EL&C Baillieu Strategy Research
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EL&C Baillieu
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Australian Strategy Insight

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Investment Strategy

Implications of the oil price collapse

The Brent oil price has fallen ~50%, or ~US$30 per barrel (bbl), year-to-date (Figure 1), driven by three factors: i) the impact of COVID-19 on China, with the Government lockdown driving a sharp decline in China oil demand; ii) the global spread of COVID-19, with a substantial hit to global travel and oil demand; and iii) the collapse of the OPEC plus Russia oil cartel and their subsequent moves to increase production and take market share.

Below US$40/bbl, the oil price is at levels last seen in early 2016, when OPEC attacked the US shale oil boom, and in late-2008 during the global financial crisis (GFC). In our view, these prices are unsustainable; the OPEC budget breakeven is ~US$84/bbl and US producers typically need at least US$50/bbl.

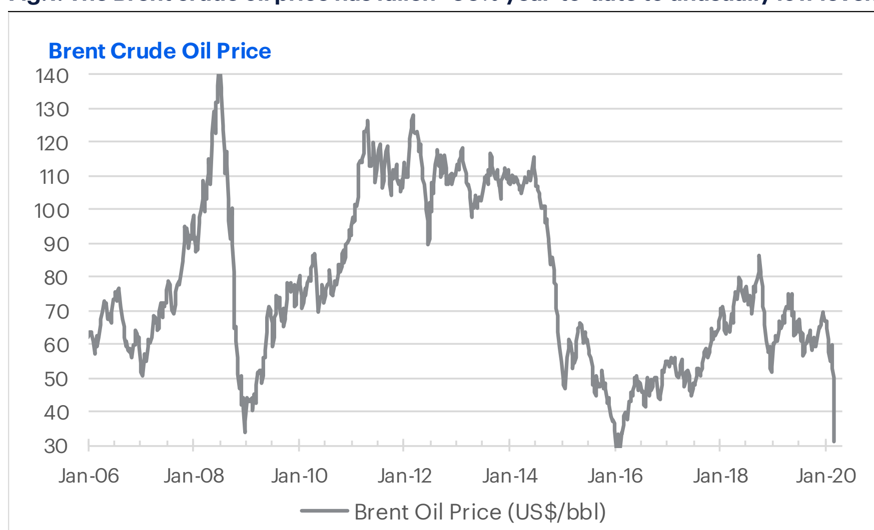
In the short-term, the Saudi-Russia price war and sharply higher inventories should keep prices low. A low-to-mid-US$30s/bbl oil price will add 0.8-1.1% to real GDP in the major economies, led by China. A hit to the US oil patch will moderate the benefit to the US. Australia will be a moderate beneficiary.

Transport stocks, typical winners from lower oil prices, face a bigger headwind from lost demand. Consumers benefit but need the capacity and confidence to spend. We remain wary of domestic consumer discretionary stocks.

Energy stocks have been beaten down by the oil price collapse. We prefer Woodside Petroleum (WPL) and Beach Energy (BPT), both resilient and offering upside as prices recover.

Market implications: The oil price collapse, adding ~1% to GDP, should help economies and markets recover from COVID-19. For transport stocks, the losses from lower demand outweigh the benefits of lower fuel costs. Households are winners but need confidence to spend – we remain wary of domestic consumer discretionary stocks. Energy stocks, down with the oil price, offer unusual value. As mentioned, we prefer Woodside Petroleum and Beach Energy, which appear resilient and offer upside as the price recovers.

Fig.1: The Brent crude oil price has fallen ~50% year-to-date to unusually low levels



Source: Datastream, EL&C Baillieu

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Implications of the oil price collapse

- The Brent oil price has fallen~50%, or ~US$30 per barrel (bbl), year-to-date (Figure 1), driven by three factors: i) the impact of COVID-19 on China, with the Government imposed lockdown leading to a sharp decline in China oil demand; ii) the global spread of COVID-19, with a substantial hit to global travel and oil demand; and iii) the collapse of the OPEC plus Russia oil cartel and their subsequent moves to increase production and take market share. Below US$40/bbl, the oil price is back around levels last seen in early 2016, when OPEC drove the oil price lower to attack surging US shale oil production, and in late-2008 in the midst of the GFC. In this note, we analyse the implications of lower oil prices for producers, consumers and markets.

