INVESTMENT BRIEF

Q1 2020

Strategic Investment Group®

Oil Fuels Pandemic Fire

Oil prices fell by two thirds in the first quarter of 2020. This decline, a result of a rapidly slowing global economy and an ill-timed price war among major oil producers, is fueling the impact of the pandemic on markets. Companies in the energy sector as well as major oil exporters and their state oil companies have been particularly hard hit. From a macro perspective, the precipitous drop in oil prices has reinforced the disinflationary impact of the pandemic, pushing inflation expectations to record lows. This quarter's special topic considers the interplay of pandemic economics, financial markets, and oil.

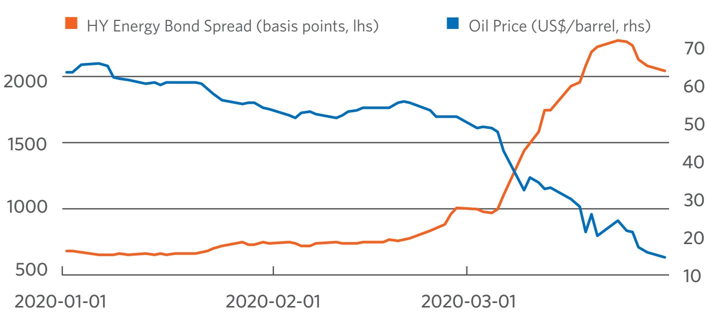
Dwindling Demand, Soaring Supply

Measures to contain the pandemic are exacting a heavy economic toll. Lockdowns that have brought the transport sector to a halt and severely curtailed industrial output are dramatically depressing energy demand. As demand dwindled, Russia and Saudi Arabia engaged in an odd version of Russian roulette in which all barrels are loaded and each player takes turns shooting by flooding the market with additional supply. In the face of these demand and supply shocks, oil prices crumbled, falling from over $60/barrel in January to under $20/barrel in March (Exhibit 1).

EXHIBIT 1:

High Yield Energy Bond Spreads Spike as Oil Plummets

Source: Bloomberg. Data through March 31, 2020.



Blow to Shale Producers and Oil Exporters

The sharp decline in the price of oil and the prospect of a protracted period of diminished demand have reinforced the market dynamics unleashed by the pandemic and measures to contain it. Concerns about the impact of a severe economic contraction on corporate profitability and ability to service a heavy debt load had caused credit spreads to widen significantly across all industries and sectors. With the collapse in the price of oil, the spike in spreads of high yield bonds issued by companies in the energy sector was especially sharp (see Exhibit 1).

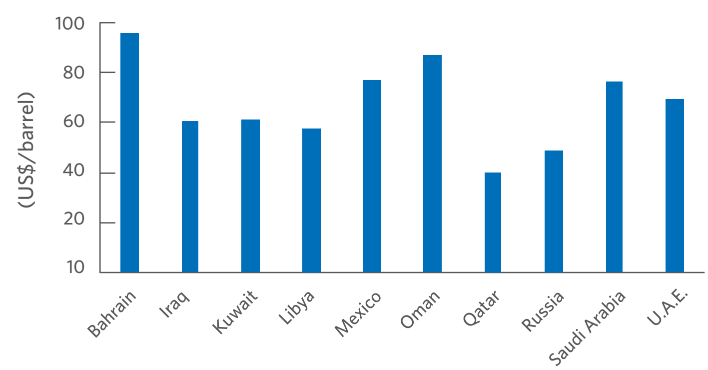
The U.S. shale industry in particular faces some unpleasant arithmetic. The oil price averaged $46 per barrel in the first quarter, below the $48-54 median breakeven price required to justify new wells. Oil prices at current levels (below $20/bbl.) are not sufficient to cover the median operating costs of existing wells, estimated to be $27-35 per barrel. If they were to persist, prices at current levels would call into question the viability of many shale producers, particularly those that have taken on large amounts of debt to finance the high capital intensity of shale oil production.

The prospects of major oil exporters are also grim. Countries like Saudi Arabia and other major exporters in the Gulf derive roughly 70% of their export revenue and 60-70% of their fiscal revenue directly from oil; their indirect economic reliance on this single sector is even greater. Oil exporters have been experiencing difficulties balancing their budgets since the oil price decline in 2014, and have resorted to increased debt issuance and drawing down currency reserves built when prices were higher. Oil exporters in the Gulf, normally associated with abundant surpluses, were already on an unsustainable path of burning through their large currency reserves. The additional blow to oil prices from the pandemic and price war has pushed prices well below the levels needed to balance the budgets of major exporters (Exhibit 2). Both Russia and Saudi Arabia have recently resorted to new large debt issuances to fill the gap in their finances. At current prices, they face a wrenching retrenchment in government spending in order to return to fiscal sustainability.

EXHIBIT 2:

Breakeven Oil Price for Major Producers

Sources: Bloomberg and IMF.



Contraction and Disinflation

The pandemic has created a truly unprecedented global economic contraction notable for its severity, unpredictability, and the speed with which output and employment has plummeted. The oil price war is heightening uncertainty, compounding already powerful disinflationary forces, and taking a particularly heavy toll on fragile industries and countries, reinforcing the pandemic's destructive power.

1001 Nineteenth Street North, 16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com