Economic Insight

Oil – Beyond geopolitics?

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Executive Summary

This paper attempts to rationalise recent oil price strength and perspectives for the remainder of the year. Post-trough recovery and demand-led strength have been substituted by geopolitics as prime oil price driver since early Q2 18.

- **The peak may be behind us**. A number of the drivers underlying recent oil price strength could diminish in strength or reverse. A currently elevated geopolitically induced risk premium might shrink once actual market flows become clear. Financial positions might shift towards a less bullish stance. It is our view that the peak of the economic cycle is behind us. Further, high oil prices by themselves could have a restraining impact on demand. There will be supply side response. Substitution is encouraged.

- **Base case USD 72/bbl**. We assume 2018 GDP growth of 3.3%, 2.5% USD appreciation, a return of financial net long positions to their two year average, and 0.5mbpd supply loss on the assumption that most of the loss from Iran will be mitigated while Venezuelan production shortfalls will not. Opec has about 2mbpd of spare capacity and there may be room for marginal growth from US production. Our sensitivity analysis shows upside to USD80/bbl in a bull and downside to 67/bbl, in a bear case.

- **2019 central forecast USD 69/bbl** assuming 3.1% global GDP growth, 2.5% USD appreciation and 2mbpd oil supply growth on the basis of a strong likelihood of some OPEC production increase, and US shale production becoming debottlenecked in H2 19.

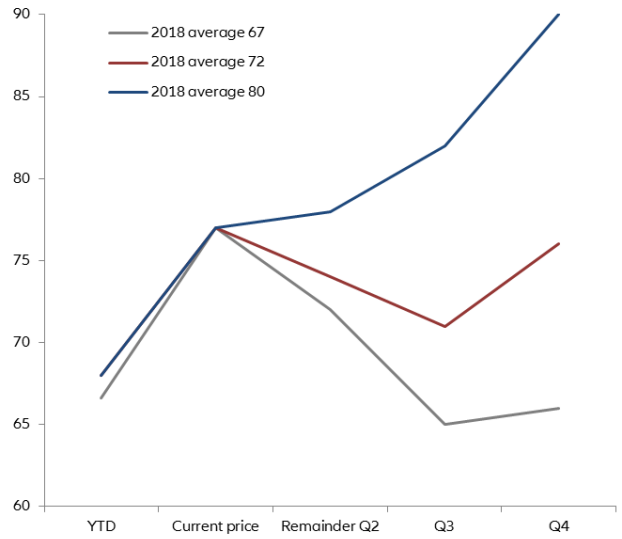
- **Sector impact.** A number of sectors are now finding themselves with increased input costs. These are notably speciality chemicals, airlines, shipping, road transport, mining and the heavy industry and manufacturing sectors. We see margins sustained in those sectors with pricing power, notably speciality chemicals, pockets of the machinery sectors and tight base metal segments. We see risk of margin contraction for airlines, certain shipping routes and metals characterised by over-capacity, notably steel. Expectations for persistent oil price strength are likely to lead to accelerated EV adoption. The oil and gas sectors across the value chains are seeing positive capacity utilisation, earnings and cash flow impacts. Oil prices above USD 75/bbl increase viability, adoption, development and financing prospects for alternative energy, new technologies and substitution processes. These sectors could emerge with new strength following a period, during which weak oil prices forced efficiencies and tight focus on financial sustainability.

Geopolitics has substituted fundamental demand strength as prime oil price driver since Q2 18, with the result of a rising risk premium. We expect a sustained high risk premium on the back of elevated political risk, yet see scope for balancing of market flows.

For 2018, our central case of an average price of USD 72/bbl Brent is based on sustained demand growth driven by global economic strength (1.6mbpd/3.3% global GDP growth 2018). Along with this, we expect that net supply losses from geopolitical events, i.e. Venezuela and Iran, will be contained, due to lack of multilateral enforcement in case of the Iran sanctions, and a degree of mitigation through increased production elsewhere. There is scope for increased OPEC production. OPEC currently has spare capacity of 2mbpd compared to our estimated supply loss of 0.1mbpd. Ministers have indicated they might propose a gradual reduction of output cuts and pledged to secure "stable supplies" as the "shared consumers' anxiety". Chances that OPEC and Russia may revise their supply cut agreement this month have greatly increased following the latest leg up in the energy complex. Beyond that, higher prices incentivize production on a global basis.

An oil price above our central scenario would require greater net loss of production. Full loss of production from Iran and Venezuela without any mitigation, combined with strong demand would suggest a Brent Crude price rising to about UJSD 90bbl during the remainder of the year (that would imply an annual average of USD 80/bbl in 2018). Indeed, we estimate that current market prices are driven by uncertainty of actual market flows, and this has translated in loss at the higher end of the spectrum being priced in and resulting in elevated risk premiums as outlined above. A further rise of the oil price from current levels would require confirmation of maximum production loss along with a sustained risk premium. Prevailing uncertainty may keep risk premiums high and support prices. Several factors could counteract the rise in oil prices, notably negative demand impact and rising production. We believe that most likely, those would come into play in 2019. In the US, pipeline capacity close to 2mpbd will get commissioned in H2 19, which will allow for another leg up in shale output from current record levels. For 2019 we expect an annual average of Brent at USD 69 USD/bbl.

Figure 1: Oil price scenarios (USD/bbl) – central case USD 72/bbl



Sources: Bloomberg, Euler Hermes

Companies in certain sectors are now finding themselves with increased input costs. These are notably specialty chemicals, airlines, shipping, road transport, mining and the heavy industry and manufacturing sectors. We see margins sustained in those sectors with pricing power, notably specialty chemicals, pockets of the machinery sectors and tight base metal segments. We see risk of margin contraction for airlines, certain shipping routes and those mining/metals segments characterized by over-capacity, notably steel. Expectations for persistent oil price strength are likely to lead to accelerated EV adoption. The oil and gas sectors across the value chains are seeing positive capacity utilization, earnings and cash flow impacts. Oil prices above USD 75/bbl increase viability, adoption, development and financing prospects for alternative energy, new technologies and substitution processes. These sectors could emerge with new strength following a period during which weak oil prices forced efficiencies and tight focus on financial sustainability.

Figure 2: Sector impact

Sector	Impact
Specialty chemicals	• Input **cost pressure – mitigated** through pricing pressure; watch commoditized segments
Manufacturing & heavy industry	• Input **cost inflation – high end mitigates** through pricing pressure
Airlines	• **Margin pressure** through rising fuel cost with little scope for pricing power in very competitive environment
Road transport	• **Pass through of fuel costs** in **function of end market**
Shipping	• **Margin pressure** due to fuel costs in function of competitive intensity **by route/merchandise** • **Possibly positive impact** for industries **exposed to low cost imports**
Automotive	• **Acceleration of EV** adoption if expectation for long term increase in oil price
Mining	• **Cost pressure, offset in** commodities with **tight markets** (nickel, possibly copper), **margin contraction** in markets with **overcapacity** (e.g. steel)
Oil and gas	• **Positive earnings and cash flow** impact across the value chain; particularly E&P • **Recovery of energy services** as result of increased investment spend • **Positive repercussion on gas** industry through price and substitution linkages
Alternative energy & new technologies	• Much increased **viability of oil substitution** technologies • **Acceleration of adoption** of mature technologies • Greater development and fund raising ability for **early stage technology** under expectation of persistent high oil price

Source: Euler Hermes and Allianz Research

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