Infected:

COVID-19 IMPACTS ENERGY MARKETS

Austin Zaunbrecher, CFA, CMT
Senior Portfolio Manager/Energy Analyst

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Executive Summary

- The emergence of COVID-19 quickly changed the world. With lockdowns and quarantines, the gears of the global economy ground to halt. Growth expectations became curtailed and risky assets were sold off across markets as investors clamored for safety. No sector of the economy has felt the impact of the virus more acutely than energy.
- The dramatic decline in expectations for global growth from the disease sent crude prices tumbling over the past months. Many expect the largest contraction in demand for oil in decades.
- Demand was not the only reason for weaker oil prices though. The breakdown of the OPEC+ meeting at the beginning of March began a price war between the Saudis and the Russians raised global supply of crude when the markets demanded a reduction. The U.S. domestic energy industry became caught in the crossfire.
- Energy prices have spent the past month historically volatile, and the countries and companies have implemented drastic changes in order to cope with the downturn. The moves that are initiated during this tumult will determine which industry players will survive and ultimately thrive during the next cycle upswing.
- This paper examines the unprecedented recent weeks in the energy markets, the steps that led the industry to its current state, and what needs to occur to see a turnaround in crude prices.

"This is a plague."

President Trump, *March 31, 2020*

Sitting in my newly fashioned home "office," and listening to the President's daily White House briefing on the Coronavirus, COVID-19, I was struck at the word that he used to describe the disease: plague. The word called to mind a book I read a few years ago, *The Plague;* Albert Camus's tale of fictional pestilence that gripped the North African town of Oran. **To be clear: I am not comparing the current health crisis with a bubonic-type plague!** Camus's story deals more with the human reaction to extreme conditions and radical lifestyle changes rather than a disease. I believe most have heard enough about curve flattening, vaccines, and social distancing. Instead, let us focus on the disruptive changes that the virus has wreaked on markets and industries, specifically the energy industry.

Source: Hedgeye

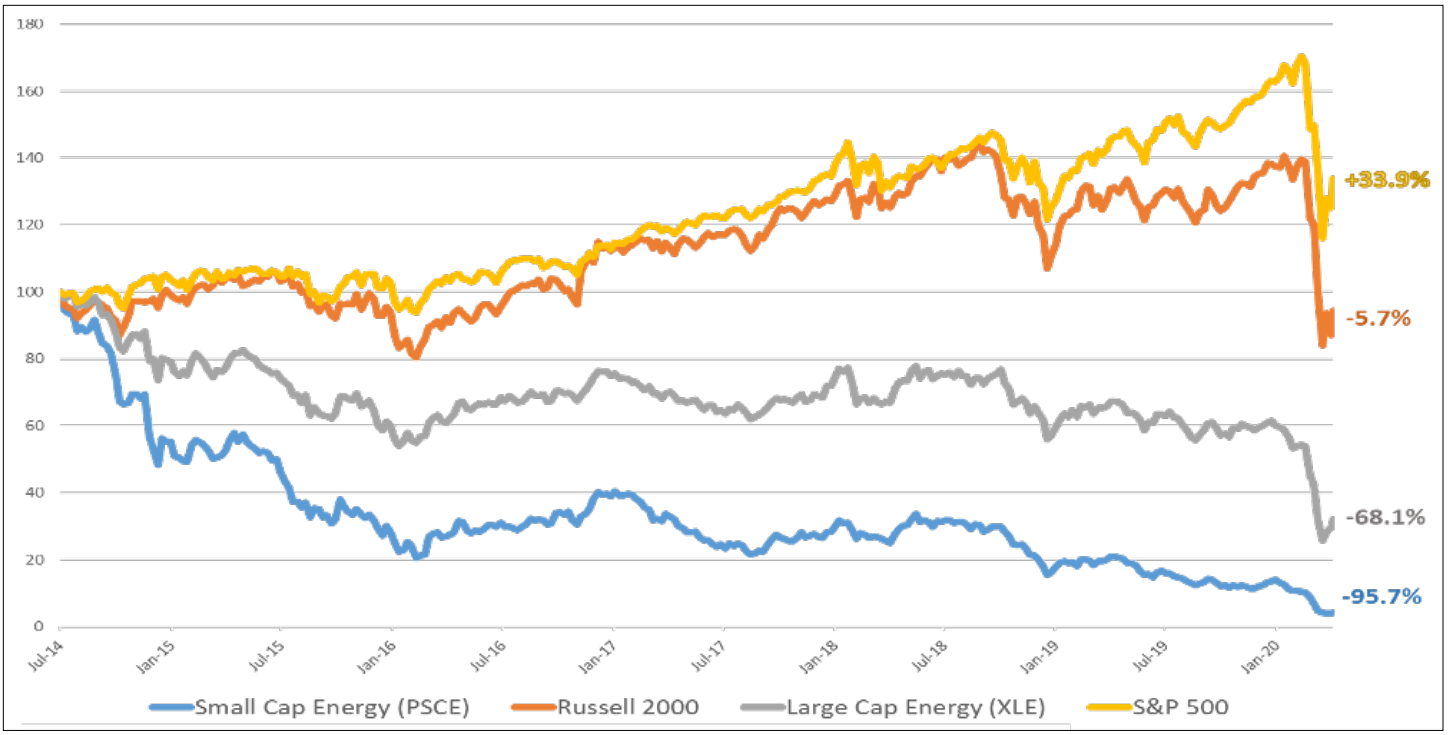
We will examine the confluence of factors that have produced oil prices last seen in the months following September 11, 2001, the breakdown on both supply and demand, the immediate concerns for the energy industry, and the future opportunities for the space.

