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Commodities Strategy

Crude Oil Prices Collapse After Spectacular Failure Of OPEC+ Pact

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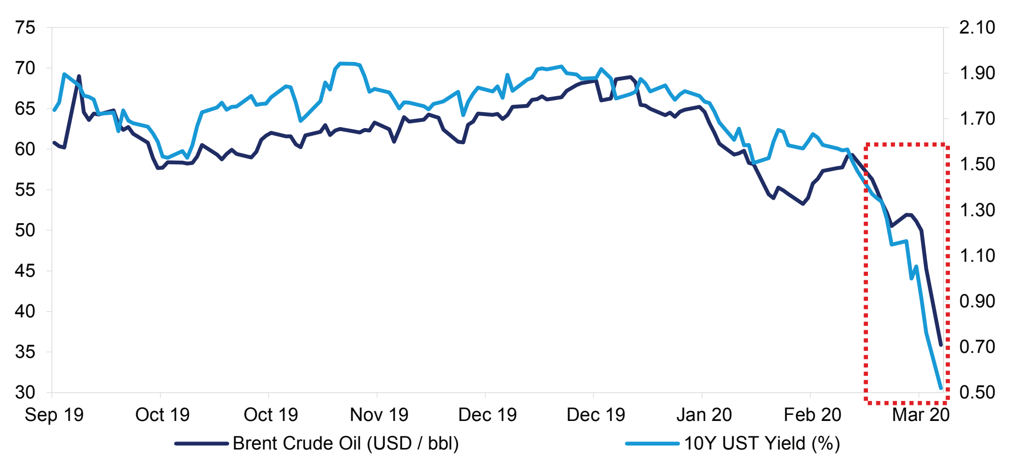
- Following the failure in production quota talks between OPEC and Russia (OPEC+), crude oil prices collapsed towards USD 30 / bbl. Russia has now said that it is no longer bound by any production quota, while Saudi Arabia has immediately lowered its oil prices.
- This failure of the OPEC+ talks, coupled with coronavirus (COVID-19) related intense slowdown in global growth and demand, now risk a significant global oversupply in crude oil. We therefore downgrade our Brent Crude Oil forecast materially to USD 35 / bbl by 1Q20, USD 30 / bbl by 2Q20, USD 35 / bbl by 3Q20 and USD 45 / bbl 4Q20. The anticipated mild recovery in crude oil price in 2H is contingent upon the COVID-19 outbreak being brought under control by the middle of the year.
- There are severe and wide ranging implications following this collapse in energy prices. For starters, interest rates will now stay depressed at "Lower for Longer" as lower energy prices risk triggering a sharp drop in inflation expectations. Currencies of key commodities and energy exporting countries like the CAD and RUB have now come under immediate selling pressure. There is now a spike in volatility across key asset classes with increasing scrutiny on rising credit costs in the US High Yield sector.
- Given the intense financial market volatility, there is now higher probability of further coordinated monetary policy easing by G7 central banks. Both Saudi Arabia and Russia may well be "encouraged" to return to the negotiation table to prevent further calamitous sustained drop in energy prices.

Plunge In Crude Oil Price Towards USD 30 / bbl Triggers Safe Haven Rush

News of the spectacular failure in OPEC+ talk late last Friday (06 Mar) sent crude oil prices cratering towards USD30/bbl. The ensuing sharp equity market sell-off triggered a renewed rush into safe haven assets, pushing 10Y UST yield from 0.8% to yet another low of 0.5% as USD/JPY fell from 106 to below 102. Needless to say, gold prices spiked towards USD 1,700 / oz.

