Economic Analysis

COVID-19 and oil markets

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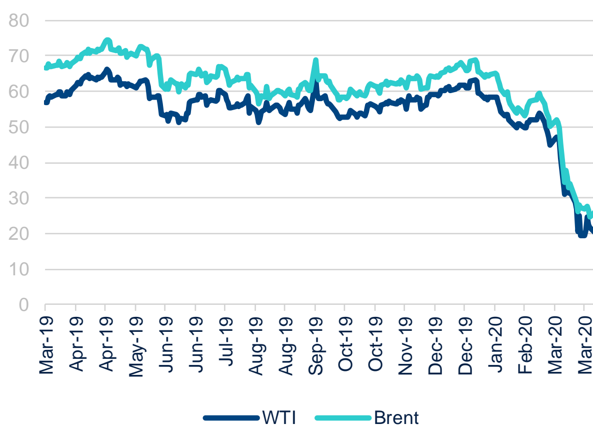
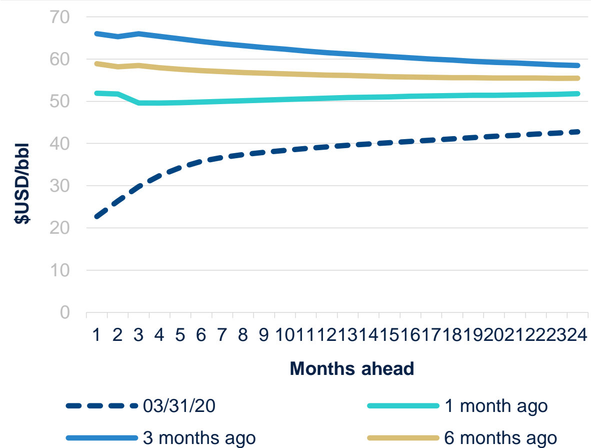
These are unprecedented times for energy markets. Crude oil demand has crumbled as economic activity has been suspended around the world, and nearly 3 billion people stay at home to flatten the curve of contagion. Meanwhile, the ongoing price war between Saudi Arabia and Russia promises to add millions of unnecessary barrels of oil into the market. As a result, prices have plummeted to levels not seen since the early 2000s, threatening the stability of energy companies and producing countries.

Figure 1. **Crude oil prices**
(USD per barrel)



Source: BBVA Research and Haver Analytics

Figure 2. **Brent crude oil price futures**
(USD per barrel)



