



**December 1, 2014**

## **AN UPDATE ON OIL**

### **Insights from Eric Lascelles, Chief Economist RBC Global Asset Management**

RBC Global Asset Management Chief Economist Eric Lascelles hosted a conference call to address the recent material decline in global oil prices. With prices falling from above US\$100/barrel to \$70 per barrel, Eric addressed the likely economic impact on a variety of nations, including the U.S., Canada and Organization of the Petroleum Exporting Countries (OPEC) members.

While it is clear that the current decline in oil may diminish the economic capacity of many nations, Eric also discussed the positive developments that may dominate globally as a result of sustained lower oil prices.

#### **Why did oil prices decline?**

While the speed of the move is surprising, the direction and ultimate level is less so.

- On the demand side, emerging market economies – the marginal consumer of resources – have been slowing for several years.
- On the supply side, producers have naturally responded to a decade of extremely high prices by producing more.

#### **Where could oil prices go from here?**

A further near-term decline is not impossible given the momentum the market has recently demonstrated, but we believe oil prices are ultimately unsustainably low relative to production costs. Nevertheless, other than via OPEC, it usually takes some time for supply to respond to lower prices. This is because most producers have some buffers in place that mute the initial effect of an undershoot of prices, such as explicit hedges. In addition, operating costs are much lower than upfront investment costs, meaning that production will usually continue at existing facilities even if the viability of new projects fades.

The last collapse in oil prices occurred in mid-2008, when oil prices fell from almost \$145 to \$31 in the span of a few months. Today's situation seems different; in 2008, oil prices were coming off of bubble-level readings with high speculator involvement, whereas the starting point was much less extreme today. Moreover, global demand was collapsing in the run-up to the 2008/2009 great recession. Despite that, the decline in oil prices could not be sustained and oil prices rebounded to the \$70+ range within six months. There is reason to think the minimum sustainable oil price may even be a bit higher today.

From a geopolitical standpoint, there are a few considerations.

- Sanctions on Iran could be lifted in the near future. While this does have potential implications for supply, it wouldn't happen until next year and production would not rise aggressively for quite some time.
- Iraqi production remains well below prior highs, but they have been trying to increase production without success for quite some time, and ISIS presents at least a low-grade risk.

- Russia is incented to produce as much as possible given economic and fiscal woes, but arguably they already are producing at capacity.

While only one million net new barrels of oil are needed per year to meet rising demand, the natural decay rate on existing production (about 6-9% per year) means that another 5-7 million barrels must actually be found to replace fading production elsewhere. Thus, significant investment and exploration needs remain. While conventional oil production is in slight decline, unconventional oil production – mainly U.S. shale oil – is rising. Canadian production in Alberta requires prices in the \$50-70 range to attract oil sands-SAGD production, and arguably \$75+ to justify more traditional oil sands techniques (though much depends on the local currency, which has been helpfully declining). Meanwhile, U.S. shale requires prices in the \$65-80 range to experience unabated production. Thus, recent price declines have the ability to start eroding new investment decisions, if they stick.

### Why didn't OPEC cut production?

There are several theories around why OPEC decided against cutting production.

- OPEC is the low-cost producer and as such they can stomach lower oil prices better than the rest. However, the cost of production is not the relevant metric. The countries that make up OPEC require very high oil prices to meet their budgetary needs, especially post-Arab Spring. To balance their budgets, OPEC countries need between high double-digit and low triple-digit pricing. Iran requires \$136/barrel (bbl), Venezuela needs \$121/bbl, Nigeria needs \$119/bbl, Russia needs \$102/bbl, while Saudi Arabia needs \$93/bbl.
- Another theory is that OPEC is acting to hurt Russia, perhaps at the behest of the West. However, this makes no sense as several OPEC nations are aligned with Russia and they would not accept such a large economic hit willingly.
- A third theory is that OPEC wants to hurt U.S. shale producers. This is conceivable, as there is no question that shale oil is displacing OPEC production. However, this is an unwise strategy (since shale oil and OPEC can operate in harmony at prices around \$80/bbl, whereas it would take prices sustained below \$60/bbl to eliminate shale production) and ultimately unlikely to be successful as shale oil is highly entrepreneurial, meaning producers can stop production abruptly and then begin again as soon as prices reach sustainable levels. A temporary bout of unprofitable prices would not permanently kill shale oil – the genie is out of the bottle.
- Finally, and in our view most credibly, OPEC knows it should cut production, but simply wasn't able to act. Some producers are so desperate for revenue that they aren't willing to consider cutting production. Others recognize the need, but prefer that Saudi Arabia absorbs the entirety of the decline, as they often do. However, Saudi Arabia is fed up with doing this alone, particularly since they already have idle capacity.