Chart 1: 10Y UST Yield Plunge Alongside The Collapse In Brent Crude Oil

Source: Bloomberg, UOB Global Economics & Markets Research

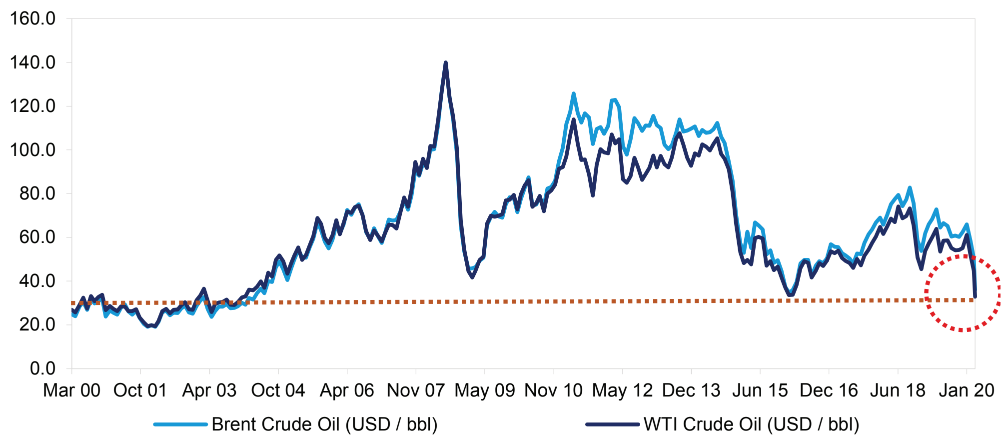


OPEC And Russia Go Their Separate Ways

Heading into the talks, there were hopes that in view of the COVID-19 triggered global growth and demand slowdown, cool heads will prevail as OPEC+ members will grudgingly agree to extend their existing production cut of 2.1 mio bpd. The existing production pact with OPEC+ started in Nov 2016 and was progressively extended and expanded amidst on-going difficult global backdrop during the US-China trade conflict. Prior to this latest round of talks last week, there were proposals by OPEC to add yet another 1 mio bpd of production cut to reinforce crude oil prices.

Chart 2: Both Brent And WTI Crude Oil Collapse Towards USD 30 / bbl After OPEC+ Deal Fell Apart

Source: Bloomberg, UOB Global Economics & Markets Research

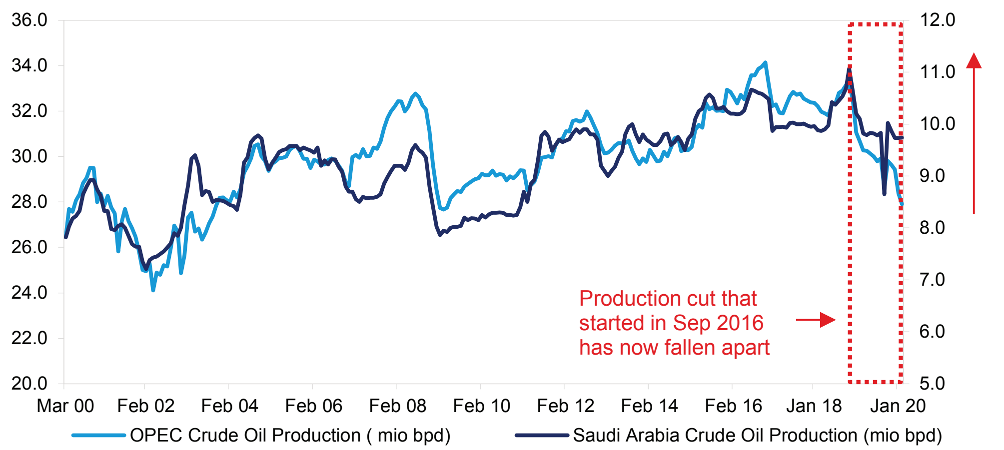


However, the talks fell apart instead with both Saudi Arabia and Russia failing to agree on additional production cuts. Industry reports suggested that Saudi Arabia is frustrated with Russia's persistent non-compliance with the existing production quotas. While Russia felt that further production cuts under existing weak global macroeconomic backdrop is futile.