"Disasters always come out of the blue."

Albert Camus, *The Plague*

As we have stated in the past, the energy downturn is largely a *symptom* of market turmoil and not the cause. The Coronavirus, COVID-19, and the grinding halt to the global economy that it created serve as the proximate cause to the volatile financial markets. The virus's extensive impact caught much of the developed world off guard and equities and other risk assets have responded in kind. **Energy stocks fell by over 50% during the first quarter and oil, as measured by West Texas Intermediate (WTI), dropped 67%. The drop in crude prices represent the largest quarterly decline ever.**

Relative Performance of Energy Stocks to Broad Market from July 2014 Oil Price High



Source: FactSet

It would be misleading though, to state that the difficulties in the energy industry began with the Coronavirus. Since 2014, the energy industry has struggled with bouts of volatility, as oil prices tried to regain footing after OPEC (Organization of Petroleum Exporting Countries) failed to respond to rapid U.S. shale production. Since oil prices hit a cycle high of the low $100s in mid-2014, the energy sector has dramatically underperformed the market as a whole (-16% vs. +7% for the S&P 500), and certain industries (exploration and production companies and oil field services) have fared even worse.

	1Q20	Jun. 30, 2014 – Mar. 31, 2020 (annualized)
Energy Sector (XLE)	-50.4%	-16.2%
U.S. Oil – WTI	-67.1%	-25.0%
E&P Companies (XOP)	-64.9%	-32.1%
Service Companies (OIH)	-69.7%	-35.6%
Refiners (CRAK)	-39.7%	N/A
Energy Small Caps (PSCE)	-70.4%	-42.6%
S&P 500	-19.6%	7.1%

Source: FactSet

By 2018, in response to an increasingly weakened geopolitical position, OPEC established a formal relationship with ten other crude-producing nations including Kazakhstan, Mexico, and the third largest oil producer in the world, Russia. Dubbed "OPEC+", the new organization created quotas to limit the amount of crude exported from their member states. Yet, by late 2019, concerns began to appear within the new coalition that some members had taken too much of the production quota while other members were more lax on their commitments.

Even without the drop in demand due to Coronavirus, many analysts expected OPEC+ would need to further curb production in the first part of the year in order to balance global supply and demand. After several geopolitical flare-ups, the Iranian attack on the Saudi Aramco Abqaiq processing facility in September and the killing of the Iranian General Qasem Soleimani in January, crude prices failed to find a stable higher level. Meanwhile, U.S. shale production continued to climb to record levels with pushes for efficiency and calls for capital discipline, putting pressure on prices. WTI slipped below $50 a barrel by early February just as reports of the Coronavirus having spread outside of China began to appear in headlines.

