JAKE SIEWERT

This is *Exchange at Goldman Sachs* where we discuss developments currently shaping markets, industries and the global economy. I'm Jake Siewert, global head of Corporate Communications here at the firm.

Yesterday on March 9th, stocks had their worst day since 2008 as investors reacted to a price war for crude oil between OPEC and Russia. Jeff Currie, our global head of Commodities Research, is joining us by phone from our London office to explain what's going on. Jeff and his team have a new report out called *The Revenge of the New Oil Order*. Good morning, Jeff, and welcome to the program.

JEFF CURRIE

Good morning, Jake.

JAKE SIEWERT

So Jeff, what's going on in oil markets? Oil's been one of the hardest-hit asset classes from coronavirus, but what led to the start of the price war over the weekend?

JEFF CURRIE

Well, it's tempting to think that the coronavirus and the price wars are two new, separate, downside risks to the oil market. However, I really like to think that this price war really is a second-round effect of the coronavirus. In terms of what this did to our price forecast, it took what at the beginning of the year was a 63-dollar-a-barrel price forecast on Brent, the coronavirus took it down to $45 a barrel. The price war has now taken it from 45 down to $30 a barrel at least over the next six months.

Now when we think about what were the immediate causes of this was, to begin with, Russia failed to agree with the rest of OPEC for a production cut. The second-round effect of this was that Saudi responded over the weekend by slashing official sales prices by as much as $12 a barrel under Brent prices. That gives the evidence that this is likely a price war. So the other question that comes out of this really is the why now, and we think there's

three reasons for this. The first is that when you look at the balance sheets of the U.S. producers, they had already been damaged substantially by the decline in prices due to the coronavirus. That's my point that this is really a second-round effect of the coronavirus itself. So acting today, it's much easier to tip the balances of these companies than it would be otherwise.

The second reason has to do with the fact that U.S. sanctions have had a substantial impact on Russia, particularly on the

gas side. You've had the Nord Stream sanctions.

You have also had sanctions on Rosneft, and on gas, again, second-round effects of the coronavirus. You've seen that gas demand in China was down 40 percent, at least the imports of LNG. Those LNG exports from places like the U.S. were going into the European market where there was still a premium. When we think about the impact that this has had on Russian gas prices, it has been substantial.

Then the third reason, again why today, Saudi imposed an ultimatum on Russia, and Russia typically does not like those kind of outcomes, and so that's why we tend to think that, hey, this is the beginning of a price war. I really don't like the word "price war." I like to really call it a market share strategy.

JAKE SIEWERT

So Jeff, how have investors reacted, and how do you explain yesterday's selloff in stocks?

JEFF CURRIE

As you indicated, yesterday we saw the biggest down day on record, at least similar to what happened in 1991 following the conclusion of Gulf War I. Yesterday we dropped nearly 25 percent in one day. The energy stocks also plummeted to levels that erased nearly two decades of gains. What investors are now focused on is when to buy. This morning markets are up somewhere between five and ten percent, but we think it's too early to get long on a sustainable basis, at least the commodity.

The energy equities as our energy equity analyst would argue is a very different story. They don't have a negative carry like the commodity does itself and in some cases are paying dividends as much eight percent that would protect you from any more potential downside that we think is relatively high given the current environment. So we would say no to the commodity of getting long right now, but yes to the energy equities.

JAKE SIEWERT

Cutting through the noise, how do these new developments fundamentally change the outlook for oil and gas markets?

JEFF CURRIE

It does several things. First, it shifts it back to the new oil order. The new oil order which we introduced in 2014 was really predicated on the idea that low-cost producers have an economic incentive to increase production to gain market share. The reason for this is the fast-cycle nature of shale that can expand production rather quickly and take market share away from the OPEC countries.

In fact, we like to argue the economics of a production cut simply do not make sense. The evidence of this can be seen by looking at the economic implications that occurred following the production cuts in 2016. When we look at OPEC production, OPEC+ including Russia, it was down somewhere around 4.4 million barrels per day. In response to that, the shale and other non-OPEC producers increased production by 5.7 million barrels per day.

Now that is also an economic for the OPEC countries, but who ultimately paid the price for it? It was the shareholders of the energy equities. So it was a combination. It just did not make economic sense. So the new oil order is predicated on this idea that, hey, the low-cost producers should be pursuing a strategy of market share.

The second implication is that our new price forecasts are now $30 a barrel on a Brent basis for 2Q and 3Q of this year. Then beginning in fourth quarter, we now expect to see a steady upward march in prices; 40 in the fourth quarter going to 45, 50, 55 and then ultimately $55 a barrel in the fourth quarter of next year. That represents a normalization in the market that we saw at the beginning of this year. I think third in terms of thinking about what does this do to the fundamental outlook, we see inventory builds occurring in the second and third quarters of this year.

This is primarily driven by OPEC+ growing production by as much as 800,000 barrels per day. Yes, the numbers that are being tossed around this morning are much higher than 800,000 barrels per day, but 800,000 barrels per day puts Saudi at somewhere around 10.5 million barrels per day. Inventories are likely to begin to decline when you get to the fourth quarter of this year; hence, it's why we have the rise in prices ensuing after that, and then we begin to begin to see a normalization process, and I think that that's really behind why we see prices rising in the fourth quarter of this year.

So in terms of thinking about this, there are three distinct phases that we have identified during these price war-type dynamics. The first is a survival phase.
The second is the inflection phase, and the third is the regeneration phase.

