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Macro View

Issue No. 34 | OCTOBER 2, 2023

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By Hubert Marleau

The Global Energy Complex is Complex

A few weeks ago, I argued that the real enemy of the market was the geopolitical crude oil wrecking ball and not the potential government shutdown. History suggests that markets usually shrug shutdowns off, as they come and go and, in turn, are always classified as non-events by investors. It was not any different this time around. In a stunning and surprising turnabout, Congress approved a last minute plan to keep the government running through mid-November to alleviate this deeply unpopular insanity. Although the centrists and the moderates were marginalized by the belligerent extremes of their parties, the predicament was not the real deal. Yes, the market could have missed important data prints as a consequence, but the most important and preferred inflation gauge, upon which the Fed relies on the most to make policy decisions, was released on Friday on time. The PCE price index, excluding food and energy, increased 0.1%, below consensus, registering a y/y increase of 3.9% with a 3-month annual rate of 2.2%, not far from the Fed's 2.0% inflation target. The swap market is now pricing in a 67% chance of no further rate hikes this year while the New Fed staff Nowcast for real GDP stands at 2.1% for Q3 and 2.0% for Q4.

The Fed has already conceded that core goods and rent disinflation is well underway. This means that rate hiking is over, setting the stage for rate cuts next year. But the real deal is that financial markets hate furious increases in the price of oil because of their immediate impact on inflation. The summertime oil rally has sent prices close to $100 a barrel, where several analysts have their forecast. Brent crude, the global benchmark, rose above $95 a barrel, registering a huge gain of 30% since June. Unfortunately, the price for oil is a cost component embedded in prices for every product that needs to be shipped to markets, For example, the Baltic Freight Index is up from a July low of 950 to 1750 today, registering an 84% increase. This inflation scare has reinvigorated investors' fear of inflation, soured consumer sentiment, and raised concerns for the Fed. The move came to the bond market as an exogenous shock as the energy-to-world GDP rose 1.4 percentage points to 6.9% in just 3 months, pushing nominal yields on 5-year Treasury notes to 4.68% from a July low of 4.00%, the real rate to 2.37% from 1.75%, and changing the expectation of inflation from 1.4% to 1.9% in one year's time. This jolt caused the S&P 500 to fall 6.4% from a July high of 4592 to 4300.

The oil surge was caused by Saudi Arabia and Russia's decision to extend production cuts to the end of the year, removing more than a million barrels a day from the market, while global demand, particularly in China remains robust and conditions in the spot market are extremely tight. This was a risky gamble, financially and politically,

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that is paying off handsomely. Analysis by Energy Aspects shows that oil revenues in Saudi Arabia this quarter are up by $30 million a day compared with the April-May period, equating to $2.6 billion for them and about $2.8 billion for Russia. This bold strategy, which was launched last October when Opec slashed production by 2 million barrels a day, followed by a smaller 1 million cut in May, worked because Opec+ was in the driver's seat. Energy bills as a % of world GDP were relatively low, oil prices were near their marginal cost of production, and worries about a global recession - plus talk of sluggish Chinese growth - were widespread. Above all, the Opec members were ready and willing to bet that Western producers were excessively frugal and, in turn, would not respond aggressively to higher energy prices. They were right. Non-OPEC producers, like U.S. shale, pursued fiscal discipline, increasing production in a slow and steady manner to keep prices firm, boosting OPEC's leverage, and taking advantage of the situation to rake in billions of dollars. Production costs are low in Saudi Arabia and Russia, averaging $9.30 and $12.80 a barrel respectively. At $95.00 a barrel, most of the revenue from oil exports is pure profit, allowing Russia to pay for the war in Ukraine and Saudi Arabia to finance its ritzy infrastructure projects.

The Sweet Spot for Oil is $75 to $90 a Barrel:

According to Andrew Lees of Macro Strategy Partnership, when energy as a % of World GDP is around 7.0%, as it is now, economies are said to be in balance: below that level there is growth potential, but if above it it's unsustainable. It's the range at which producers make acceptable returns and where demand is right on the edge of being crimped. The futures curve reflects that estimate. Brent Crude September Contract is $84 versus a $94 spot price, an unusually large, eye-popping discount. History shows that when energy bills claim too high a share of world GDP, OPEC softens up.

Prince Abdulaziz, Saudi Arabia's energy minister, may be correct in saying that the decision made was not about jacking up the price of oil but about balancing things out. In this connection, Russia and Saudi Arabia must be careful about how high they push prices to avoid denting demand and making investments in alternative sources of energy such as solar and wind more attractive. Plus there is the risk of a pullback in fuel consumption in developing countries because oil prices and the value of the dollar have been rising in tandem: a double whammy, which could elicit government responses, oil crossing the $100 mark being psychologically significant.

At some point OPEC is bound to face geopolitical pressure to release more supply in 2024. India, China, and the U.S., the 3 largest consumers of oil in the world, will likely become more bellicose and assertive as their consumers become increasingly uneasy about gasoline prices. Indeed, commercial interests do not seem to believe that oil's sizable rally is sustainable. U.S. shale companies aren't rushing to drill more to flood the market with more crude. They are gun-shy, not because they are facing pressure of higher operating costs and interest rates, but because

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they are thinking long-term about business and afraid about the fickleness of OPEC, who can change their mind on a dime, like putting 2 million barrels a day more into the market a single month.

Interestingly, the Bloomberg Industrial Metals Index, which is composed of futures contracts on copper, aluminum, zinc, nickel and lead, has been gyrating in a narrow trading range since May and is clearly not conforming with the upward performance of oil. Moreover, there has been a tremendous divergence between the price of oil and the performance of petrocurrencies. Canada and Norway's petroleum accounts for 20% and 40% respectively of total domestic exports, and not much has happened to their currencies. This tells me that the momentum should fade over the coming months, and explains why 1) refiners have pulled oil out of storage rather than using current production to supply customers; 2) investors have not bid up small oil and gas producers, who are significantly cheaper than the majors; 3) diminished spare capacity across oil-producing countries could force them to raised output; and 4) there are reports that China might be done with filling its oil reserves. Moreover, unlike what happened in the 1970s, the current spike was not triggered by Middle East wars. On the contrary, the U.S. is discussing terms of a mutual defense treaty with Saudi Arabia that resembles military pacts with Japan and South Korea, which would normalize the Kingdom's relations with Israel.

There you have it. The long-end of the futures market for oil might not be a thoroughly reliable anticipatory indicator, but it's still the best way to predict what is forthcoming because it reveals what the commercial interests are up to. Refiners and producers play the long end of the curve, leaving the short end with the financial traders In this connection, they are counting on a small drop-off in oil prices. That would indeed be good news for stock operators, given that October starts on Monday. The S&P 500 made gains in October 7 times in the 10 years, suggesting that if September is a poor month, the next one is better.

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