> "He couldn't picture such eccentricities existing in a plague-stricken community, and he concluded that the chances were all against the plague's making any headway among our fellow citizens."
>
> *The Plague*

News in February started relatively calm for global markets. Yet, it became clear that, despite dubious official economic numbers, the virus's impact on China seemed sufficient to dramatically curtail growth. At the same time, the virus had started its spread across the world with South Korea, Iran and Italy becoming epicenters of the disease. While cases in the United States started to slowly appear, markets considered a minimal potential impact to the country and the economy from the virus.

The virus headlines progressively worsened throughout February, and by the last week of the month, stocks and other risk assets, including crude, began to quickly slip. Commodities like oil, often a proxy of future global growth, fell as demand expectations dropped off with the notion that the virus would shut in economic activity.

U.S. oil, measured by WTI, fell to roughly $45 a barrel by the end of February, a drop of over 26% for the year at that point. It became increasingly apparent that the OPEC+ meeting, scheduled for the first week of March, would need to extend and increase production quotas from their members in order to offset failing global demand.

Source: Hedgeye

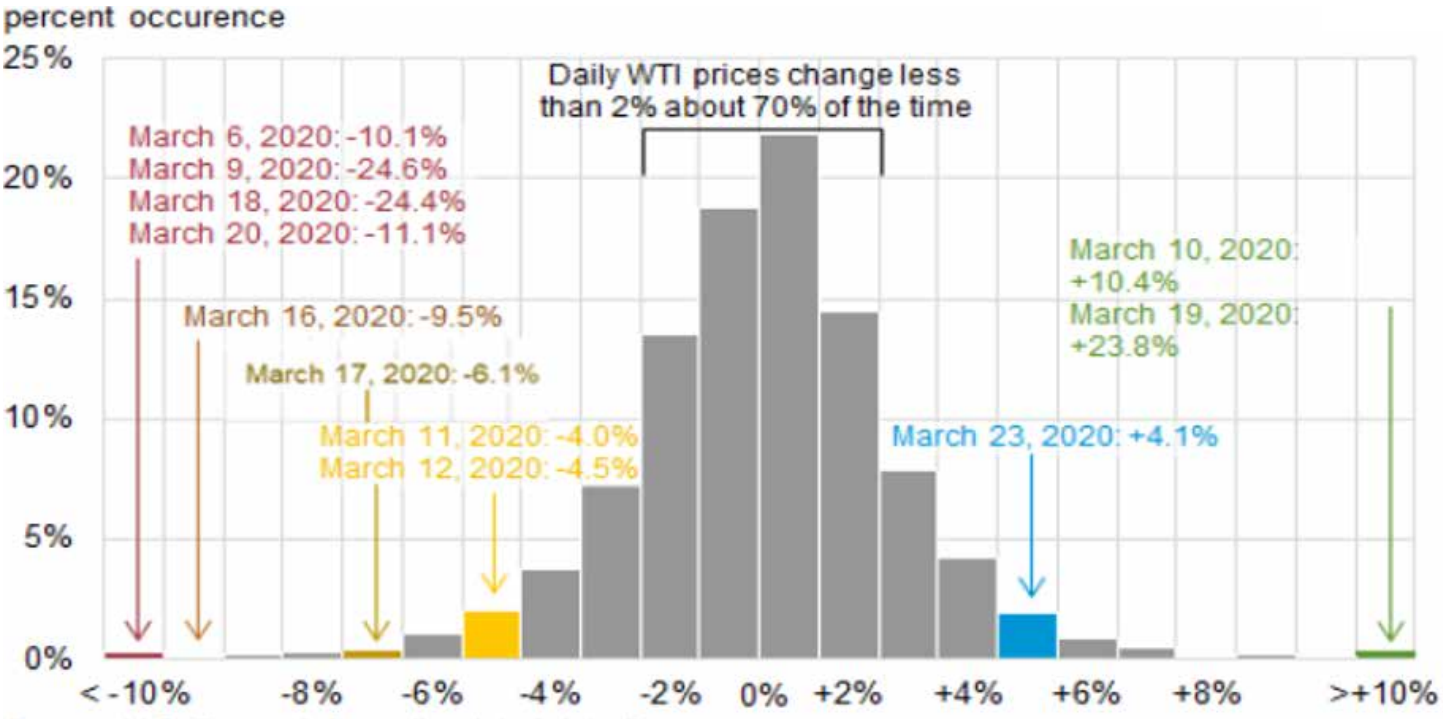
On the first day of the meeting, the original OPEC members, led by Saudi Arabia, agreed to cut 1.5 million barrels a day (MMBD) (from a total of 25.5 MMBD excluding Iran and Venezuela) contingent upon Russia and the other OPEC+ members sharing in part of the reduction.[1] Russia, however, did not play along with the wish of the Saudis. Whether the Russians were upset about smaller OPEC members cheating on their quotas or they were making a more calculated gambit to capture increased market share, it was clear the OPEC+ alliance was fractured beyond repair. Alexander Novak, the Russian Energy Minister, announced that Russia would not agree to any cuts and, beginning April 1, they would be able to produce as much oil as they wished.

