INVESTMENTS®

Energy

Impact of oil market dynamics

Crude oil prices have plummeted, with a demand shock from the COVID-19 outbreak and a supply shock caused by the breakdown in OPEC+ talks driving an unprecedented move. WTI has fallen 49% from its level to start the year, including a spectacular 28% drop on March 7, the largest one-day decline since the Gulf War.[1] While significant, economic and financial market exposure to the energy sector in the U.S. has fallen since the last oil downturn, helping to buffer potential impacts.

KEY TAKEAWAYS

- Oil prices plummeted after OPEC+ talks broke down and Saudi Arabia and Russia started a price war
- The outcome is still uncertain, though there could be impacts on the U.S. shale industry
- The U.S. economy and financial markets are less exposed to energy than they were before the previous crude downturn

The historic price move, driven by a breakup in the Saudi-Russia alliance that has attempted to manage crude markets since 2016, presents many uncertainties for markets. For now, it is unclear how long oil prices will remain this low. Demand impacts from COVID-19 are still an unknown variable, and the intentions of major world producers are nearly impossible to predict.

A marriage of convenience collapses

Oil prices had already been under pressure as the COVID-19 outbreak caused fear of a demand shock. But the latest move was precipitated by a dramatic end to price collusion by Saudi Arabia and Russia.

Following the oil price crash of 2014–2016, when OPEC flooded the market with supply in an attempt to drive the surging U.S. shale industry out of business, Russia and OPEC agreed to form an alliance (dubbed OPEC+) to control oil prices. Russia and Saudi Arabia, OPEC's unquestioned leader, are the second- and third-largest oil producers in the world, respectively. Since the first cuts in early 2017, the countries have twice come together to support prices – once in December 2018 during the U.S.-China trade war, and again in December 2019 amid slowing global growth. In fact, as recently as July of last year, OPEC's Secretary General predicted the alliance would last "for eternity."[2]

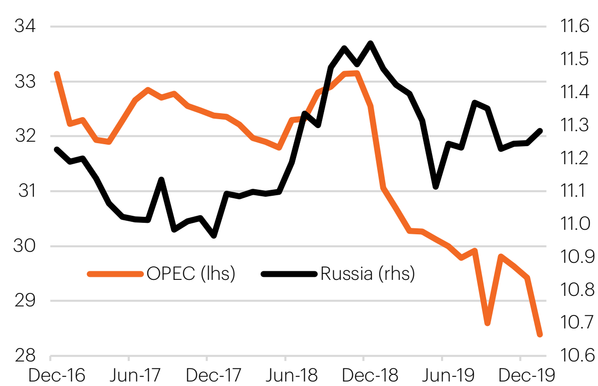
Enter COVID-19, which has now seemingly disrupted every corner of financial markets. The prospective demand shock caused by the pandemic prompted OPEC to consider further production decreases, with Saudi Arabia eventually suggesting a 1.5 MMbpd cut. Russia, which had been dragging its feet in complying with the original December 2019 reductions, was

1 Bloomberg Finance, L.P. as of March 12, 2020.
2 Bloomberg Finance, L.P.

skeptical of further cuts. OPEC then attempted to pressure Russia by unilaterally announcing an intention to curb production by 1.5 MMbpd.

The pressure campaign did not work, and Russia resisted the additional cuts. On March 7, Saudi Arabia, not wanting to relinquish market share by cutting supply while Russia continued to pump more, declared a price war, slashing crude export prices and promising to increase exports significantly over the coming months. Russia followed suit, pledging to return production to pre-OPEC+ cut levels. With a price war the new reality, other oil-producing nations such as the United Arab Emirates also announced they would begin ramping up production.[1]

OPEC AND RUSSIAN CRUDE PRODUCTION
Millions of barrels/day



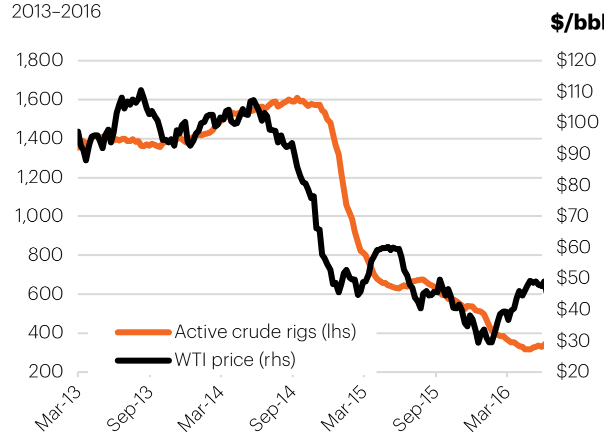
Source: Bloomberg Finance, L.P.

Certain factions within Russia, including leadership at state-owned oil company Rosneft, have long been skeptical of coordinated action with OPEC, feeling it acted to prop up the U.S. shale industry. Additionally, U.S. sanctions on Russian energy interests have created a tense environment between the nations. The Russians' moves may be a calculated attempt to pressure American shale producers, who generally have a breakeven price between $40–$50/bbl. These moves could have wide-ranging economic and geopolitical impacts globally.

Impact on U.S. energy industry

In the short term, many U.S. producers have hedges on for multiple months into the future, having taken advantage of futures prices in the high $50s in 2019.[1] This means any potential impact on investment would likely come after the fall in oil prices. During the previous supply-driven crash in 2014–2015, the start of the fall in crude rig counts lagged the price decline by around six months.

U.S. RIG COUNT VS. CRUDE PRICE
2013–2016



Source: Bloomberg Finance, L.P., Baker Hughes.

