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Global CIO Outlook
The Endgame for Oil

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In the fourth quarter of 2014, I asserted that a barrel of oil would average $45 during 2015 and 2016. Given the nature of the growing supply glut and OPEC's unwillingness to cooperate on reducing output, I also projected that there was risk of a **spike down to $25 per barrel** before prices would stabilize. While far from consensus, my pessimism at the time now smacks of optimism. Today, looking at the market fundamentals in place, I believe we have reached a new point in the global energy story: The endgame in the decline of the price of oil.

Others are not so sure. As prices continue to fall, the market continues to be confronted with lower and lower predictions for the price of oil. For example, several bulge-bracket banks recently registered price targets of $20. Not to be outdone, Deutsche Bank suggested prices could fall to marginal cash costs for U.S. shale, possibly as low as $7 per barrel. Sentiment has turned so negative that a growing consensus of analysts are beginning to herald a new era for oil where prices remain close to current levels for many years.

Just as prices are reaching levels where U.S. output is beginning to decline, analysts have begun to identify a list of factors that will keep oil prices depressed. First is Iran, where post-sanction production is poised to rise by an estimated 500,000 to 1 million barrels per day. Questions remain as to how much of that "increased" production has already hit the market and whether an increase of that size is even possible in the near term.

Another factor contributing to the bleak outlook is on the demand side, as many observers anticipate a continued slowdown in global growth. China looms large in this story, but concerns remain about recessions in Japan, Europe, and the United States.

However, just as the consensus call in 2014 for a quick rebound in the event oil traded down to $60 reflected undue complacency—one analyst insisted at the time that there was an absolute floor at that price—today's prognostications of permanently subdued energy prices seem equally unsubstantiated.

To be sure, China is a concern, but policymakers there know that social and political stability hinge on future growth. They have a long list of tools to exhaust—including a sharp yuan devaluation—before they allow their country to fall into the chaos associated with a full-blown recession. The path forward for China is likely to be bumpy, but a genuine recession is not in the cards.

As for Japan, Europe, and the United States, central bankers are telling the world that recession is not an option. In recent weeks, policymakers have signaled that they are loath to surrender hard-won victories of growth and employment in the wake of the financial crisis and will use every tool at their disposal to keep the world afloat, even at the risk of future asset bubbles.

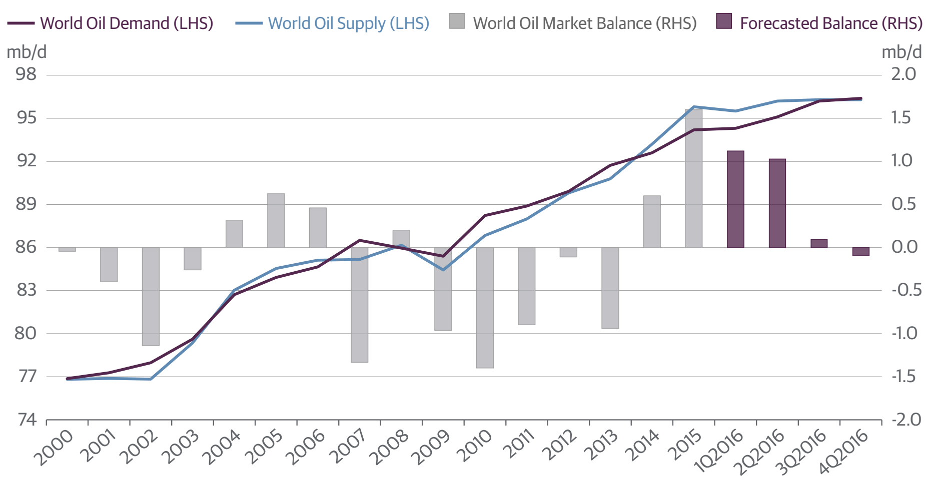
The global oil surplus of approximately 1.6 million barrels per day in 2015 is likely to evaporate slowly during the course of this year. Global demand growth should absorb 1.2 million barrels while output declines from exhausted fracked wells in the U.S. and other non-OPEC countries should reduce output by about 400,000 barrels in 2016.

The question of increased Iranian production might very well delay the rebalancing of demand and supply, but by 2017 the continued decline in U.S. output and increased consumption due to lower gas prices should allow oil prices to begin to rise. Of course, markets usually discount events well ahead of time so by the second half of 2016 oil should be on firmer footing.

As prices inch closer to the cash cost of production, and oil producers defer large amounts of planned investments to later years, we will likely see production declines in major non-OPEC producers in 2016. Such declines could be offset by a higher output level from OPEC, especially factoring in a potential post-sanction increase in Iran's production. However, world demand growth, supported by cheaper prices, will erode the majority of the surplus, and should help bring the market into balance by the end of the year.

World Oil Supply/Demand Should Balance in 2016

World Oil Supply/Demand Balance



Source: IHS, Guggenheim Investments. Data as of 2.3.2016. LHS= Left hand scale, RHS= Right hand scale.

Are we about to head into a new era of skyrocketing oil prices once supply equilibrium is reached? Probably not. One lesson learned from recent experience is that U.S. production proved to be much more resilient to price declines than expected. Innovations in fracking and new extraction techniques are accelerating. The industry is demonstrating an ability to innovate quickly and is likely to continue to reduce the marginal cost of U.S. oil production.

The increasing output from new innovation will likely serve to increase supply once prices begin to rise. This will improve supply elasticity so that price increases will be moderated over time. Nevertheless, prices will need to rise to bring new supply online. According to our research, this price rise should commence this year. The result will be a more predictable environment for both producers and consumers as this oil bear market finally draws to an end.