The economic implications of the sharp drop in oil prices

- In 4Q19, the Brent oil price averaged US$63.3/bbl, slightly below the full-year 2019 average of US$64.3/bbl, which itself was down 9% from the US$71.0/bbl in 2018 (Figure 1). The 2020 oil price collapse to-date lowers the Brent oil price by more than 40%, or about ~US$30/bbl, into the low-to-mid-US$30s/bbl.
- A falling oil price is a net stimulus to global growth, acting like a tax cut for consumers who generally spend the windfall. On our estimates, a ~US$30/bbl decline in the oil price increases real incomes in the US and China by ~1.1% of GDP, and by about 0.8% in Japan, Australia and Europe (Figure 2). The greater sensitivity to changes in the oil price in the US and China reflects their lower fuel taxes.
- Of course, whilst a windfall for oil consumers, a sharply lower oil price is a major hit to oil producers. On the one hand, producers like OPEC generally have government spending funded by their oil revenues, which they are reluctant to cut back, leading to budget deficits. On the other hand, most non-OPEC energy companies quickly adjust by reducing exploration and development spending.
- The US shale oil sector appears particularly vulnerable. Since 2011, the shale oil boom has increased US oil production from less than 8 million barrels per day (mbpd) to about 17 mbpd in 2019, contributing ~0.2% p.a. to US growth over this period. In the oil price shock of 2014-16 (when the Brent oil price fell 69% from about US$109/bbl in 1H14 to a quarterly trough of US$34/bbl in 1Q16), US production fell ~4%, or about 0.5mbpd, and the US oil rig count, a proxy for exploration, fell almost 80%, taking 0.6% off GDP (see Figures 4 and 5). By comparison, 2020's much smaller ~US$30/bbl decline in the oil price, and exploration at roughly half 2014 levels, should mean the economic impact of a US oil downturn is far more muted this time, potentially taking ~0.2% off growth.
- Overall, because of the impact on the US oil patch, the positive effect of lower oil prices on the US is likely to be smaller than in the past – somewhere between the gross and net numbers of Figures 2 and 3 – and more muted than elsewhere (Figure 2). Indeed, with oil production in Japan and Europe immaterial, and less than one-third of consumption in China, the benefit of lower oil prices should be larger in these markets, and largest in China (Figure 3).

Fig.2: Impact of US$10 and US$30/bbl changes in the oil price

Country	GDP (US$bn)	Oil Demand	US$10/bbl Change	US$30/bbl Change
US	20580	20.5	0.36%	1.09%
EU	18737	13.3	0.26%	0.78%
Japan	4972	3.9	0.28%	0.85%
China	13368	13.5	0.37%	1.11%
Australia	1420	1.1	0.28%	0.84%

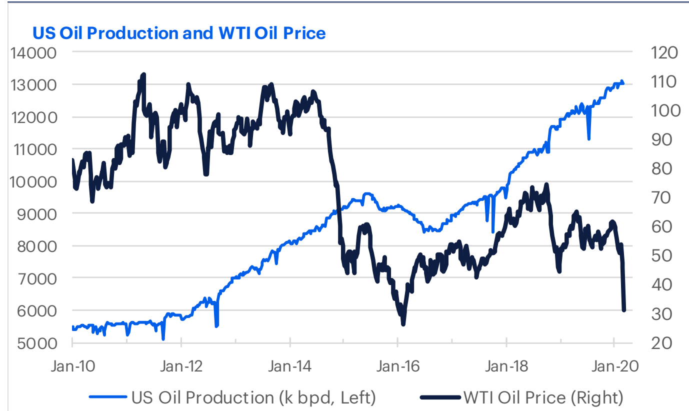
Source: BP Statistical Review, IMF, EL&C Baillieu