Crude settled down more than 10% on the news of the collapse of the OPEC+ meeting, but the news would take a decidedly more negative tone in the following days.

> "Though in their heart of hearts they were far from recognizing the enormity of what had come on them, they couldn't help feeling, for obvious reasons, that decidedly something had changed."
>
> *The Plague*

If the Russians stepped away from the Friday, March 6 OPEC+ meeting under the presumption that they could extricate themselves from the newly formed cartel without consequences, they grossly underestimated their Saudi counterparts. Crowned Prince Mohammed bin Salman of Saudi Arabia used the Russian move as a *casus belli* to launch an all-out price war. The Saudis announced they would raise their production immediately to 12.3mmbd[2] (from 9.7mmbd), even though they could only bring online about 12mmbd. They would dip into their deep reserves in order to flood the market with crude. Since then, the Saudis announced they would target production of 13mmbd by April 1. The Russians countered that they would increase their own

Frequency of West Texas Intermediate (WTI) futures daily price percentage changes (January 1999–March 2020)



Source: U.S. Energy Information Administration

production by at least 500 thousand barrels a day. **By the time the oil futures markets opened on Sunday, March 8, crude was down nearly 20%. It would close on March 9 down nearly 25%, one of the largest one day drops in history.**

The decline in oil prices due to the pending supply glut from the Saudi and Russian antagonism, increasingly negative news of COVID-19 spread, and concerns of a drastic global slowdown, all drove equities markets down across the globe. The MSCI ACWI finished down over 12% for the week of March 9, 2020.[3] The historic volatility in the equity markets hit levels only seen in 1987 and 1929 as investors seesawed on news trying to gauge the deterioration of economic growth. WTI finished the week at $31 a barrel.

The breakdown of negotiations between the Saudis and the Russians was seen as landmark in the history of oil markets. Oil prices saw historic volatility levels, both positive and negative which has continued in early April. OPEC had served as the lever that controlled the price of crude since its founding in 1960, however, by the early part of this decade, with the rise of shale from the United States, its grip on the global market clearly had loosened. The Saudis increasingly led a fractured coalition of nations with divergent interests, and even after implementing modestly successful production quotas in recent years, they continued to lose market share to the U.S. and Russia. The OPEC+ agreement gave hope that a "new OPEC" could reassert dominance over the global crude market for the last decades of the oil age. Even with a rapprochement between the Saudis and the Russians, it appears that the future of OPEC+ will likely not serve as the balancing mechanism of the oil markets.

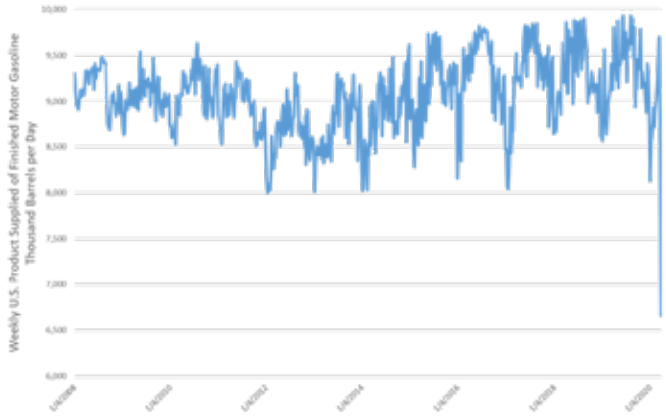
> "And then we realized that the separation was destined to continue, we had no choice but to come to terms with the days ahead."
>
> *The Plague*

On March 15, after the historically volatile week in financial markets, the Federal Reserve announced for the second time in as many weeks that they would be cutting the Fed Funds. In an unprecedented intra-meeting move, they lowered the rate 100 basis points (1.0%) to 0.00–0.25%; it had sat at 1.50–1.75% at the start of the month. Along with a new bond buying program and balance sheet expansion, the Fed and Central Banks throughout the world aggressively tried to stabilize the financial system.

