LIKE OIL AND WATER

The oil price is simultaneously getting squeezed downward by both weak demand and higher supply. What next?

Some consequences of the outbreak of Covid-19, the novel coronavirus, were easier to foresee than others. For example, the number of new infections in China has slowed to a trickle in recent days, and early signs of an economic recovery have been quite encouraging. For global oil markets, the consequent rebound of Chinese demand can hardly come soon enough. Prices have collapsed in recent days. And, unlike previous sharp moves, this one is neither purely related to supply nor demand. The price is simultaneously getting squeezed downwards from both sides.

We believe that the reason for this unlikely course of events is that OPEC and Russia picked the precise moment when demand was already weakening due to Covid-19 to start a price war. "Both seem to have now shifted from a strategy geared toward price maintenance (achieved via cuts in production) to market-share maintenance (achieved via increase in production)," explains Darwei Kung, Head of Commodities at DWS.

We anticipate the market-share competition to last for an extended period of time. Given domestic budget constraints in both Russia and Saudi Arabia (the leading OPEC+ producers), we do not believe the supply shock can last indefinitely. However, we believe as the market-share battle continues, the price for oil will stay under pressure. Small to mid-sized U.S. shale-oil producers are likely to bear the brunt of the market-share losses. If the price remains under 35 dollars per barrel of West Texas Intermediate (WTI) for a prolonged period of time, most shale-oil producers appear unlikely to be able to generate enough cash flow to fund the capital expenditure necessary to maintain existing production levels.

Wanting to reverse part of the growth in U.S. oil production in recent years is probably part of the reason for Russia's intransigence. Now that the OPEC+ agreement has broken down, however, restoring it might be difficult. Past periods of oil-market instability proved hard to control, even for Saudi Arabia. And in absolute terms, at least, the oil-price collapse has not been all that historically large, as our "Chart of the Week" shows.

Sources: Refinitiv, DWS Investment GmbH as of 3/10/20

1 OPEC+ is an informal alliance of OPEC members and other oil-producing countries, led by Russia, aiming to coordinate their production strategies.
GLOSSARY

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

Shale oil is a type of unconventional oil found in shale formations.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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