Fig.3: The net impact of US$10 and US$30/bbl changes in the oil price

Country	GDP (US$bn)	Net Oil Demand	US$10/bbl Change	US$30/bbl Change
US	20580	5.1	0.09%	0.27%
EU	18737	11.8	0.23%	0.69%
Japan	4972	3.9	0.28%	0.85%
China	13368	9.7	0.27%	0.80%
Australia	1420	0.7	0.19%	0.57%

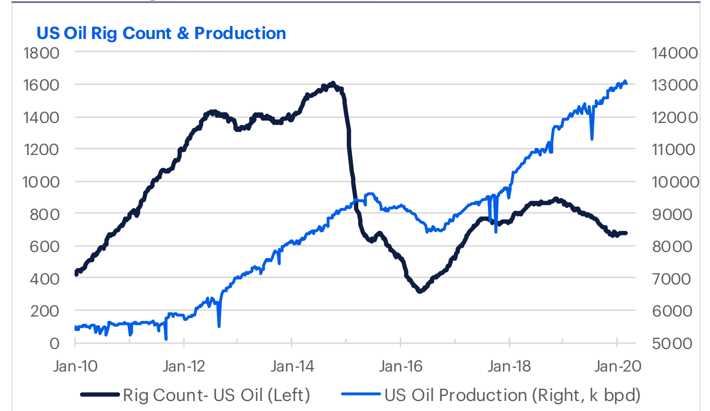
Source: BP Statistical Review, IMF, EL&C Baillieu

Fig.4: US oil production fell ~4% following the WTI oil price crash of 2014-16



Source: Datastream, EL&C Baillieu

Fig.5: US rig count fell 80% between 2014-16 – given a much lower starting point, we would expect a smaller decline in 2020

