Orlando's Outlook: Crude oil pendulum swings to extremes

11-16-2018

Bottom line *As crude oil surged this summer more than 20% to an overbought 4-year high of nearly $77 per barrel in early October, investors were convinced West Texas Intermediate (WTI) would be back above $100 or higher by year-end. Oil sharply reversed course over the past six weeks, plunging nearly 30% to an oversold 1-year low of $55, evoking new investor fears of a retest of crude's 15-year low of $26. We didn't share the market's extreme concern in either direction, as crude oil hasn't yet managed to repeal the economic laws of supply and demand. To that point, there are a half-dozen important crosscurrents that have fueled investor confusion and can help to explain the extreme volatility of the current cycle. Our best guess is that WTI is bottoming out here and will remain within a $55-$75 trading range into next summer.*

OPEC successfully rebalanced the oil market At the beginning of 2017 through mid-2018, the 14 OPEC and 13 non-OPEC oil-producing nations (including Russia) agreed to a joint production cut of 1.8 million barrels a day (about 1.8% of global oil supply). This was OPEC's first coordinated joint reduction in crude-oil production in eight years, and it sharply reduced the global oversupply of oil. As a result, WTI rebounded almost 80%, from its trough at $42 per barrel in June 2017 to $75 in June 2018.

Mission accomplished With the price of oil back on track, OPEC reversed course starting in the second half of 2018, increasing oil production by one million barrels per day (BPD). Why the course correction? Saudi Arabia's plans for its Aramco IPO have been shelved indefinitely, while Russian President Putin successfully won re-election for another 6-year term in March 2018. So two of the world's top oil producers no longer needed to artificially prop up oil prices by cutting production and they decided to ride the gravy train for a while. The third mega oil producer is the U.S., which was not part of that Saudi/Russian OPEC agreement, so American frackers were pumping away to beat the band. Consequently, crude slumped 13% to $64 in mid-August due to increased supply.

Iranian nuclear sanctions push crude higher President Trump recently re-imposed economic sanctions on Iran (OPEC's second-largest producer at 2.7 million BDP) to enhance his leverage to renegotiate the nuclear deal of 2015, which could reduce Iran's exports by as much as 1 million BDP. Trump also is hoping to prevent Iran from developing long-range ballistic missiles, launching cyber-attacks and funding terrorism. Oil exports, which account for 80% of Iran's revenue, could push its economy into recession next year, according to the International Monetary Fund (IMF), which reduced its forecast for Iran's economy from 4% growth in 2018 to a recession in 2019, with a contraction of 3.6%. This should provide it with ample incentive to re-open the nuclear pact. One silver lining for the oil market, however, is that the U.S. issued waivers in early November to eight countries, which are thought to be China, India, Turkey, South Korea, Japan, the United Arab Emirates, Taiwan and Iraq, to allow them more time to find other suppliers globally, such as Saudi Arabia. Because of this expected reduction in global supply, WTI rose nearly 20% in anticipation, from $64 in mid-August to $77 in early October. But the news about the waivers contributed to the recent decline in prices.

Slower global growth roils energy market The five largest economies in the world have hit a speed bump in recent months. The housing and auto markets remain challenging in the U.S.; the Chinese economy has slowed and its stock market has dropped 25% this year; economies in both Japan and Germany posted negative GDP in the recent third quarter; and the U.K. remains under pressure due to the impending Brexit deadline. As a result, the expectation is that demand for oil will slow in 2019, pushing crude oil prices lower.

Continued dollar strength could hurt crude prices The dollar fell 21% from 1.03 to 1.26 versus the euro over the course of 2017, which coincided with a 20% rally in WTI. But this year, the dollar has rallied 10% back to 1.12, while crude prices have slipped about 11% since the beginning of the year. The direction of the dollar and its relation to oil prices tends to be inverse.

Trump uses the jawbone Heading into the midterm election, Trump was tweeting that gas prices were too high in the U.S. and that OPEC should boost production to drive WTI prices lower. The Oct. 2 murder of journalist Jamal Khashoggi in the Saudi embassy in Turkey has left Saudi Arabia in a quandary as its leaders attempt to extricate themselves from this self-imposed public relations nightmare. They may have, in fact, kept their elevated oil production in place through the election to curry favor with the U.S.

Cold winter could help support prices With a freak snowstorm this week, we're now experiencing the coldest, snowiest November in the northeast in 80 years, which could help to boost prices in coming months.

Meet me in Vienna For all these reasons, we expect OPEC will reverse its recent increase in production at its upcoming meeting on Dec. 6.

Over the river and through the woods Gas prices have fallen about 9% since the beginning of October, to $2.65 per gallon, and we could see another 5% or so decline to about $2.50 in coming weeks. Combined with the lowest unemployment rate (3.7%) in half a century, the strongest wage gains (3.1%) in a decade and high consumer confidence, the American Automobile Association (AAA) projects the busiest Thanksgiving travel season in 13 years. More than 54 million Americans will travel 50 miles or further this holiday weekend, a 4.8% year-over year (y/y) increase. Air travel is expected to be even busier, with nearly 4.3 million travelers, a 5.4% y/y increase.

Happy Thanksgiving, everyone!

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