So when we go back to the survival phase, we started to see this, you know, particularly in the most recent time period in 2014. However, when you think about what's happening in the current environment, if you're Russia or you're Saudi Arabia, you would actually like a lot of these companies to survive but survive as zombies. Why zombies is because the assets stay under the control of these management. Then they likely have high levels of debt, are unable to invest because ultimately if we get to the regeneration phase in that environment, you would see the assets turn over to a new management, new balance sheets that are likely to operate them in a more efficient manner, leading to lower long-term prices.

So we think that, you know, as we see the survival phase begin to happen, I think it'll be very difficult for Russia or Saudi Arabia to be able to target prices perfectly to end up with zombie companies. As they move to the inflection phase which is what we see happening in the fourth quarter of this year or late third quarter we see a bottoming in prices. That's when you're likely to

see the most volatility in prices, a flattening of the curve, but that creates the birth of a new bull market and then moves us to the third phase which is the regeneration phase which is what we need to see which is restructuring.

JAKE SIEWERT

So when's the last time we've seen a price war or a market share strategy like this, and how does the outlook now compare to then?

JEFF CURRIE

Today is far more dire. When we look back over time, ~~there's~~ there are two episodes where we saw substantial price wars. One was in 1986. The other one obviously is more recently in 2014 and '15. When we think about what Saudi's doing here from a pricing dynamic, meaning slashing the official sales prices, it's more akin to what happened in 1986 which, by the way, ironically it was what ultimately helped lead to the fall of the Soviet Union; hence, why there's a bigger historical artifact here.

In terms of thinking about why is this similar to 1986, is in 1986 they did a net backing program which basically guaranteed refiners a certain level of profitability, and again by slashing prices to refiners and in cases of seven to $12 below Brent, it's basically helping create profits for the refiners so that they take Saudi Arabian crude. Beyond that, the similarities I think of the 2014 episode really need to be thought about because what failed to come out of the 2014 price war was a rebalancing of the market.

JEFF CURRIE

So we've talked about 1986. What about 2014? What are the similarities there? I think it's key to recognize that in 2014 the rebalancing or the regeneration was stopped short. What stopped it short? You had stimulus from China, OPEC production cuts and then ultimately fiscal policy out of the U.S. That kept prices far higher than what they would have been otherwise, and we failed to see the rebalancing. In fact, if anything, we saw too much capital flow into the sector.

You know we've long said that rebalancing the barrels or the BTUs of a market is not sufficient. You also need to rebalance the capital markets. That was the core thesis behind the idea of lower for longer is to have prices remain low enough to sideline capital to see a rebalancing of the financial markets. That didn't happen because of, again, China's stimulus, OPEC production cuts and the fiscal stimulus coming out of the U.S.

So when we think about the current environment, the question really is, are we going to finally see that phase three, that regeneration and restructuring of the industry that should have happened five years ago and could potentially happen over the next several years?

JAKE SIEWERT

So Jeff, what are you expecting to see next? Will you see OPEC come together and put together a deal in the coming months?

JEFF CURRIE

Our base case is that this lasts through the summer months. However, if we look at this morning, Saudi Arabia came out and announced production to be increased to 12.3 million barrels per day. We view that as more saber-rattling. It would be difficult for them to achieve those kind of numbers which would be an indication they're threatening Russia to try to get a quick settlement. However, when you saw the Russian Energy Minister Alexander Novak's response to that, he was talking about seeing an OPEC meeting in May or June of this year.

Again, we like to go back to the point that when we look at the economics behind a decision not to cut, meaning to keep production at levels or raise them and pursue a market share strategy, they're much more sound than the economics of making production cuts. We've already seen the pain. Prices have come off sharply. Production is starting to rise. So the question is, how long will this go on? I tend to think that it at least will go on through the summer months. We've heard indications that Saudi Arabia has already slashed prices to some refiners going out to June. So I think thinking about this lasting into the summer months is a pretty good assumption right now. It's important to note that an agreement is not necessarily bullish. They could come to an agreement of quotas that are at higher levels, extending a market share strategy but formalizing it under an OPEC+ agreement. So when we're talking about agreement, it's not necessarily bullish. It could just be a continuation of the current strategy.

JAKE SIEWERT

So what's the top question you're getting from clients right now?

JEFF CURRIE

The questions that we're getting from clients right now are really, "Is this a one-off event, or is this much more structural?" Again, we like to argue this is likely to be more structural. We're going back to problems that were apparent in '15 and '16 that were cut short by stimulus and OPEC production cuts, and we're now back in an environment which we're creating that rebalancing.

Yes, the coronavirus helped be able to accelerate this process through lower demand and lower prices. In a price war, it's much easier to accomplish it today than it would have been at a much higher demand environment, but I think the key here is that ultimately this rebalancing is inevitable, and we need to go through it. The question, is the timing right today given the weakness in demand? It probably is.

JAKE SIEWERT

So Jeff, what's something else that people aren't talking about coronavirus and oil that you think they should be?

JEFF CURRIE

You know, again going back to this point about second-round effects. We've talked about second-round effects with the price war, meaning that the weak demand and low prices in oil is allowing these low-cost producers to pursue a market share strategy with lower cost to them than would be in a higher-demand environment.

The ones that I'm really worried about are second-round effects that more are political dissatisfaction. You look at places, you know, whether if it's Italy, U.S. There's a lot of the population that are unhappy with the response of the governments to this health crisis.

JAKE SIEWERT

Well, Jeff, thank you for joining us today.

JEFF CURRIE

Thank you, Jake. It's a pleasure to be here.

JAKE SIEWERT

That's all for this episode of *Exchanges at Goldman Sachs*. Tune in again Friday for our markets update to close out the trading week.