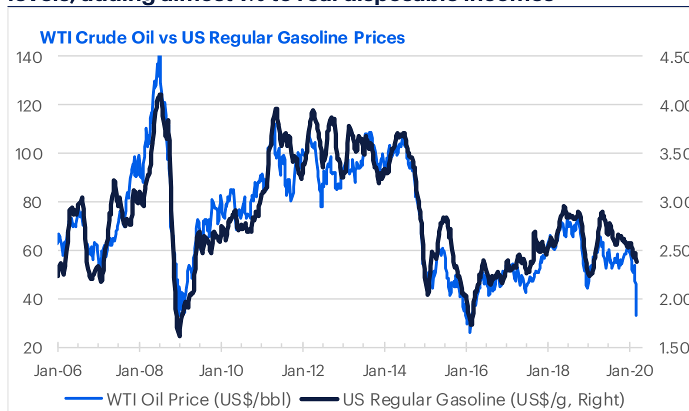


Source: Datastream, EIA, EL&C Baillieu

Winners from the sharp drop in oil prices

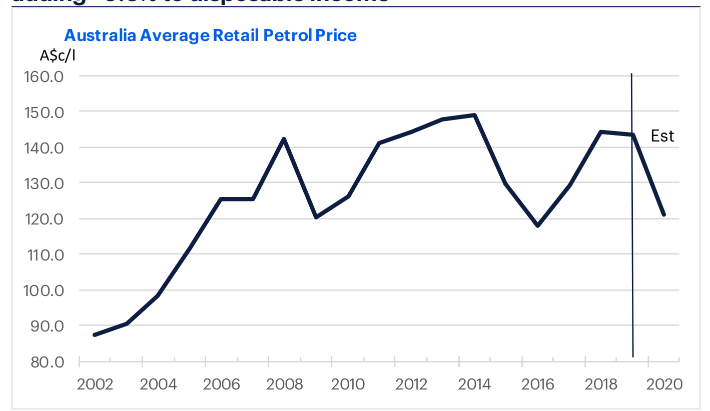
- Transport companies – airlines, truckers and railroads – are generally winners from lower oil prices. However, given the fall in travel demand associated with COVID-19 quarantines and lockdown restrictions, the lower oil price is of limited benefit to airlines. In the first nine days of March, Sydney airport saw a 25% decline in international passengers and 6% decline in domestic. We expect it will get far worse: Qantas has cut its international and domestic capacity by 90% and 60% until the end of May. So even with the lower oil price saving about A$900 million in fuel costs in FY21, our analyst has substantially downgraded forecasts for Qantas Airways (QAN). Likewise, the hit to global supply chains and demand are likely to overwhelm the fuel cost positive for truckers. On the other hand, assuming coal volumes see little impact from COVID-19, the impact of lower fuel costs for Aurizon Holdings (AZJ) is likely to be a net positive. The bulk miners are also likely to benefit from lower diesel and gas costs (~10-15% of operating costs) and a lower Australian dollar.
- The sharp decline in oil prices should be a significant stimulus for households. In the US, for example, gasoline prices, already down 9% from their 4Q19 levels, should decline 25-30% if the WTI price stabilises in the low-to-mid-30s. With gasoline a 3.4% share of consumption, this price decline should add ~0.9% to US real disposable incomes (Figure 6). Similarly, if the Brent price were to stabilise in the low-to-mid-30s, down about US$30/bbl from 2019 average levels, oil could add about 0.8% to both advanced and East Asia GDP growth.

Fig.6: US gasoline price is likely to decline 25-30% from 4Q19 levels, adding almost 1% to real disposable incomes



Source: Datastream, EL&C Baillieu

Fig.7: AUS petrol price likely to fall 15-20% from 2019 levels, adding ~0.6% to disposable income



Source: Datastream, EIA, EL&C Baillieu

Six reasons why the impact on Australian households could be dissipated

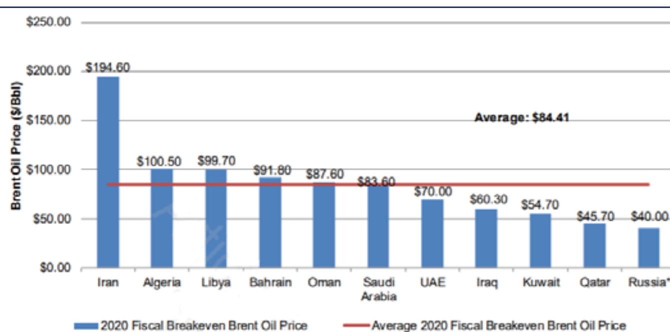
- A sharp decline in the oil price is a much-needed tailwind for Australian households. That said, with taxes on oil far higher in Australia than the US, combined with a ~10% weaker currency, the retail petrol price should decline a smaller ~16%. With petrol taking a 3.6% share of consumer spending, the impact of a US$30/bbl decline in the oil price is smaller than in the US at an estimated 0.6% of income (Figure 7). Moreover, weak consumer confidence entering the COVID-19 shock is, in our view, likely to mean that a good share of the benefit of lower prices is saved. This is because Australian households face six headwinds:
  - **Low wage growth:** Nominal wages are up just 2.2% YoY, or about 0.4% in real terms, and have been moving sideways at around these levels for five years.
  - **Record debt:** The household debt to income ratio is around record levels at 189%. Whilst housing credit growth has slowed to ~3% YoY, this is growing roughly in-line with income growth. Now with the RBA cash rate at effective zero, the decline in the household interest burden from lower rates is virtually exhausted.
  - **Rising debt burden:** The shift from interest-only to principal and interest, whilst close to complete, remains a headwind, lifting the debt burden by 0.2-0.3% p.a.
  - **Falling interest income:** After a decade of premium deposit rates post-GFC, the banks have pushed deposit rates sharply lower, hurting interest income. In addition, after the special dividends of 2018-2019 associated with asset sales, such as BHP's onshore oil assets and Rio Tinto's coal assets, dividend income is also under pressure.
  - **Tax bracket creep:** The average tax rate has risen by 0.3-0.4% p.a. since 2011, a reflection of no adjustment to tax brackets since the GFC and a declining benefit from negative gearing from record low mortgage rates. Whilst the low and middle income tax offset has slowed the creep in FY20 to 0-0.2%, it is likely to accelerate again in FY21 without further action.
  - **Low saving rate:** During the home price boom of 2012-17, the household saving rate fell from ~9% to ~3% of income. Even double-digit declines in home prices barely lifted the saving rate. So, whilst home prices have rebounded, fragile consumer confidence and the lack of a saving cushion makes households likely to pullback in response to a threat like COVID-19.
- Overall, we expect the positive of lower oil prices on Australian consumers to be somewhat dissipated by the headwinds facing households. As such, we expect discretionary consumer spending to remain under pressure, and would continue to avoid consumer cyclicals such as non-food retailers.