In the short term, it had the opposite effect. Stocks and risk assets sold off as concerns of both collapsing demand and insufficient supply chains spooked investors. **Crude tumbled all the way to $20 a barrel in the United States; it had lost two-thirds of its market value in less than three months.**

Concerns about crude demand increased rapidly through the rest of March. As more cities, states, and countries announced "shelter in place" or similar restrictions, estimates for global demand plummeted. When OPEC and their counterparts met at the beginning of the month, concerns from the analyst community involved a cut of 1.5mmbd but would not cover an estimated oversupply of 3–4mmbd. By the end of the month, estimates for demand declines had fallen to 12–15mmbd with some analysis estimating that global demand had fallen over 20mmbd, a 20% decline. The U.S. gasoline market, the largest component of global demand—about 10% in 2019—contracted by over 2.2mmbd a day in late March with expectations for steep declines in the future.

Weekly Gasoline Demand



Source: U.S. Energy Information Administration

"One Corner of the U.S. Oil Market Has Already Seen Negative Prices," blared a Bloomberg headline on March 27. A sparsely traded crude, Wyoming Asphalt Sour, had its price turn negative.[4] While the circumstances underlying the fundamentals of that particular grade were extremely bearish—high transportation costs and low relative quality— the fact that the price of a barrel of oil turned negative was enough to catch eye of investors. Expectations increased that other crude differentials, the difference of price between the benchmark WTI or Brent and other grades, would continue to turn negative. Canadian Oil Sands from Alberta seem especially vulnerable to the downward pressure in the current environment. The impact of the global slowdown on oil prices found a new low.

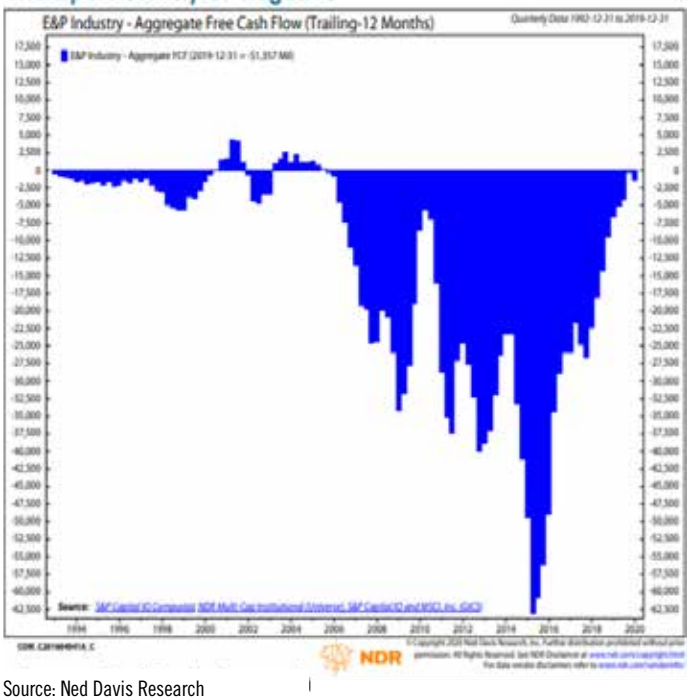
> "Big fish eat little fish."
>
> *The Plague*

Typically, during times of stress in an industry due to an economic slowdown, one anticipates the higher quality, more well-capitalized companies to take advantage of the situation and acquire parts or the whole of weaker, more distressed firms. The recent downturn due to COVID-19, however, might not follow the typical pattern for the energy industry.

Since the 2014 oil price decline, the energy industry has gone through round after round of consolidation and by 2019, the appetite for leverage and prioritizing growth had disappeared as investors clamored for operating efficiencies and return of capital to shareholders. Numerous starts and stops to commodity prices, a smaller and smaller percentage of the overall equity markets, the broken promises of the industry becoming free cash flow positive, and misaligned and outsized executive compensation have made investors leery of jumping into energy stocks. Companies that focused on growing production and acquiring new acreage underperformed those that prioritized share buyback and dividend growth.