Immediately after the talks fell apart, Russian Energy Minister Alexander Novak was quoted as saying that starting from 1 Apr (the date when the existing production cuts will lapse) "neither OPEC nor non-OPEC countries had any restrictions to productions". Across the weekend, Saudi Arabia followed up immediately with steep price cuts for its Official Selling Price (OSP) of all its crude grades to all its export destinations. OPEC members are most likely to follow up with similar price cuts to their respective crude oil grades.

Chart 3: Saudi Arabia Can Easily Grow Production By 2 to 3 mio bpd

Source: Bloomberg, UOB Global Economics & Markets Research



There is increasing concerns that both Saudi Arabia and Russia will now ramp up production in an all-out price war. In particular, Saudi Arabia was producing less than USD 10 mio bpd over the past year as a result of the production cuts and they have the capacity to boost production by as much as 2 to 3 mio bpd if necessary. Russia currently produces slightly more than USD 11 mio bpd.

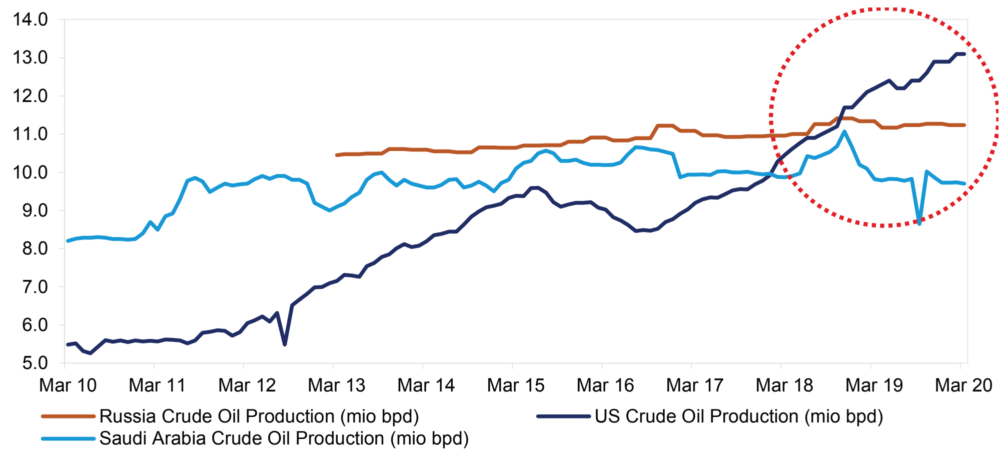
We Downgrade Our Brent Crude Oil Price To USD 30 / bbl By 2Q20

Last week, the IMF MD Kristalina Georgieva warned that global growth will likely be weaker than the 2.9% print in 2019. Prior to the COVID-19 outbreak, the IMF had forecasted at the start of the year that global growth in 2020 will rebound to 3.2%. That forecast is now outdated given the intense growth slowdown triggered by the COVID-19 outbreak. The IMF is likely to publish an updated global growth forecast by late March during their virtual meeting (The IMF's annual Spring Meeting in Washington has been cancelled in view of the health risks during the COVID-19 outbreak).

This failure of the OPEC+ talks, coupled with slowdown in global growth and demand, now risks a significant global oversupply in crude oil prices. Back in mid-February, after the COVID-19 just broke out, the International Energy Agency (IEA) had downgraded its global oil demand forecast to the lowest growth rate in about a decade. The growing US energy exports are now vulnerable given that both Saudi Araba and Russia have engaged in an all-out price war.