In the end, it continues to make a great deal of sense for OPEC to curtail production. Cutting one million barrels per day of production – around 3% of what OPEC produces – should theoretically raise prices by 10-25%, back to equilibrium levels or around \$80/bbl. This seems like the most likely outcome, and we suspect that OPEC will meet again to reduce production before next June, or will unofficially reduce production between meetings.

### What about the outlook for demand?

The global economy can sustain 3-4% annual growth. Energy efficiency gains advance at around 2% each year and substitution toward other fuels like natural gas also erodes the underlying growth in demand for oil. This leaves oil demand growth running at around 1% per year.

The imbalance between supply and demand is actually fairly small – between 0.5 million and 2 million barrels per day out of a global market of 93 million barrels per day. It will not take much to achieve equilibrium, and producers are highly incented to make this adjustment. We continue to believe that a price somewhere around \$80/bbl is a reasonable long-term target.

### What are the implications of lower oil prices?

The global economy benefits from lower oil prices due to increased money in the pockets of households and businesses, on the order of a few tenths of a percentage point to GDP. More generally, the combination of lower oil, lower yields and weaker exchange rates should provide a boost of between 20-70 basis points to most major economies over the next year. For the U.S. economy, the impact is not purely good as shale producers are hurt by the price action. However, overall it is still a net positive for the U.S. economy.

The implications for Canada's economy are varied. Alberta and Newfoundland are hurt by lower oil prices, though it's not quite as bad as it first looks since Western Canadian Select prices have fallen slightly less than the global metrics, and a weaker Canadian dollar buffers the blow. Nevertheless, weakness comes mainly in the form of lower profits and revenues to the government, but also to a lesser degree in fewer new investments. There is a risk of spillover into other parts of the economy (such as housing and consumer spending), but only if the price decline fully sticks.

For the rest of Canada, the implications are mainly positive. A lower Canadian dollar is good for manufacturers and exporters, and lower oil prices help Ontario's auto industry. Lower oil prices help demand from the U.S. as a trading partner, and Ontario's economy gets a boost of around 60 basis points from lower oil prices. Overall, the Canadian economy probably falls slightly behind on the oil versus Canadian dollar trade, but not to a large extent. The federal budget could lose around \$2.5 billion per year due to the decline in oil, which take the expected surplus down to around zero. This means the scope for additional goodies in the lead up to the 2015 elections has declined.

A secondary consideration is the depressive effect that oil has on inflation. On the surface, declining oil prices is bad since low inflation is already a concern around the world (particularly so in Europe). A deeper investigation reveals that it is not such a bad thing:

- The boost to global economic growth arguably dominates the one-time, temporary effect of lowering inflation.
- To the extent that central banks nevertheless feel compelled to act, it could increase the odds of quantitative easing in Europe (a good thing).
- We suspect it will not elicit a significant change in central banker behavior.

### What are the implications for markets?

#### Stock Markets

The impact on stock markets has been mixed. Lower oil prices are obviously quite negative for resource firms, arguably slightly good for most other companies, and quite good for firms that are heavily reliant on energy inputs, such as autos and manufacturers. But, to the extent oil may be overshooting, opportunities begin to emerge in the opposite direction.

## **Currencies**

From a currency standpoint, some currencies move substantially due to resource prices, such as the Canadian dollar. Although the Canadian dollar has fallen by less than oil prices recently, it declined to a greater degree beforehand. Our analysis suggests the two are in approximate alignment.

## **Credit market**

Some U.S. oil producers who have financed in the credit markets may already be running into difficulties. The high-yield credit default rate could rise palpably if oil prices remain very low.

## **What can investors expect going forward?**

Oil prices are exhibiting significant negative momentum. However, from a longer-term perspective, they have probably already overshot. In our view, oil at US\$80 seems to be a reasonable longer-term assumption. Going forward, this brings implications both good (for the global economy) and negative (for oil investors and producers).

---

The information contained in this report has been compiled by RBC Global Asset Management Inc. (RBC GAM) from sources believed by it to be reliable, but no representations or warranty, express or implied, are made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC GAM's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. RBC Funds, RBC Parameters Portfolios and PH&N Funds are offered by RBC GAM and distributed through authorized dealers.

® / ™ Trademark(s) of Royal Bank of Canada. © RBC Global Asset Management Inc. 2014

## **A NOTE ON FORWARD-LOOKING STATEMENTS**

This report may contain forward-looking statements. The words "may," "could," "should," "would," "suspect," "outlook," "believe," "plan," "anticipate," "estimate," "expect," "intend," "forecast," "objective" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events. The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

