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Special Alert: Why the OPEC June 5th Meeting Will Be A Non-Event and Why Iran Matters More

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Why the OPEC June 5th Meeting Will Be a Non-Event and Why Iran Matters More

Six months after the "Thanksgiving Massacre" where WTI crude oil prices plunged by nearly 10% in one trading session, analysts and traders are again anticipating the next moves of OPEC at its semi-annual gathering in Vienna on June 5th. Both analysts and certain OPEC members, such as Venezuela and Nigeria, have been calling for OPEC production cuts in an effort to support oil prices. The calls for OPEC production cuts has died down since January-March earlier this year (when WTI spot bottomed at $43 a barrel), given the recovery in WTI crude oil prices back to around $60 a barrel. For this and other reasons, I do not believe OPEC will cut production at its June 5th meeting; I also believe it will be a non-event with respect to its impact on crude oil prices. Instead, I believe the potential lifting of Iranian oil export sanctions at the end of this month will have a greater impact on oil prices.

Bottom line: OPEC does not cut production and will make a statement to the effect of: "We will re-evaluate at the next meeting in fall of this year." This is also the consensus so I don't believe this is a market-moving event. At the last meeting during Thanksgiving, the markets were blindsided as both analyst expectations and option spreads suggest OPEC will cut by 250,000 to 500,000 barrels a day. The markets would not be blindsided this time and will consider this OPEC meeting a non-event.

Three reasons why I don't believe OPEC will cut

1. Both crude oil prices and global crude oil demand are rising, mainly driven by rising Chinese, U.S., and Indian demand. In the previous two oil supply gluts/major bear markets during 1986 and 1998, OPEC has only cut when oil prices are falling, not when oil prices are rising. Over the next three years, global oil consumption is expected to grow by more than 3 million barrels/day, while global oil production may only grow at half that level (1.5 million barrels per day) over the next three years—setting aside the possibility of the lifting of Iran's oil export sanctions. This means the supply/demand dynamics in the oil market is finally balancing and thus there is no need for OPEC to cut production;

2. In early August 1986, oil prices put in a definitive bottom (after hitting a low of $10.40 a barrel on March 31 and $10.75 a barrel on July 9 after the Saudis flooded the markets) after OPEC patched together an agreement after ten days of meetings—eventually agreeing to a 3 million barrel per day cut for the rest of 1986 (http://www.eia.gov/forecasts/steo/archives/4Q86.pdf). The last major cuts in 1998 occurred in the midst of the Asian crisis and after OPEC—in a major policy mistake—raised production limits at its November 30, 1997 meeting. There are two take-aways here: First, if OPEC decides to cut, the intentions of the cut will be telegraphed well in advance because negotiations would have started long before June 5. In today's 24-hour news cycle, much of it would have already leaked out; it also makes sense to gauge how the market (and U.S. shale oil producers) will react to determine the size of the cut; second, it will take a major economic slowdown in either the U.S. or China for OPEC to cut given its past history and given current expectations for global demand growth to surpass supply growth over the next several years;

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3. OPEC has 81% of the world's oil reserves that are relatively cheap to produce (http://www.opec.org/opec_web/en/data_graphs/330.htm); its members currently only produce 33% of the world's production. As such, OPEC should continue to aim to increase its market share. This is not only basic math; OPEC is witnessing first hand of the old adage "The stone age did not end for the lack of stones." It is now obvious that major coal reserves in China, India and the U.S. will stay in the ground forever given the global natural gas/LNG glut as well as the increasing adoption of nuclear power, wind, and solar generation in both China and India. OPEC does not want to end up in a similar situation with its oil reserves staying in the ground forever (due to more stringent U.S. CAFE standards, increasing EV adoption, and the commercialization of Level 4 autonomous driving vehicles by 2020-2025, likely first in Europe) so it makes perfect sense for OPEC to front-load as much production as possible – especially since there remains sufficient demand growth coming from China and India over the next several years (and China is ensuring a steady/secure source of demand as it begins to construct pipelines through Pakistan to reach the Middle East—bypassing the Gulf of Malacca which is controlled by the U.S. and India). This is just one more reason for OPEC to not cut to defend its market share.

Why Iran Matters More and Why It Will Put a Lid on Oil Prices

By far the more important event is the potential lifting of Iranian oil export sanctions at the end of this month. I have seen initial supply growth estimates of 200,000 to 400,000 barrels/day immediately if sanctions are lifted as Iran has about 20-30 million barrels of offshore storage that it could immediately export. From there, the timeline/production increase estimates get murkier. The IEA estimates Iran could increase production by as much as 800,000 barrels/day in six months, but export sanctions will need to be gradually lifted so not all this crude could be exported right away. Moreover, repealing the export ban in Europe requires a consensus of EU members, which will take time as well.

Bottom line: In a "best-case" scenario for Iran where export sanctions are lifted across both the U.S. and the EU, Iran will be free to export as much oil as it could—pending the restart of some of its oil fields and replacing and investing into new CAPEX. In this scenario, Iran could conceivably raise its output by 700,000 to 800,000 barrels/day anywhere from 6-18 months after sanctions are lifted. Since Iran's costs of production are among the lowest in the world, the country will have no problem in regaining its market share—most likely at the expense of U.S. shale.

Three Major Risks to Our Base Case Scenario of $50 to $70 over the Next Three Years

Over the next three years, I expect WTI crude oil to trade between $50 and $70 a barrel. There are three major risks to this scenario:

1. Projected China and Indian oil demand growth fail to show up; China has indirectly placed restrictions on passenger vehicle purchases by raising the costs of acquiring a license plate to as much as US$12,000 in certain cities, compared to $65 in California, due to policymakers' goals of curbing air pollutants and reducing traffic congestion. Meanwhile, Indian car purchases currently look healthy, but part of the reason is "pent-up" demand as automobile purchases dipped the last couple of years due to a slowing economy and high oil prices;

2. The Middle East remains a "powder keg" that no-one is willing to write about; ironically, lower oil prices will further fuel resentment in the region if governments are forced to cut back on social welfare spending. The region's young demographics—combined with a belief system that is incongruent with the post-Westphalian idea of sovereign integrity (one in which China respects)—makes the region a major "flash point" that could cause a disruption to global oil supplies;

3. The rise of the "car-sharing" economy which would have a profound impact on automobile purchases likely for the rest of the 1st half of the 21st century. This—combined with the increasing adoption of electric vehicles and commercialization Level 4 autonomous vehicles (Google's goal is 2017, although I do not believe this is feasible until a widespread 5G communications network is installed, likely during the 2020 to 2025 timeframe)—makes this a long-term disruption force in terms of oil demand. I do not believe this will occur within the next three years, but stranger things have happened before.

Biography

Henry To, CFA, CAIA, FRM

Partner, Chief Investment Officer

Mr. To currently serves as Partner and Chief Investment Officer for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds and Raptor Group). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including international monetary policy, national security, education, and crime policy. In addition, Mr. To has been an instructor in the USC/CFALA Review Program, where he taught the CFA Exam Level II Economics section. Mr. To is a regular contributor on the Forbes 'Great Speculations' blog and has been interviewed and quoted by CCTV Global Business, the New York Times Business Section, the Wall Street Journal, MarketWatch, TraderPlanet, among other publications. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, an MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.

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