The case for a rebound in oil prices

- The case for a rebound in oi prices back into the US$50-80/bbl range rests on four factors:
  - **Oil producer cost curves:** Whilst the operating costs of most oil wells are quite low, all producers need to spend significantly on exploration and development just to maintain, let alone increase, production. As such, the cash-flow break-even of most producers is much higher than their operating costs, and in most instances now above the spot oil price. With companies starved of cash flow, capital spending budgets are now being cut, with large year-on-year declines recently announced by US producers such as Apache Energy (down more than 55% YoY), Devon Energy (down 35% YoY) and Murphy Oil (down more than 30% YoY). Over time this should reduce oil production.

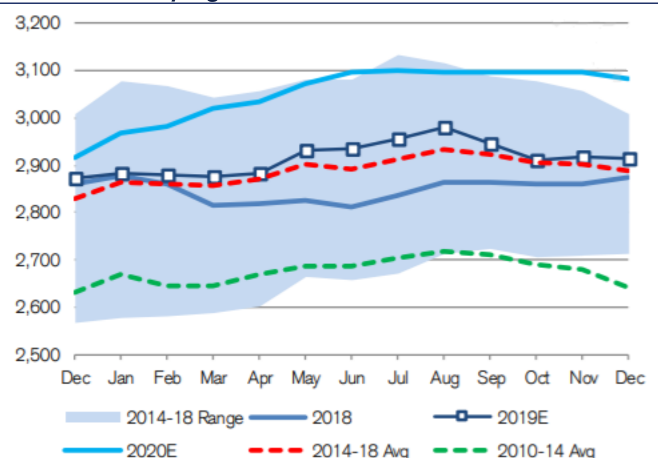
- **Limited OPEC spare capacity:** OPEC production is only 2-2.5 million barrels per day (mbpd) below the record highs of 2016-18, despite the implosion in Venezuela, civil war in Libya and US sanctions on Iran. Almost all OPEC spare capacity is in Saudi Arabia, and Saudi is the player lifting production following the collapse of the OPEC-Russia supply cartel. If Saudi increases production by 2-2.5 mbpd, but in so doing pushes the oil price lower by US$10-20/bbl, they gain ~US$70-80 million per day from added volumes but lose US$100-200 million per day on lower prices for existing production. With little room to cheat, all other OPEC producers simply lose from this price war. Whilst this should encourage OPEC members to toe the Saudi line, Russia appears better placed to resist this pressure for some time.
- **OPEC budgetary needs:** According to the International Monetary Fund, Saudi Arabia has a budget breakeven oil price of ~US$83.6/bbl (Figure 8). If correct, in the low 30s Saudi could be in deficit to the tune of ~US500 million per day, or more than 20% of GDP (in 2015-16 its deficits were 15-17% of GDP pa)! Such massive deficits could undermine its reform process. Furthermore, the IMF estimates that no one within OPEC has a budget breakeven below US$55/bbl (Qatar is withdrawing from OPEC). Russia is again in a stronger position, with its budget assuming US$40/bbl oil price.
- **Little growth in non-OPEC, non-US oil production:** Over the past five years non-OPEC or US production has contributed less than 10% of incremental global production. That said, the global rig count is supportive at 17% above-average levels, though 21% below 2014 peak level.