Chart 4: US Energy Exports Now Under Threat

Source: Bloomberg, UOB Global Economics & Markets Research



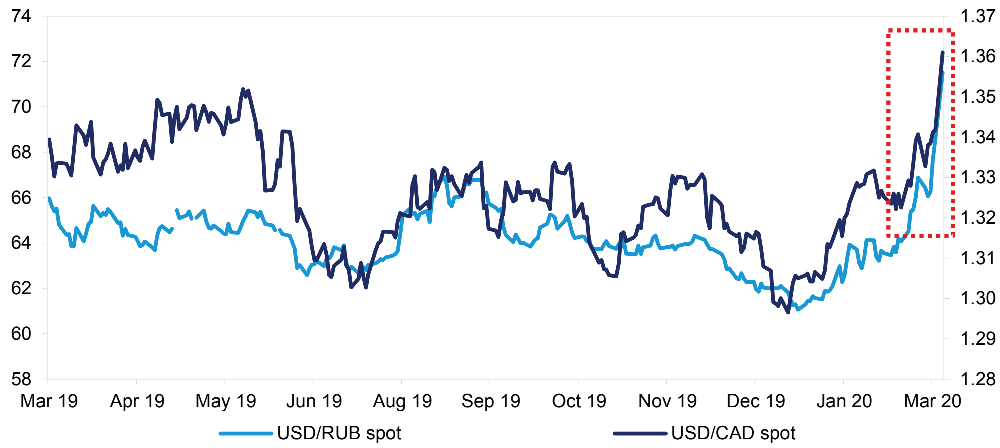
As a result, we downgrade our Brent Crude Oil forecast to USD 35 / bbl by 1Q20, USD 30 / bbl by 2Q20, USD 35 / bbl by 3Q20 and USD 45 / bbl 4Q20. The expected mild recovery in forecast in 2H of the year is subjected to the anticipated recovery in global growth and demand once the COVID-19 outbreak is brought under control by mid-year.

Key Implications Of Lower Crude Oil Prices

The lower energy prices will pressure commodities related currencies further, in particular those of oil producing countries. AUD/USD fell this morning below 0.65 as the CAD collapsed from 1.3450 to 1.37 against the USD. The RUB closed last Friday at a very weak 68.50 against the USD and is likely to head towards 70 when trading resumes later today. The Emerging Market FX (EMFX) Index started the year struggling at 61 it has now fallen below 60 to a new all-time low of 56.90.

Chart 5: RUB And CAD Nosedive On Collapse In Crude Oil Price

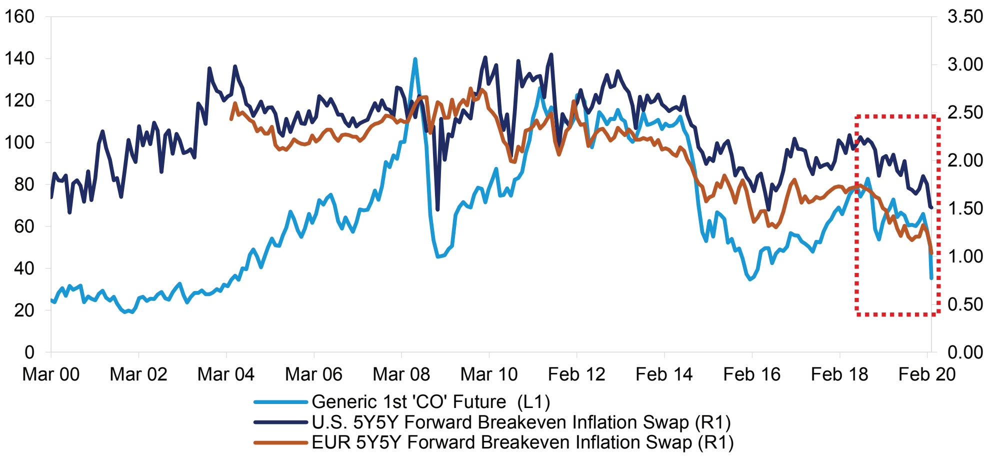
Source: Bloomberg, UOB Global Economics & Markets Research



Interest rates profile will now be "Lower for Longer". Amidst the knee-jerk limit down sell-off in equity markets, FED Fund Futures now imply that the FED will need to cut all the way down to zero by the end of this year. We maintain our view for the FED to cut by 50 bps when they next meet on 17/18 Mar and refrain from revising FED outlook amidst such intense uncertainty. But it is clear that this move lower in energy prices risk triggering a deflationary spiral that will keep interest rates globally locked in at even lower levels. In fact, both the US and EU 5Y5Y forward looking inflation indicators will now likely follow energy prices lower, reinforcing market expectations of more central bank easing to come.