The prolonged downturn of energy stocks means that the industry players have no appetite for taking on more leverage for acquisitions. Private equity players flooded the market for energy companies over the last five to seven years and now are looking for exit strategies. If commodity prices remain subdued for an extended time, many companies will be forced to look at restructuring options. If that occurs, the major integrated energy companies will be able to acquire assets at fire sale levels to the detriment of many independent upstream companies that helped U.S. production hit record levels.

Shale persistently CF negative



Source: Ned Davis Research

> "Officialdom can never cope with something really catastrophic."
>
> *The Plague*

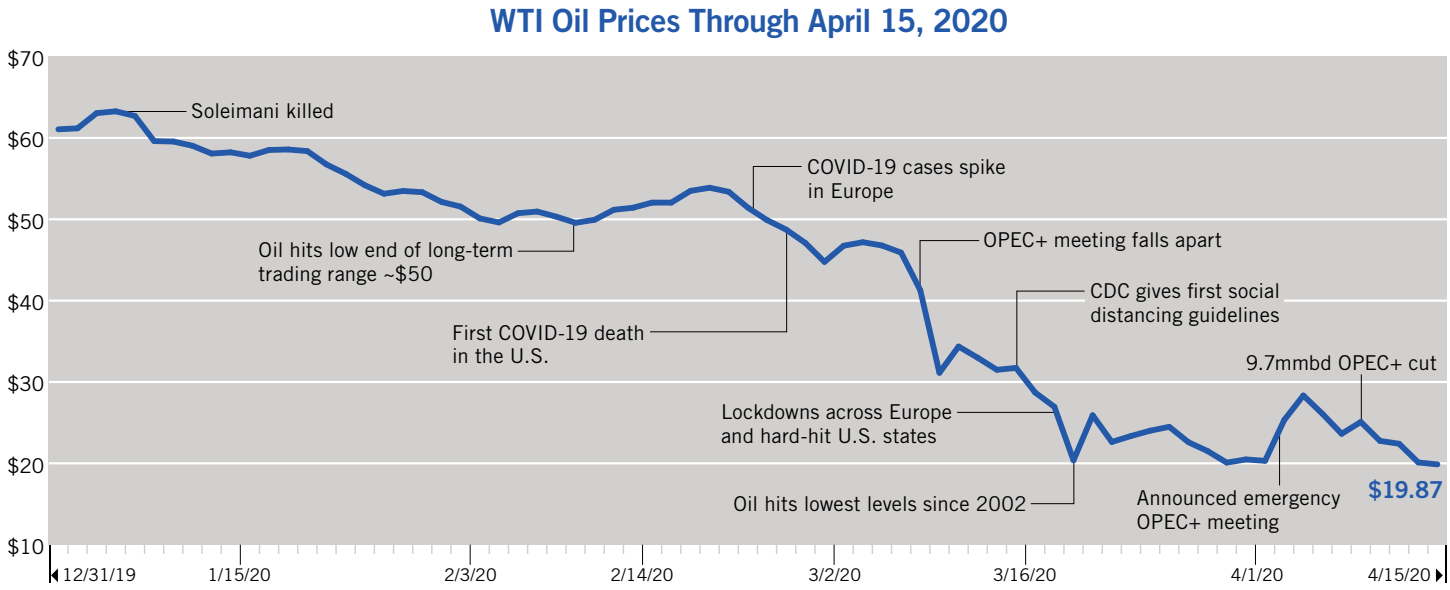
Clearly, the Coronavirus has put stress on governments and leaders globally. The Saudis and Russians remain under acute pressure to end their price war that escalated in early March. A few underlying fundamentals will exert influence on all parties that may help resolve the dispute.