Fig.8: OPEC + Russia fiscal breakeven average US$84/bbl



Source: IMF, Russia, EL&C Baillieu

Fig.9: The Saudi-Russia price war should drive OECD oil inventories to very high levels



Source: Datastream, EIA, EL&C Baillieu

The case against a rebound in oil prices

- **Strongman politics**: The Saudi crown prince Mohammed bin Salman and Russian President Vladimir Putin are both strongman leaders, used to getting their way, and unlikely to back down and lose face. This suggests the current price war could continue for some time.
- **Inventories, while not far from the five-year average, are likely to spike higher:** With the price war driving a surge in oil supply, and COVID-19 a collapse in demand, oil inventories should rise rapidly (Figure 9). As we have seen since 2016, such a surge in inventories takes years to soak up. This should continue to pressure prices.

- **US oil industry flexibility:** In 2014, the oil price collapse was expected to crush the US shale oil industry. Instead, cost-cutting and innovation enabled US production to continue rising, even at much lower oil prices than in 2014 (Figure 4). Whilst estimates of US marginal cost – including a return on investment – lie around ~US$50/bbl WTI, implying losses and cutbacks at current prices, another round of innovation and efficiency gains could again lower cost curves.
- Overall, our analysts have reduced their Brent oil price forecasts to US$42/bbl and US$50/bbl in 2020 and 2021 (from US$63/bbl and US$65/bbl respectively) and the long-term price by ~10% to US$60/bbl.

Implications for the energy sector

- The energy sector has been hit hard by the oil price collapse. Lower oil prices have three main implications for stocks:
  - Lower earnings, as lower prices feed into lower profits.
  - **Pressure on growth projects if lower prices persist.** Projects that could be delayed would include Woodside's Scarborough and Browse LNG projects, Santos' Dorado, Oil Search's Alaska oil and PNG LNG projects, and Beach's Waitsia project. Any such delays would be negative for the mining services and contractor sectors.
  - **Asset sell-downs could be challenged** for many of the above projects, including Woodside's Scarborough, Santos' Dorado and Oil Search's Alaska.
  - **Pressure on balance sheets**, although our analysts do not see this as a major issue, with Oil Search most challenged.
- Overall, in a context of a very low short-term oil price, followed by a recovery, we see the best opportunities in Woodside Petroleum and Beach Energy:
  - WPL: attractions include its balance sheet strength, low cash-flow break-even for its base business, pipeline of growth projects and, in the current environment, acquisition opportunities.
  - BPT: positives include Beach's strong balance sheet (net cash), relatively high exposure to domestic fixed price gas contracts, and acquisition opportunities presented by low energy sector stock prices.

Investment Implications:

- The Saudi-Russia oil price war adds another driver to the economic counterattack to COVID-19. An effective counter-attack probably entails four factors: i) successful quarantine and lockdowns to contain the spread of the virus and allow resumption of normal activities; ii) monetary stimulus and support, easing pressure on borrowers and ensuring system liquidity; iii) fiscal stimulus to minimise second-round effects on exposed businesses and households and add impetus to the recovery; and iv) much lower oil prices. So if the economic hit from COVID-19 can be contained to 1-2 months and, say, 4% of GDP, then pent-up demand following 1-2 months isolation, monetary stimulus of ~1% of GDP, fiscal stimulus of 1-2% of GDP and lower oil prices of 1% of GDP should drive a strong recovery.
- Oil prices down for at least 3-6 months undermines energy sector profitability and cash flow. If it lasts much longer, we could see project delays and deferral of asset sell-downs. Our preferred energy stocks would be Woodside Petroleum and Beach Energy, reflecting their balance sheet strength and exposure to a recovery in the oil price.

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