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Macro Insights

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OPEC, Fracking, and Fundamentals

The OPEC Agreement reached on November 30 to cut production quotas did not change our view of market fundamentals and, hence, our forecast for oil prices though 2019. Saudi production was already scheduled to decline with or without the agreement. But the Saudi "cut in production" was used to coax cuts out of the others, fulfilling a Saudi principle: "We go along, but not alone!" But, by raising the floor price to around $45 per barrel, it moved the price above a threshold that should produce a material rebound in fracking. As oil prices rise further, fracking will continue to rebound, limiting the rise in oil prices over this period. The one surprise, and greatest uncertainty, is Russia's pledge to cut production by 300,000 barrels per day. As always, my views on oil markets are informed by ongoing conversations with our Senior Adviser, Larry Goldstein.

The OPEC Agreement and Saudi Production

The Saudis have been clever indeed. Their production was scheduled to fall just as this agreement was being reached. That reflected a normal seasonal decline in domestic demand. The conversation in August about trying to reach an agreement to freeze production at next OPEC meeting had already propped up front-end prices, which had been under downward pressure and had fallen below $30 at one point. The agreement last week delivers the cutback that became more likely following the August OPEC meeting. The announced cuts allow the Saudis to still meet contractual commitments, accommodate the seasonal decline in domestic demand, and bought production cuts by other OPEC members, specifically, and reliably, from the GCC members, Kuwait, UAE and Qatar. Iran got a very small increase in its quota relative to current production. Russia pledged a decline as well.

Fracking and the Elasticity of Supply

A fundamental reality in the oil markets has been a low elasticity of supply and demand which result in sharp swings in oil prices in the near term for modest changes in supply or demand. Of course, inventory building and runoff do moderate oil prices swings relative to fundamental demand and supply.

But fracking has changed price dynamics in the oil market to some degree. Fracking allows speedy cutbacks in production when oil prices fall sharply, but also a quicker reversal in production when oil prices rise above a threshold for profitable drilling. In my June commentary, that threshold was estimated at $45 per barrel! [Turning the Corner: It's About Supply, but not OPEC] A WTI price in the $35-to-$45 range did not meet that threshold. But a floor of $45 does. And our expectation that oil prices rising to close to $60 by late 2017 or into 2018 would result in further increases in fracking production. We already see a sharp increase in fracking.

Fundamentals

Of course, oil prices are all about supply and demand. [Supply and Demand with a Vengeance]. With production cuts, we are expecting inventories to be worked off in coming quarters and for more normal levels of inventories to be reestablished. At that point, prices will reflect market fundamentals.

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With the inventory overhang effectively worked off, we expect fundamentals should justify a price close to $60, and we see oil prices in a $60-$65 fundamental range for some time after that. Of course, with limited inventories, disruptions can have a large, albeit temporary, upside effect on oil prices. And, of course, disruptions have been a way of life in the oil industry. So we see asymmetric upside risk relative to that range. There is also upside risk to our oil price path to the extent Russia fulfills its pledge to cut its production.

What about the Next OPEC meeting?

The next OPEC meeting will likely be in late May. So this agreement has a time stamp on it, about six months. As that meeting approaches, uncertainty will increase, along with volatility in prices. But the Saudis will again dominate the OPEC decision. Saudi demand for oil will have increased, as will the price of oil. That will justify higher production quotas, depending, of course, on the elasticity of supply from fracking and changes in the trend increase in demand.

Bottom Line: The OPEC Agreement Leaves Our Forecast Unchanged

In our updated forecast, to be posted soon, our path for oil prices is largely unchanged beyond the near term. We see WTI at $57 at the end of 2017 and $63 at the end of 2018.

Here are links to recent commentaries:

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