing similar trends. China, too, has begun to reduce its demand for oil in favor of other sources. Although its economy is growing much faster than those of other nations, its per-capita energy use is beginning to slow for the same reasons that Western demand has slowed.

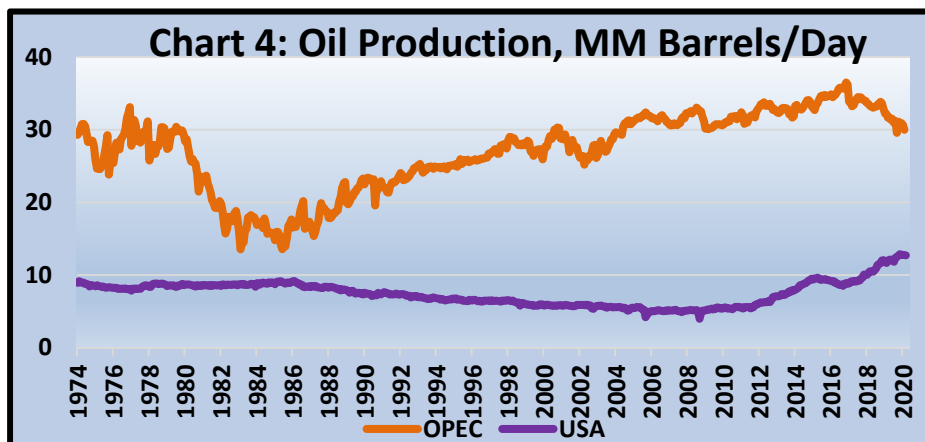
These are not healthy trends for OPEC. Regardless of short-term issues such as recessions and pandemics, the long-term outlook for oil demand is weaker now than it has ever been. American demand (the blue line on Chart 2) is likely to tip further downward, and Chinese demand (the red line on Chart 2) has already flattened its trajectory.

If the demand picture is dispiriting to OPEC, the supply side of the oil industry is no more comforting. Many competitors have emerged to challenge its dominance of the energy economy. Alternative fuels – wind, solar, and nuclear – have caught media attention, but their impact on the global energy markets has been marginal. The biggest factor has been the astonishing increase in American oil production since the widespread adoption of fracking revolutionized the industry in the past decade. Chart 3 shows the remarkable increase in overall production, both in barrels (brown line) and in year-over-year percentage change (orange line).



Source: Energy Information Administration

As American production was accelerating, OPEC's ministers faced a difficult choice: Should they keep up their own production, which would flood the market and potentially crush prices, or should they cede market share and try to prop up prices? Their decisions can be seen in Chart 4; the Saudis, in particular, changed course on several occasions.



Source: Energy Information Administration

For three decades from the mid-1980s, OPEC resolutely increased production. Until 2010, this was a simple decision, because American production was falling. But when fracking suddenly reduced the cost to lift a barrel of oil out of the ground, American production took off. The cartel was slow to respond, until by mid-2014 it became evident that the market was being inundated with oil. Prices plunged from a high of \$110/barrel in June 2014 to a low of \$26 by early 2016.

Late that year, OPEC changed course, finally deciding to protect price rather than market share. The shift in policy is starkly shown in Chart 4, as average daily production fell 18% from late 2016 to just before the Covid-19 pandemic emerged. But this change in strategy isn't what turned the tide for oil prices; OPEC was responding, not leading. Months earlier, American producers had started cutting production as prices continued to fall. Many filed for bankruptcy; others cut their dividends, axed capital projects, or took similarly harsh measures to keep themselves afloat. A close look at Chart 4 shows that American production turned down almost a year before OPEC changed its strategy.

For the first time in many decades, Americans – and not OPEC – were determining oil prices. In the years since that mid-decade price crash, OPEC has tried several times to assert its leadership, but it has failed every time. Earlier this year, Saudi Arabia tried to arrest the steep fall triggered by the Covid-19 pandemic's impact on oil consumption. Russia (not a member country, but part of the larger OPEC+ group) refused to go along with suggested production cuts, and prices collapsed – obliterating the 2016 lows and even dipping briefly below \$20. Prices have since doubled as economies have started to reopen, but they remain 35% below year-end levels.

