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Market Context

A meeting of OPEC and its non-OPEC partners last week turned from a foregone conclusion of enhanced and extended production cuts to the opening salvo in a renewed price war that could permanently alter the global oil market. The COVID-19 outbreak has significantly impacted global oil markets, with daily demand declining as much as ~5 MMBbl/d and poised to fall further if the impact on demand accelerates in non-Chinese markets. Markets were expecting OPEC+ (largely Saudi Arabia and Russia) to agree to further production cuts to offset the temporary fall in demand. Instead, Russia pushed back and was ultimately unwilling to agree to incremental production cuts. In response to the impasse, Saudi Arabia offered significant discounts on exports to the US and Europe over the weekend and effectively launched a price war.

The primary goal of a price war at the moment is a sharp reduction in US shale and other high cost non-OPEC production – as OPEC+ has cut to support prices in recent years, non-OPEC producers have more than filled that gap with production increases. At this point, Russia and Saudi Arabia likely have the wherewithal to see this through and we should expect a challenging crude oil market through the rest of 2020. The impact of lower prices on Russia will be moderated by a corresponding move in the ruble and Saudi Arabia stands to benefit from an improved fiscal picture if it comes out of price war with market share recaptured from higher-cost producers.

With 1 – 2 MMBbl/d entering the market in the short-term from Saudi Arabia and Russia and demand falling as COVID-19 impacts economies in North America and Europe, prices will likely go lower in the short-term. Inventories will build throughout the year, reinforcing the production surplus and continuing to put pressure on oil prices. Drilling activity will fall sharply as already stressed US producers fight to survive. While short-cycle in nature, US production declines will not be immediate but will instead decline over the course of the year. Other high-cost production will necessarily decline also as producers retrench in the face of low prices. Prices could dip into the 20s and possibly lower if the oversupply becomes so acute as to force high-cost producers to shut in production (lifting costs for US shale are in the mid-$20 area). Prices will likely fluctuate in the high 20s – low 30s as this plays out assuming no change in course by the key players in this drama. Saudi Arabia in particular will have to weather significant budgetary challenges in the short-term to sustain this approach and June's OPEC meeting could be a point at which they reassess this strategy.

Absent a shift in strategy, Brent is likely to range between $25 - $35 over the next two quarters and into Q4. Assuming a sharp rebound in demand in the second half of the year as the COVID-19 impact ebbs and US production falls sharply due to reduced investment, the market will likely approach balance toward the end of the year and prices should return to longer-term marginal cost of production which is still likely in the $40 - $50 range. If demand rebounds from the COVID-19 impact sooner than expected or Saudi Arabia (and OPEC) changes course and seeks to address market imbalance at the June meeting, we could see a more rapid recovery in prices beginning in Q3.

Investment Implications

View on Chinese growth: We expect the Chinese economy to contract in Q1 by around 2% QoQ; our base case is for a recovery later in Q2/Q3, assuming that the virus in China is getting contained, which is supported by the latest high frequency data that we observe such as road traffic, airport passenger flow, housing transactions which have been recovering in recent days whilst the daily growth of new infection cases in China continues to fall. For the full year 2020, our base case is a fall in the growth rate from 6% last year to 4.9%. The spreading of the virus to numerous countries outside China increases the downside risk to global growth and further disruption to supply chains, particularly in high tech supply chains if the situation in Korea and Japan deteriorates.

Asset Class Performance Views: The current market moves are the result, of the oil price shock, the COVID-19 shock, and (related to those) a liquidity shock, in our view.

Update on Market Liquidity: Given heightened volatility, liquidity has suffered. Liquidity in the high yield space is currently very limited, with mostly sellers and few buyers and bid-offers are gapping out. Pricing and trading in the investment grade space is more orderly and a better reflection of where the market is.

Developing Opportunities: We are beginning to see what we believe to be some attractive opportunities in the EMD hard currency space given the recent volatility and disruption from the responses to COVID-19. While yields are lower globally, spreads have widened across our markets. This has brought the investment grade space into focus; it was trading tight at the beginning of the year, but has moved to fair value vs developed markets. So in addition to some dislocations in the corporate space, sovereign paper is now more attractive than recent months.

Notwithstanding the risks to the global environment, the coming weeks should provide for some investors, where suitable, an opportunity to add to your strategic EMD exposure. It will also provide an opportunity to access higher yields than developed markets given the large move in treasuries.