In the longer term, if prices were to stay in the current range for an extended period, energy firms' capital expenditures would almost certainly fall. Large producers like ExxonMobil and smaller E&P firms had already been scaling back capital plans given the lower futures prices at the start of this year.[3] There may be heightened defaults and bankruptcies in this type of scenario, concentrated in financially weaker E&P firms as well as oilfield services companies.

The good news for financial markets is that they are less exposed to energy than at any time in the recent past. In 2011, energy accounted for about 13% of the S&P 500; today, it is just 3%.[1] In the high yield bond market, energy debt – which before the last oil downturn made up 16% of the high yield space – now makes up just 9.5%.[4] This implies that heightened stress in the energy sector would likely have a lower contagion impact on broader markets than the last time around.

The U.S. shale industry is resilient, however. Even considering an episode of prolonged lower oil prices, crude volumes could trend downward temporarily but would likely recover. This presents continued opportunities in sectors like infrastructure, where many firms have long-term, volume-based contracts in place and less pure commodity sensitivity. Additionally, lower crude production would, all else equal, lead to lower natural gas supply. This could help increase gas prices – at the time of this writing, NYMEX gas prices are up 10% week over week – and support natural gas producers.[1]

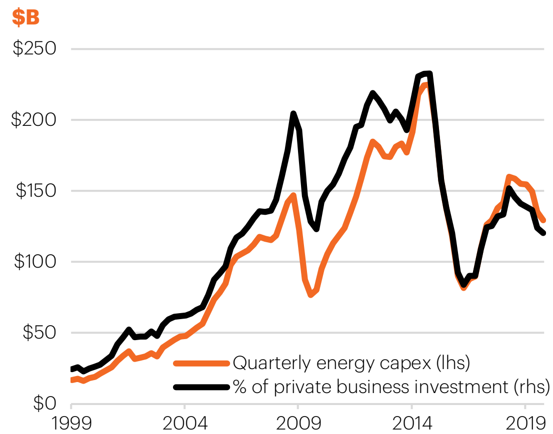
3 Citigroup.

4 Bloomberg Finance, L.P., ICE BofAML.

Impact on the U.S. economy

Looking at the impact on the broader U.S. economy, we can use the 2014–2016 episode as a downside case. Energy sector capital expenditures peaked in Q3 2014 at $225B, or around 7.5% of total business investment. Over the succeeding six quarters, energy investment fell by 64% as a drastic drop in oil prices caused firms to scale back capital projects. We estimate that this caused a 4.7% drag on total business investment and a 0.8% total detraction from GDP.[5]

ENERGY CAPITAL EXPENDITURES



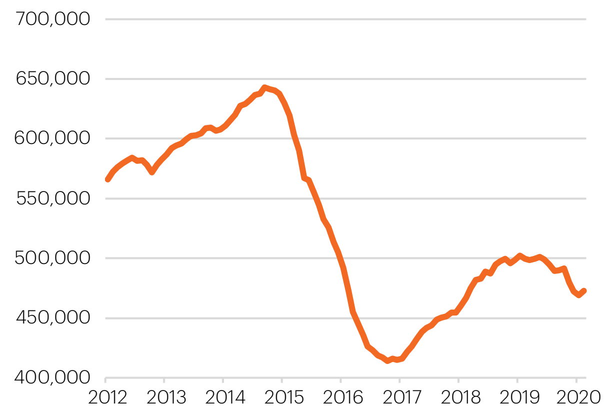
Source: Bureau of Economic Analysis, FS Investments.

Compared to the years leading up to the previous downturn, energy accounts for a significantly lower percentage of total business investment today. No matter what measure you use – capex, rig count, employment – energy has a smaller impact on the overall economy. At close to 4% of business investment, a major slowdown in the sector would add to headwinds for the economy but would likely not cause a recession by itself.

Looking at employment, we calculate that previously, the oil & gas industry saw a 36% decline in employment – about 230,000 workers.[6] This hit energy-producing regions particularly hard, putting a dent in consumer spending. As we can see in the graph to the right, employment in the industry has not meaningfully recovered since then. Another major downturn in energy would cause loss of employment, though the absolute number of workers laid off would likely be less given the lower starting point.

In all, the U.S. economy is less exposed to the energy industry than it was six years ago. A downturn could cause regional pain, especially in the Permian basin in Texas, the center of the shale revolution. On the other hand, lower gasoline prices could be a marginal positive for consumer spending, though how much gas savings would trickle down to the rest of the economy is uncertain.

OIL & GAS INDUSTRY EMPLOYMENT



Source: Bureau of Labor Statistics.

Looking ahead

This is clearly still a fluid situation, as Russia's oil minister, Alexander Novak, stated that the nation remains in contact with OPEC. Saudi Arabia has significant stockpiles throughout the world that will allow the country to increase exports very quickly. This "shock and awe" strategy is likely an attempt by the Saudis to demonstrate that they have the ability to take market share from Russia at a moment's notice, with the end goal being to bring Russia back to the negotiating table.

The existing supply curbs are set to expire at the end of March, at which point all parties will be free to pump as much oil as they please. A wide range of scenarios are still in play, from a deal that brings production cuts back to a prolonged price war. The good news in a downside case is that both financial markets and the U.S. economy are less exposed to the energy sector than they were in the past. With energy assets having sold off so aggressively already, there could be significant valuation opportunities available in the future.

5 U.S. Bureau of Economic Analysis.

6 U.S. Bureau of Labor Statistics.

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