Market Analysis

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Global Oil Markets in 2019-2020

Part II: Oil Price Formation in the Era of Financial Volatility and Shale

Key Question: Will we see more 40+% price moves in 2019 and 2020?

Despite a benign fundamentals environment, the 4Q2018 crude price meltdown marked the third 40+% price decline within 60-days since 2014, a threshold that had only been breached twice since 1987. We believe that recent price volatility is rooted in two key structural factors: the deepening financialization of oil markets and the emergence of a reactive and inherently financialized source of supply in US shale production. We do not expect these forces to recede in 2019, and the likelihood of another year of high-amplitude swings is very high, in our view. In this report, we examine the drivers affecting oil price formation and what it means for oil markets going forward. Our key takeaways include:

- **The financialization of oil has amplified the role of expectations in oil price formation while the surge of US shale has added a dynamic element into this process,** magnifying the fundamental consequences of price over/under-shoots. The combination of the two has so far added a destabilizing element in oil price formation. Right now, this is being compounded by a destabilized and unpredictable global political and economic environment.
- **US shale: purveyor of supply reactivity, destroyer of market stability?** Conceptually, US supply reactivity acts as a source of physical market stability by mitigating protracted over/under supply. However, three elements of the US shale system have also led it to play a destabilizing role since 2014: 1) volumetric growth swings large enough to upend global markets (volumetric potency); 2) inherent dynamism vis-à-vis short-term prices changes, compounded by dramatic changes in recent years in the capital efficiency of production; and 3) a financialized industry via hedging which while dampening long-term prices can act as catalyst in a sell-off.
- **Financialization and shales reactivity have made supply management by Saudi Arabia and its allies more complex and less effective.** Ultimately, price swings in the shale era continue to show that the price equilibria mismatch between Saudi budgetary needs and US shale capex/growth sets up a structural mismatch that can only be sustained via ever-deeper supply management. The size of the problem is actually growing as shale production and annual changes in output both get bigger. The central contradiction between Saudi revenues and volumes is getting worse, and the market is cognizant of it, and will continue to test the Saudi (and shale producers) resolve(s) when, rather than if, warranted.
- **Volatility spares no one.** Beyond the more immediate challenges of volatile prices to US E&P balance sheets and OPEC's management efforts, volatility could potentially inject further caution into long-cycle investment decisions or accelerate diversification away from oil and bring forward the timeline of a prospective demand peak.

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