Chart 6: Both US And EU 5Y5Y Forward Inflation Indicators Are Now Likely To Fall Further

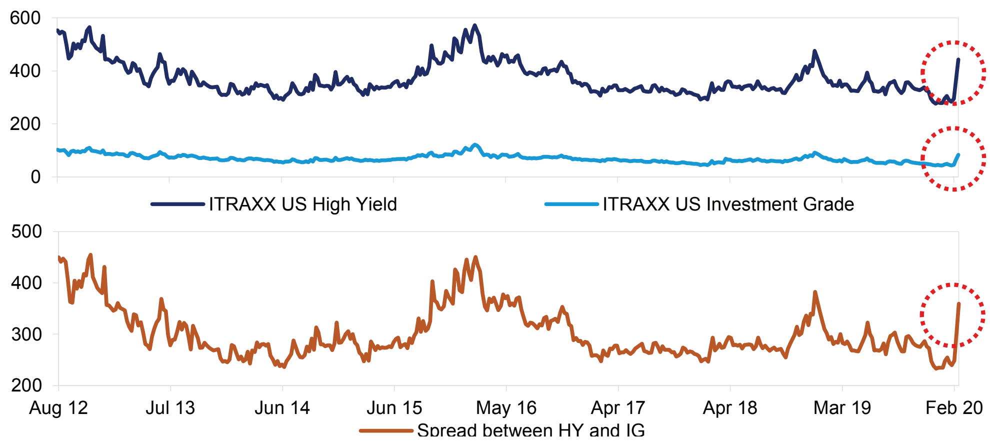
Source: Bloomberg, UOB Global Economics & Markets Research



This collapse in energy prices will also pressure the US High Yield market which is dominated by energy names. Prior to this breakdown in production talk between OPEC and Russia, the US High Yield index has already started to price in higher credit risk.

Chart 7: US High Yield Credit Cost To Rise Further

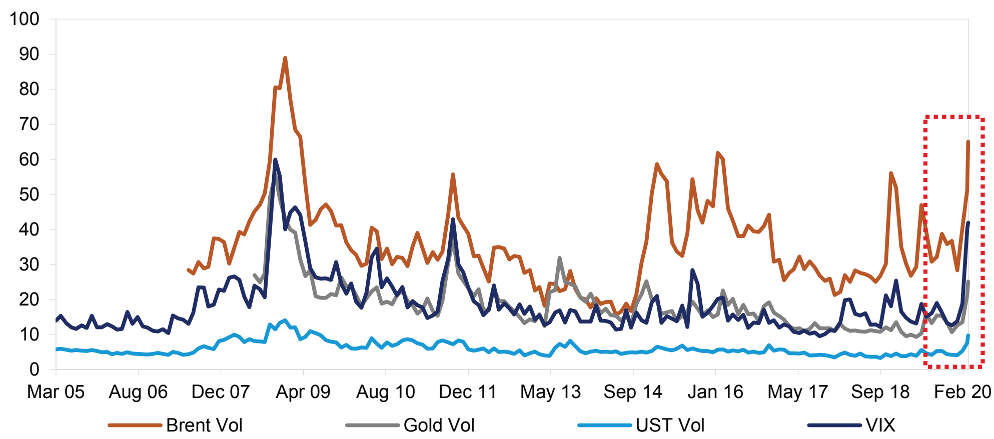
Source: Bloomberg, UOB Global Economics & Markets Research



Needless to say, we now have a perfect storm in the form of a spike in volatility across all key asset classes. As of last Friday's close, VIX saw a significant surge above 30 towards 40 while US Treasuries volatility rose to 10% (which in itself is unprecedented), Gold volatility spiked to 25% while Brent Crude Oil volatility recorded 65%. Unconfirmed trader commentary suggested that Brent Crude Oil implied volatility tested 100% this morning (09 Mar) amidst the melt-down.

