Oil at nearly USD60: Why, and can it last?

UBS AM Asset Allocation team, market update | November 8, 2017

Crude oil prices crossed the technical barrier of USD55 per barrel last week and accelerated after major oil producer Saudi Arabia launched a widespread crackdown on corruption. Can this move in oil continue, and if so, what effects can we expect on other asset classes?

Demand and supply imbalances

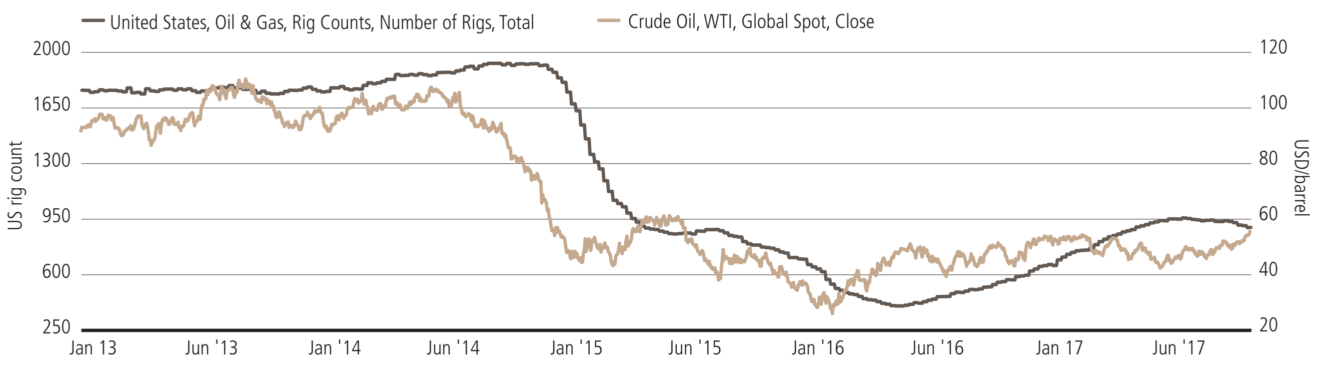
Entering this year, the consensus view was that WTI crude oil would remain in a USD40 to USD60 range—US shale production would contract if prices fell too low and increase if prices rose too high. While this hypothesis held for most of the year, a more than 30% surge in oil prices since June has forced a rethink of that thesis.

Certainly, global growth has accelerated thereby supporting the demand picture, and OPEC has largely done its part holding to its agreed supply cuts. But the key has been the failure of US shale to deliver the kind of production increase that most expected. Note that US rig count continues to decline modestly even as oil prices have accelerated. US shale producers have been in cost-cutting mode, focused more on boosting profits as opposed to boosting investment.

At the same time, with prices nearing USD60 per barrel, North American energy production is profitable and producers can be expected to restart dormant wells soon. Looser regulations from the Trump administration make it easier for US energy companies to export, thus increasing the incentive to produce more and invest in exploration and extraction. Thus we do not expect prices to continue increasing at the recent pace. Higher prices will ultimately encourage supply, which should provide some stability after what has been a genuine price surge in recent weeks.

The key risk is geopolitics, which takes on greater importance with the recent decline in oil oversupply. Yesterday's crackdown in Saudi Arabia has increased concern about stability and policymaking within the world's oil largest exporter. On its own, we do not expect this news to drive prices higher. Saudi Arabia was expected to support an extended production cut when OPEC meets at the end of this month and this news does not change that. Nonetheless, there is a non-zero probability of an escalation in tensions in the Middle East which contributes to yet higher oil prices. If the proxy wars between Saudi Arabia and Iran escalate in Syria, Yemen and elsewhere, there could be disruptions to energy production in addition to huge humanitarian costs.

Crude oil prices and US rig count



Source: NYMEX and Baker Hughes via Macrobond; UBS Asset Management. 2012-2017 YTD. Data as of November 6, 2017.

Implications for other markets

Taking a step back, had the news from Saudi Arabia been met with genuinely increased geopolitical risks, we would have expected to see the VIX, a key measure of risk aversion, spike higher. However, the VIX remains around 9, a historically low number, suggesting that such sentiment is not apparent at the moment and spillovers to risk assets should be limited. We will watch geopolitical developments closely, but at this point are not particularly concerned. Rather, our perception is that recent oil price moves are much more a reflection of genuine changes in fundamentals as opposed to major geopolitical risk. As such, it is reasonable to expect that this will take care of itself over time as US and Canadian suppliers (not bound by OPEC accords) ramp up their output. In that case, the main effects could be a temporary increase in top-line inflation and an increase in US capital expenditure by energy firms. Higher oil prices may boost breakeven inflation expectations on the margin, contributing to a modest rise in yields. Barring a further sharp rise in oil prices, consumers and businesses should continue to drive growth in the economy. We remain overweight global equities and underweight fixed income in our multi-asset portfolios.

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