First, not only are U.S. shale companies uneconomic with crude prices in the $20's, the Russians and the Saudis need higher prices to sustain their fiscal balances. While it is difficult to estimate a precise "fiscal breakeven" level, most estimates indicate that Russia requires oil prices in the mid $40s to $50 in order to maintain their fiscal budget. Saudi Arabia is a bit trickier. The Saudis have the lowest cost per barrel of getting crude out of the ground, however, estimates for breaking even on their fiscal programs are higher than the Russians due to their extensive social program's reliance on crude revenue. They may need oil high as $80 a barrel to balance their budget. Additionally, in recent years, the Russians have gathered considerable foreign reserves in order to withstand a drop in commodity prices. On the other hand, the Saudis' foreign reserves have fallen.[5] **The precarious fiscal position that lower oil prices place on all parties involved increases the urgency for a resolution.**

Foreign Exchange Reserves

Source: tradingeconomics.com

Perhaps the largest underlying question is where will all the excess oil go? Storage has increasingly moved to the forefront of market participants' minds as supply has continued to increase and demand craters. Across the world, inventories are reaching capacity while refining throughput has continued to dip. Oil supertankers are waiting at sea for an outlet to deliver their cargo. Most analysts believe that at this pace, storage capacity will hit its maximum capacity sometime in April or May putting extreme downward pressure on prices without a resolution to the supply and demand dynamics.



Source: FactSet

> "Destruction is an easier, speedier process than reconstruction... But if you refuse to be beaten, you have some pleasant surprises."
>
> *The Plague*

The first quarter of 2020 will be remembered for the intensity of the sell-off risk assets. Bear markets have historically had larger drawdowns, but the speed of selling from the high for the stock market of mid-February compares only to the Great Depression and 1987.

Even with a speedy resolution to the Coronavirus outbreak, the energy markets will remain challenged. Tensions between OPEC and their allies will continue to flare, and the supply side is likely to outpace demand for the next few quarters at a minimum. Domestically, the energy industry will face a long journey to outperformance. As noted earlier, energy stocks have considerably underperformed the broader market, but they have also lagged at times when commodity prices rise. The rightsizing of the energy sector will not happen as speedily as its destruction, but opportunity for top operators remain attractive.

All parts of the oil sector have and will continue to be under pressure: upstream cannot drive profitable returns at low prices. The service side had their revenue expectations drop as the upstream companies have cut CapEx by 30–50% in many cases. Refining margins have turned negative even after a considerable drop in throughput. The declines in energy equities will take far longer to recover than the time it took for them to decline.

Yet, the industry will come out on the other side of this crisis. Companies that withstand this storm will be positioned to take advantage of less competitive domestic industry. Opportunities to pick up assets and position themselves to take advantage of the next leg up in energy prices will compel many companies to do reallocate resources to best survive. Valuation levels for the strongest companies are attractive for long-term investors, especially with a return of commodity prices.

> "There can be no peace without hope."
>
> *The Plague*

While the next few months look difficult for not only the energy industry but the economy in general, news can dramatically shift the equilibrium in the oil markets. **The first week of April saw oil prices in the U.S. rise 50% on news that the U.S. would potentially serve as broker between the Saudis and the Russians to create a massive production cut.** Expectations for a deal include a voluntary quota from U.S. producers, and the potential for Norway and Canada to curb production. Obviously, creating a coalition of so many actors with divergent interests will be a difficult task fraught with setbacks. The world recognizes that the markets will be oversupplied as long as the economic stagnates, but cutting output is now a critical solution to balancing equilibrium.[6]

During an emergency meeting of OPEC+ members on April 9, 2020, the Saudis and Russians appeared to reach a (at least temporary) détente. The two massive producers, along with other OPEC+ members, agreed to, in principal, a 10mmbd reduction of crude through June and an 8mmbd reduction for the duration of 2020. Minutes after the news broke of the agreement, the deal hit a snag. Mexico, one of the OPEC+ members, declared they would not reduce their output by the determined 0.4mmbd amount and their energy minister left after lengthy negotiations. The Saudis refused to accept an agreement without all the members, and the deal looked in peril.

With an emergency meeting of G20 ministers scheduled for the following day, geopolitical diplomacy hit a fevered pitch. Leaders across the world conferred to ensure the deal would not fall apart and send oil prices spiraling. Eventually, with U.S. intervention reportedly to assume a portion of Mexico's quota, a confirmed deal appeared secure. Along with an expected reduction from non-OPEC+ members like the U.S., Canada, Brazil, and Norway, members of OPEC+ finally could start to reduce global supply and hopefully stabilize crude prices.

In addition to the short-term news that may boost oil prices, many market observers believe the shut-ins on projects today and over the last few months will lead to an undersupply in the future. Obviously, many moving pieces can impact the global supply-demand balance, but by late 2021 or 2022, given a recovery in demand, markets may start to move to an undersupplied position.

