Prosperity analysis

Coronavirus disease (COVID-19) and the oil price shock

Global markets are undergoing a period of increased uncertainty on account of the spread of coronavirus disease (COVID-19). It is unclear how serious this virus will turn out to be, how virulent it is and how broadly it will be spread amongst the global population.

One may hope that COVID-19 will follow normal influenza seasonality and decline in spring-summer 2020, but that is far from certain. Recent interesting data points show that of some 80,000 cases in China, fewer than 20,000 remain affected. It is hard to verify this information, but it hopefully indicates that China has been successful in its efforts to limit the spread of the virus. On the other hand, cases are reported to be rising fast in Europe, North America and certain Middle Eastern countries. Global mortality figures vary significantly; Germany has no fatalities in over 1,000 cases whilst other countries report mortality rates of up to 5%. All of this against a backdrop of influenza that kills hundreds of thousands annually. It is likely that there is both an under-reporting of cases and false-positive results.

Russia has reported relatively few cases and no fatalities thus far, though these numbers may well rise soon despite serious travel restrictions that impose self-isolation policies on people arriving from impacted countries – something that now includes most major trading partners.

COVID-19 has set off an economic chain reaction, with many Chinese industries having halted production and economic activity having slowed considerably – first in China, but now increasingly across the world. In turn, this has caused a decline in demand for certain commodities, particularly oil, which has also seen a subsequent sharp decline in prices. At the time of writing, oil prices have fallen by almost half their pre-COVID-19 levels. A marked fall first arose on demand destruction. OPEC+ countries then considered countering this with a coordinated supply cut, but negotiations broke down on Russia's apparent refusal to agree to further production cuts. Saudi Arabia reacted with a decision to flood the market to drive prices down further (and its market share up).

It is not easy to fully understand the reasoning of each party, but Prosperity sees the logic behind Russia's hesitancy to cut its production further. Doing so would have effectively meant bailing out shale producers in the US, by limiting Russia's own production in the face of demand destruction.

One may be certain that interesting game theory case studies will follow from this situation, but we feel that it may be more useful to discuss the relative position of the major oil producers. United States of America ("US"), Russia and Saudi Arabia are the leading oil producing nations. Each operates under very different geological and economic circumstances.

The US has seen a major increase in production in the last 4 years, with shale production rising by 4.5 million barrels per day to a total of some 9.5 million barrels per day. This production is relatively high cost. It is hard to get accurate data as most companies prefer to report very flattering numbers, given that they have never been cash-flow positive and rely heavily of the goodwill of capital markets. Including capital expenditure, they were barely breaking even at previous higher oil prices and are likely to have to curtail investment considerably under current prices. Many companies will not be able to service their debts if these prices remain for any extended period of time. As for the US economy, the oil sector is not large enough to have an impact on the US dollar exchange rate and lower oil prices may have a beneficial effect on demand, even if there are likely to be lay-offs in the oil sector.

Saudi Arabia is in a very different situation. They have low direct extraction costs, but the whole economy is dependent on revenues from the oil sector. Many analysts believe that Saudi Arabia needs Brent Crude oil prices of around USD 80 per barrel to balance the budget. Most consumer goods are imported, so allowing the currency to fluctuate with the oil price would have a very significant impact on real incomes – something that in turn may have serious social and political consequences. Saudi Arabia does enjoy large reserves and is therefore able to run significant budget deficits during periods of lower oil prices. There are of course time limits to such behaviour, but Saudi Arabia can likely withstand lower prices longer than US shale producers.

Russia is arguably in a more comfortable position. Russian oil companies are amongst the lowest cost producers in the world, with all-in costs of USD 12-14 per barrel of oil. Furthermore, Russia has a flexible exchange rate, with the ruble tending to move broadly in line with the terms of trade. Higher commodity prices tend to result in a stronger ruble and vice versa. The social impact is different from Saudi Arabia's, as the Russian economy is more diversified and most ordinary consumer goods are produced in Russia. A lower oil price and weaker ruble will lead to some uptick in inflation, but largely on higher-end and discretionary goods.

The flexible exchange rate protects the margins of Russian oil companies – as was observed in 2014-2015 when the margins were stable despite oil prices declining by more than half. The Russian budget also has an automatic stabiliser; all of the expenditure is in ruble and ruble-denominated revenue did not decline materially in 2015. It is also noteworthy that the Russian budget has been drawn up with this type of situation in mind, being set to balance with an average oil price of USD 40 per barrel. Excess revenues have been directed to the National Wealth Fund, which is close to reaching its targeted 7% of GDP. The Ministry of Finance and Central Bank of Russia also hold very large reserves, allowing Russia to support low oil prices for an extended period of time without serious economic consequence. The net government debt of Russia is close to zero.

Prosperity understand the logic behind Russia's apparent reluctance to participate in a coordinated oil production cut in response to the current very sharp demand-decline. There had already been considerable opposition to the previous cut, with Rosneft CEO Igor Sechin being the most vocal. Russia had previously refused to participate in similar supply cuts but did so in the form of the OPEC+ agreement. It is unclear what exactly compelled Russian participation in the last agreements and what made them elect not to continue to do so in this instance. The effect of the previous cuts was to support prices, which de facto encouraged investment into the US shale oil industry. It is not certain that this was in Russia's long-term interest. We also have a somewhat limited understanding of Saudi Arabia's views. Perhaps this tit-for-tat action is actually theatre, as they too would likely be better-off with at least temporarily lower prices than to cut deeply and cede further market share to their US competitors. There are also other oil producing countries that are more vulnerable than Saudi Arabia, such as their local competitor Iran, while the major international oil companies tend to have considerably higher-cost projects.

We do not yet know just how serious the health crisis will become, but COVID-19 has already resulted in significant disruption of the global economy, including lower oil demand. It is unclear how long this will persist, but hopefully things will be more apparent by summer.

There looks to be a breakdown in the OPEC+ arrangement with coordinated production cuts and this is likely to result in lower oil prices for most of this year. In turn, this will probably bring about H2 2020 production declines in the US and possibly some later improvement in global demand. Prosperity will hence be revising our forecasts for oil, other commodities and the national exchange rate. Our analysis though continues to show that profits in the Russian oil sector will be more resilient than other producers and that cash flows will be sufficient to support investments, debt service and dividends.

As is often the case in these situations, Russian valuations quickly turn attractive – not only in the oil sector, but across the market. Starting from an already appealing level, recent market action has unearthed value across Prosperity's investment universe.

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