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THE STRATEGIC IMPORTANCE OF THE GLOBAL OIL MARKET

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The global oil market in early-2015 is not what it used to be. In the past, environmentalists used to warn everyone that the world would soon run out of oil. Not anymore. In the past, Saudi Arabia was the swing producer. Not anymore. In the past, geopolitical risks from military conflicts like we are seeing today in the Middle East would often cause oil prices to rise. Not so much anymore. In the past, Wall Street used to worry about inflation. Not anymore. In the past, economists also used to worry about inflation.

This Letort Paper will explain why the confluence of four major factors: 1) rising oil supplies, 2) weak oil demand, 3) financial shifts on Wall Street, and, 4) a strong U.S. dollar far outweigh the geopolitical risks in the Mideast and put downward pressure on oil prices. This Paper analyzes the concomitant factors that are now putting upward pressure on oil prices, as well as those that continue to keep oil prices relatively low.

On the supply side, lower oil prices in part reflect booming U.S. oil production. The real "game changer" is the recent discovery of 30 more years of unconventional oil. The global oil market is now "swimming" in one trillion more barrels of oil that was not included in the world oil supply a few years ago. This new oil supply mostly breaks down into three types of unconventional extraction of oil: Brazil's deep water oil, U.S. shale oil, and Canada's oil sands.

On the demand side, there continues to be a sluggish global economy. For instance, Japan, Germany, and Italy are all suffering from near economic contraction. China's growth is rapidly slowing down and is a far cry from its double digit growth in the past. Meanwhile, the U.S. economy was also weak after the global financial crisis. In an effort to boost gross domestic product growth, the federal government (Fed) under Ben Bernanke loosened the monetary policy (increased the growth of the money supply), which in turn caused oil prices to rise as a hedge against expected inflation and a weak dollar, but runaway high inflation never happened. So now the Fed (under Janet Yellen) is planning to tighten monetary policy by reducing (or tapering) the pace of growth of quantitative easing, which in turn will strengthen the U.S. dollar. A stronger U.S. dollar buys more oil and therefore lowers crude oil prices.

To sum up, the major factors that determine average oil prices have all been pointing in a downward direction. In fact, in 2015, there is likely to be a growing surplus of oil on world markets created by rising oil production in the United States, Canada, and a few other countries. The result has been falling oil prices. Low oil prices have created winners and losers. Winners include the global economy as a whole, and consumers, especially U.S. consumers, and net oil importing countries. Losers include oil investors, net oil exporting countries, oil producing companies, and the workers that have been laid off by these oil exporting companies and countries. This Paper will discuss why the winners are benefitting, why the losers are suffering, how the winners and losers are responding, and how their responses affect oil prices down the road.

While U.S. consumers are winners, U.S. shale oil producers in the United States are losing. In many ways, U.S. shale oil producers are the victim of their own success. The more they produce, the more oil prices fall, and the more their profits get squeezed. U.S. oil production hit 9.2 million barrels a day in January 2015—a 31-year high. Unfortunately, this surge in oil production was totally mismanaged and helped to create a huge oil glut.

The volatility in the market makes it difficult to locate the oil market's floor at this point. However, one thing is clear: The oil sell-off is already having an impact. While a durable price recovery may not be imminent, signs are mounting that the tide is turning. The most tangible price effect is on the supply side. In this sense, a low oil price is performing its role in discouraging more supply. While there is no evidence yet of an actual reduction in overall global oil production, there is plenty of evidence of cutbacks in spending and investment that will ultimately affect supply in the future. For instance, in 2014, discoveries of new oil dropped to their lowest level in at least 2 decades. That translates into tighter world oil supplies and upward pressures on oil prices in the future.

With prices falling below $50 a barrel, a business as usual approach is a nonstarter because this would put oil companies in the red. U.S. oil companies have been forced to adapt to the new low oil price environment. Toward that end, oil companies have been cutting their budgets and postponing or cancelling "cash negative" new projects, while at the same time trying to be more efficient in squeezing the most out of their fields already in production.

There is no question that the conditions that will ultimately propel oil prices higher are now visible, but it will take a while to unwind the two million barrels a day of oil glut. U.S. oil production is still 9.2 million barrels a day—a 31-year high. Oil inventory is still at an 80-year high for this time of the year.

In assessing the corporate response to low oil prices, the good news is the oil companies are maintaining market share and providing their shareholders with dividends. The bad news is low oil prices forced Schlumberger to cut 9,000 jobs and Brent Hughes to cut 7,000 jobs. At a time when the skill-sets of older oil technicians are in short supply, this approach is arguably short-sighted. In this regard, strategists should be concerned that the corporate approach to cutting costs and capital spending could result in a lack of oil production in 4 or 5 years and a dramatic rise in oil prices. This short-sighted corporate mismanagement will arguably create the conditions for a dramatic rise of oil prices, possibly as high as $200 a barrel. Instead of this boom and bust scenario, the global economy needs more stability. How bad is the situation? Low oil prices have created the worst slump the oil industry has faced since 1986.

At a time when the United States is seeking cooperation with Saudi Arabia and the rest of the Gulf Cooperation Council (GCC) to counter the Islamic State in the Levant or Daesh, the United States and Saudi Arabia are in a bitter price war. The Saudis feel they can price U.S. shale oil producers out of the market. U.S. oil companies are responding. The coalition will struggle if the United States and the GCC are determined to run each other's oil companies into the ground. The time to set up institutions to avert these price wars or to create energy banks to mitigate them when they come is long overdue.

The main problem is the availability of financing for U.S. oil companies fighting for survival. The oil industry needs a central bank for oil to stabilize oil prices and avoid boom and bust cycles. However, a reactive bank that bails out oil companies in distress is not all that needs to be created. What also needs to be created is an international oil institution that is pro-active as well. The oil industry needs an oil early warning system (EWS). An oil EWS would monitor economic indicators that history reveals are precursors of boom and bust oil cycles.