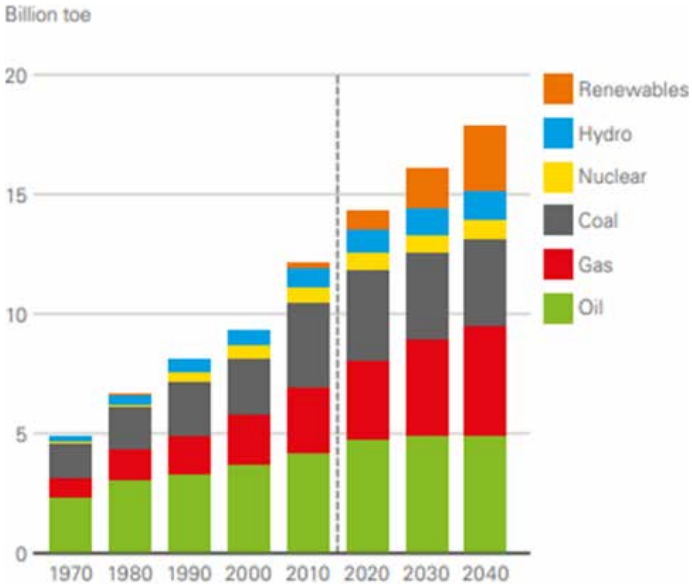
Demand may remain repressed for an extended period given the uncertainty around the impact of COVID-19, but ultimately the energy business remains cyclical and demand will recover. Full cycle price ranges for crude may be lower than in other economic cycles, but it remains unlikely that prices will remain at these depressed levels throughout the next few years.

> "Was it supposed, he asked, that the plague wouldn't have changed anything, and the life of the town would go on as before, exactly as if nothing happened?"
>
> *The Plague*

Like after any crisis, when a level of normalcy has returned to the energy markets, lessons will remain. The last six years have fundamentally reshaped the oil and gas industry and the geopolitical order along with it. Will the surviving oil and gas companies recognize the need to return capital to shareholders or will they return to prioritizing growth to take advantage of the market turmoil?

One thing is becoming increasingly clear: **the oil age is in twilight years.** Starting in the U.S. in 1859 in Titusville, Pennsylvania, when Colonel Drake drilled the first successful oil well, and then having gone on to witness a boom with the drilling of Spindletop in Beaumont at the turn of the last century, oil transformed the world and became debatably the most important commodity in human history. Yet, it likely will be seeing its peak demand in the coming decades. Both Shell and BP expect crude to hit its demand zenith in the 2030s as other fuels will replace oil. How energy companies react to this crisis and position themselves for next few years will determine whether they will gracefully ride into the sunset or be relegated quickly to the dustbin of history.

Primary Energy Consumption by Fuel



Source: BP Energy Outlook 2019

> "To state quite simply what we learn in time of pestilence: that there are more things to admire in men than to despise."
>
> *The Plague*

No doubt the world has been through an unprecedented few months with likely more ahead of us. That said, I am amazed how our communities, country, and the world have come together to battle the virus. My sincere thanks to all the healthcare workers risking health and safety, spending time away from their families and loved ones in order to keep our communities safe from the novel virus. Also, to all the people ensuring the economy keeps going from the delivery men and women, to the grocery store workers, to the agricultural workers, and everyone working during these difficult times—thank you. We will get through this crisis and return stronger from the lessons learned. Stay safe and healthy.

About Our Author

Austin Zaunbrecher, CFA, CMT is a senior portfolio manager at Hancock Whitney, where he is the lead equity analyst for the energy and utility sectors for high net worth individuals, endowments and foundations. Additionally, he is the fund manager for Hancock Horizon Investments Dynamic Asset Allocation Fund and Burkenroad Small Cap Fund. Austin has been in the banking industry for 12 years, with 7 years as a member of the Hancock Whitney team. Prior to joining Hancock Whitney, he spent 5 years working at Equitas Capital Advisors and Merrill Lynch.

Sources:

[1] Reuters
[2] *The Wall Street Journal*
[3] FactSet
[4] Bloomberg
[5] oilprice.com, IMF
[6] FactSet