Chart 8: The Perfect Storm Of Elevated Volatility

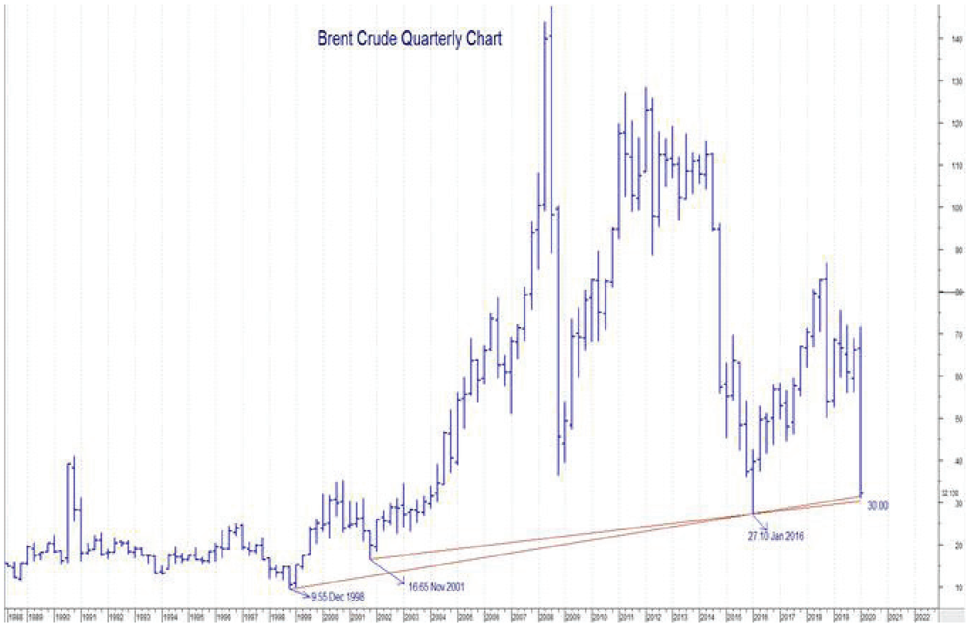
Source: Bloomberg, UOB Global Economics & Markets Research



Given the intense financial market volatility, there is now increased risk of further coordinated monetary policy easing by G7 central banks. Both Saudi Arabia and Russia may well be "encouraged" to return to the negotiation table to prevent further calamitous drop in energy prices.

Brent Crude : $32.00/bbl
Brent in a "runaway gap";
There are only a handful of significant support levels left before the Dec 1998 low of $9.55.

Source: Reuters, UOB Global Economics & Markets Research



Brent crude collapsed by -10.07% last Friday (06 Mar) and gapped down dramatically upon opening this morning (09 Mar). At the time of writing, Brent has lost an astonishing -30.0% after Friday's close. The last time Brent lost such a gargantuan amount was almost 3 decades ago in 1991 when it registered a single-day loss of -34.77%. Several strong support levels were obliterated and from here, there are only a handful of significant support levels left before the $9.55 low registered in Dec 1998.

The nearest support is at the rising trend line that sits near the round-number level of $30.00 (there is another trend line that is slightly higher $31.00). Below $30.00 is the Jan 2016 low of $27.10. The Jan 2016 low is a relatively solid support but if Brent were to register a weekly closing below this level, further loss towards the Nov 2001 low of $16.65 would not be surprising. All in, the gap this morning appears to be a textbook "runaway gap" and only in the unlikely event that Brent can close this gap (that is moving back above Friday's low near $45) would indicate that a temporary bottom may be in place.

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