The oil minister listening to Jackson Browne probably understands that his economic clout and his political influence have eroded substantially in the past decade. Investors see this, too; oil's role in American securities markets has declined dramatically. A generation ago, the gyrations in the price of oil would have sent shock waves through U.S. markets; today, they are barely noticed by most investors.⁴ The reason is shown in Charts 5 and 6:

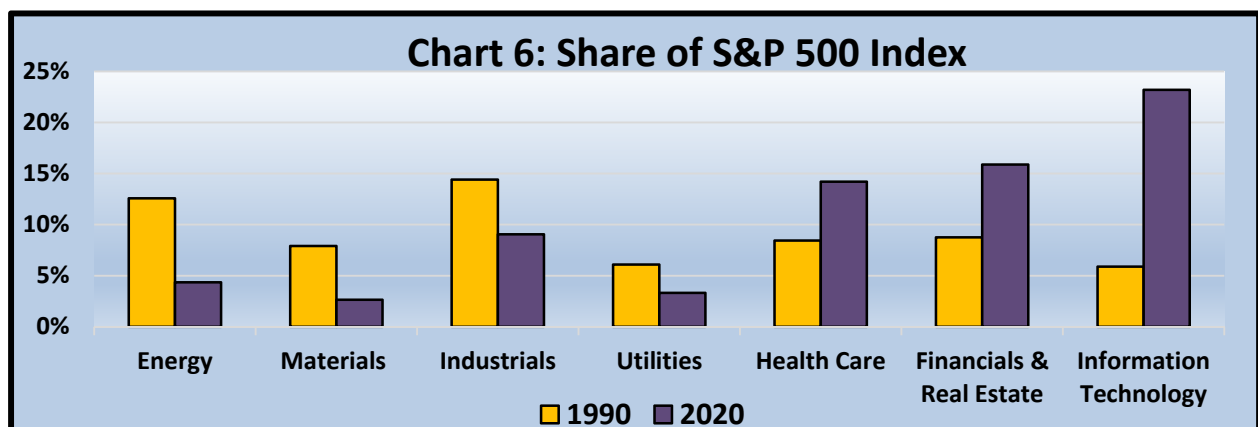
⁴ Energy sector investors do notice, of course. The plunge in oil prices this year sent sector high-yield spreads to record high levels, as bond investors feared imminent defaults; stock prices across the entire energy sector were hammered, dropping over 60% by mid-March before recovering somewhat. But the broader markets didn't care.

Chart 5: Largest Capitalizations in the S&P 500					
1970	1980	1990	2000	2010	2020
IBM	IBM	IBM	General Electric	Exxon Mobil	Apple
AT&T	AT&T	Exxon Mobil	Exxon Mobil	Apple	Microsoft
General Motors	Exxon	General Electric	Pfizer	Microsoft	Amazon.com
Exxon	Amoco	Philip Morris	Cisco Systems	General Electric	Alphabet (Google)
Eastman Kodak	Schlumberger	Royal Dutch Shell	Citigroup	Chevron	Facebook
Sears Roebuck	Royal Dutch Shell	Bristol-Myers Squibb	Wal-Mart Stores	IBM	Berkshire Hathaway
Texaco	Mobil Oil	Merck	Microsoft	Procter & Gamble	Visa
General Electric	Chevron	Wal-Mart Stores	AIG	AT&T	JPMorgan Chase
Xerox	Atlantic Richfield	AT&T	Merck	Johnson & Johnson	Johnson & Johnson
Gulf Oil	General Electric	Coca Cola	Intel	JPMorgan Chase	Procter & Gamble

Color Codes:	Information Technology	Financial	Health Care
	Consumer	Industrial	Energy

Source: Dow Jones S&P Indices

Chart 5 shows the ten largest companies in the S&P 500 index at the end of each of the past six decades. In 1980, seven of the ten largest American stocks were oil companies; today, none are. Although the sector allocations tend not to change much from week to week, the change over three decades has been enormous. Energy was the second-largest component of the index in 1990, as shown in Chart 6, but today it's one of the smallest. A hypothetical 50% fall in sector earnings in 1990 would have sliced 7% off of S&P 500 EPS, which could have sent the broader index into a bear market; today, that same 50% haircut would nip only 2% off of index EPS.



Source: Dow Jones S&P Indices

The right side of Chart 6 provides further proof that big changes in the price of oil no longer threaten S&P 500 earnings as much as they did when OPEC held sway. The information technology, financial, and health care sectors dominate the index today, and none of them depend on energy prices in any meaningful way.

OPEC's apparent decision last week to increase production appears designed to stabilize prices at current levels rather than to let rising demand (from reopening economies) push prices higher. One possible consequence could be a rise in bankruptcies among less efficient or more highly leveraged American producers that cannot sustain themselves with oil prices in the \$40 range. That may well lead to some downward pressure on energy sector stock prices, but it would have virtually no impact on tech, health care, or financial companies. That's why the turmoil in the oil patch hasn't had any meaningful impact on the relentless surge in stock prices.

So let's revisit our Saudi oil minister, seemingly comfortable in the driver's seat and enjoying his music despite some latent anxiety. It turns out that the anxiety is justified: OPEC really is running on empty, running blind. Global oil demand is likely to diminish due to efficiency and substitution effects; supply has swung from scarce to abundant; competitive providers have taken over (or at least share) price leadership; downstream industries are themselves smaller; and the broader markets no longer care very much about energy. Regardless of whether short-term prices rebound back to year-end levels, it's clear that the long-term outlook for OPEC is dim, to the ultimate benefit of American firms both within and especially beyond the energy sector.

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