

DON'T UNDERESTIMATE THE THREATS TO GLOBAL OIL SUPPLY

A drone attack took out half of Saudi oil supply. Much of this looks set to be restored swiftly. The attack nevertheless highlights geopolitical threats to the world economy.

IN A NUTSHELL

- In one of the biggest disruptions to oil supply, about 5% of global production was taken off the market.
- With sufficient oil stockpiles available and damage repair making progress, no supply shortage is expected.
- This incident, however, might dent investors' risk appetite, as it shows the fragility of vital energy infrastructure and reminds investors of how easy base scenarios can potentially be derailed.

As a result of a drone attack on Saturday on two major oil-production facilities in Saudi Arabia, 5.7 million barrels per day (b/d) of capacity were taken off the grid. That corresponds to roughly 5% of global output. In absolute terms it was the biggest, and most sudden supply shock in history. Khurais produces about 1.5 million b/d and Abqaiq, the world's biggest crude-stabilization facility, processes 7 million barrels of Saudi oil a day.

Brent started trading 20% higher on Monday but has quickly retraced to only trade at an 8% premium by early noon GMT. One reason for this could be weaker incoming Chinese economic data, pointing to slowing oil demand. Another reason might be Saudi Arabia's statement to restore roughly a third of crude output disrupted due to the weekend attack by Monday evening. However, it will probably take weeks to return to full production capacity at the damaged facilities. This is unlikely to translate into an immediate reduction in physical oil supply. Stockpiles in OECD countries rose to 2.93 billion barrels in July and were about 20 million barrels above their five-year average, the International Energy Agency (IEA) said in a recent report. Saudi Arabia alone has reserves equivalent to 28 days of production. The United States has indicated it could draw on its strategic petroleum reserves. In any case, Saudi Arabia has not been operating at full capacity recently, with exports of late at just over 7 million b/d, well below its capacity of more than 10 million b/d.

What do we make out of this? We believe the immediate reaction, with Brent up by just under 6 dollars per barrel, is

less dramatic than it looks at first sight. Brent now trades again where it traded in July and in line with the average price since the beginning of the year. If the price increase were to persist, however, oil would show a sequential price increase in the third quarter compared to the second quarter. It will be interesting to see whether the Federal Reserve (Fed) will make any reference to this incident at its meeting on Wednesday. We continue to expect the Fed to take a dovish tone.

The longer-term implications seem somewhat more significant to us. The drone attack has shown at what ease damage to vital parts of the global energy infrastructure can be done. Houthi rebels in Yemen claimed credit for the attack, but President Trump has already said that the United States is "locked and loaded depending on verification"¹ that Iran staged the attack, an assertion also made by the U.S. secretary of state Mike Pompeo² and backed by administration officials. However, Saudi Arabia has still not confirmed that Iran was behind the attack. Still, this makes any peace process between the United States and Iran less likely, after U.S. Security Advisor's (John Bolton) ousting from the U.S. administration last week sparked some hopes.

Away from politics, OPEC countries as well as U.S. shale-oil producers have recently been cautious on their production ambitions; the rig count has been declining in the United States since the start of the year by almost a fifth. They might now feel inclined to reduce capital expenditures or production by less than anticipated. Which in turn would keep a lid on oil prices over the medium term. That might

¹ Donald Trump tweet from Sep 16: "Saudi Arabia oil supply was attacked. There is reason to believe that we know the culprit, are locked and loaded depending on verification"

² "Amid all the calls for de-escalation, Iran has now launched an unprecedented attack on the world's energy supply," Pompeo said. See: <https://www.reuters.com/article/us-saudi-aramco-attacks/us-blames-iran-for-saudi-oil-attack-trump-says-locked-and-loaded-idUSKBN1W00SA>

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alleviate prospects of a higher risk premium for oil going forward. Furthermore, ongoing demand concerns are likely to further weigh on prices. Darwei Kung, commodity portfolio manager for DWS, explains: "Prior to the attack, a key question for the market was the likely surplus in 2020 given the expected decline in demand due to economic slowdown. In fact, IEA revised its demand forecast for 2020 once again earlier last week. The size of the oil-price spike is not likely to alter the demand in a significant way, but it is another headwind."

It is too early to draw precise conclusions at this point in time. That might be the reason that market reactions have been rather muted. The dollar hardly moved, and equity markets in Europe have lost less than 1%, which is all the

more surprising after a four-week rally has brought the Stoxx 600 close to its 2019 peaks.

We fear, nevertheless, that investors might give this incident more consideration, if the general market mood turns more risk averse again. Market sentiment has lately been boosted by accommodating central banks. But if logic suggests that there is little central banks could do in order to nullify the negative effects of trade wars, economic history suggests they are even less capable to mitigate the effects of any oil shock. And, regardless of the immediate and medium-term effects of this attack, it certainly shows a new level of geopolitical threat that the world economy will have to cope with.

GLOSSARY

Barrel (bbl)

A **barrel (bbl)** is the commonly used unit to measure crude oil. One barrel is about 159 liters.

Brent

Brent crude is a grade of crude oil dominant in the European market.

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Central bank

A **central bank** manages a state's currency, money supply and interest rates.

Dove

Doves are in favor of an expansive monetary policy.

OECD

The **Organization for Economic Co-operation and Development (OECD)** started in 1948 as the Organization for European Economic Co-operation (OEEC) and changed its name in 1960, now

representing 34 countries with democratic governments and market economies.

Organization of the Petroleum Exporting Countries (OPEC)

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.

Rig count

Rig count details the number oil and gas drilling rigs, as well as their operational status and regional location.

Shale oil

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

Stoxx Europe 600

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

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