Source: BBVA Research and Bloomberg

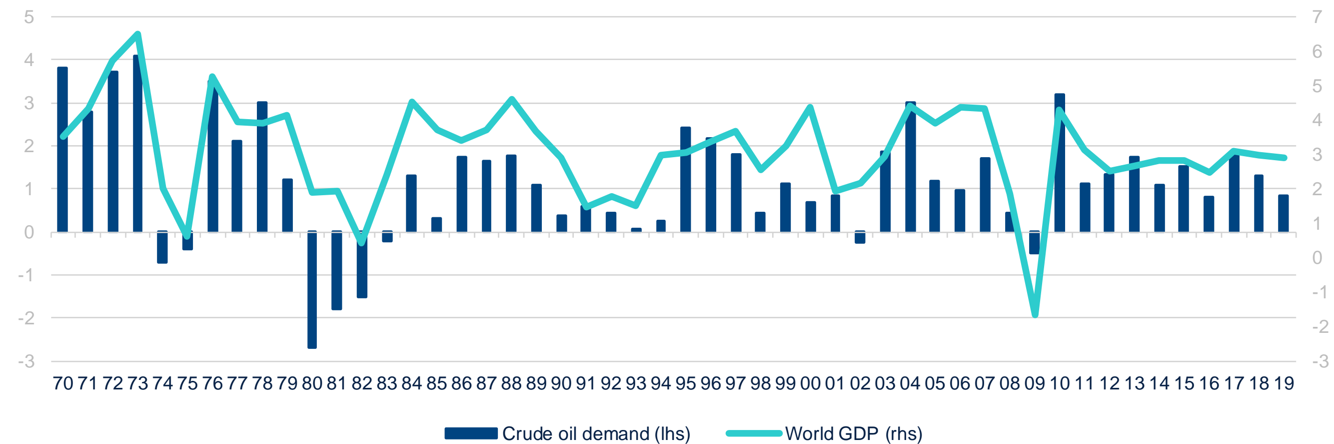
The market is severely dislocated

We expect crude oil demand to contract sharply as economic activity has been put to a halt in many countries. As millions of people are expected to lose their jobs or experience other forms of financial distress (furloughs, salary reductions, etc.), the demand for goods and services will be negatively impacted, which in turn will affect the demand for crude oil. The impact will be exacerbated by disruptions in supply chains, lower industrial production, and a contraction in foreign trade.

Overall, crude oil demand could decline between 15 and 25 million barrels per day (b/d) between the end of March and April. Losses could extend beyond this period if more prolonged lockdowns are needed to curb the spread of the disease. However, once the worst of the pandemic is left behind, the economy should recover, and so will the demand

for crude oil. Nevertheless, given that it will take time for the economy to regain momentum, crude oil demand will most likely decline in 2020 between 1 and 2 million b/d, before increasing in 2021, a decline not seen since the 1980s.

Figure 3. **Crude oil demand change and World GDP growth 1970-2019** (million b/d and %)



Source: BBVA Research and Bloomberg

After Russia and Saudi Arabia broke the alliance that had stabilized the market since 2016, supply has expanded further. This trend is likely to continue; in the following months, between 1.5 and 2 million more barrels per day could flow into the market, enough to keep prices subdued.

It is not clear how long this price war will last. Back in 2014, when the market experienced a supply glut, it took OPEC about two years to partner with Russia and other countries to cut production. In the current context, it could take less than two years for Riyadh and Moscow to strike a deal. This is because, contrary to 2014, a significant portion of demand has been wiped out by the coronavirus, and both countries will be struck by the ongoing economic downturn, which would put considerable stress on their finances. Both countries need prices to be higher than current levels to balance their fiscal budgets. Besides, political pressure from the U.S. will be intense as the country's oil and gas industry could be one of the main losers of this situation.

Not surprisingly, futures are now in "super-contango," a situation that encourages storing crude with the expectation of higher prices in the future. The resulting increase in inventories is putting significant stress on storage capacity, to the point that traders are actively turning to oil tankers as an alternative to land storage facilitates, which are rapidly saturating. Benchmark tanker rates have gone from $40K at the beginning of March to $120K per day by the end of the month.

Figure 4. **Brent six-month time spread** (USD/barrel)

Source: BBVA Research and Bloomberg

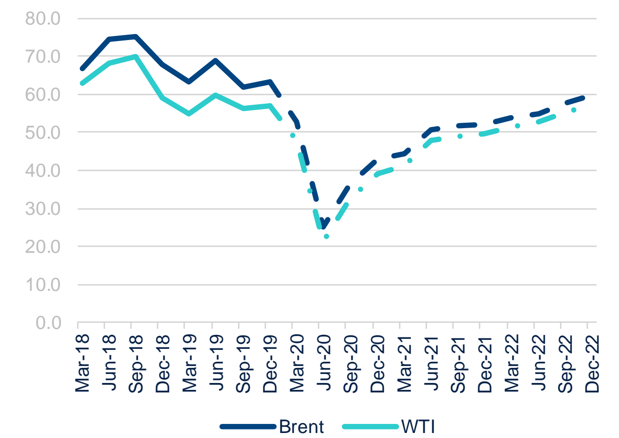
In this context, oil prices could remain very low through the rest of 1H20, hovering around $20 per barrel or less. However, as the pandemic recedes and the economy recovers, prices are likely to increase in 2H20 but not by much. Even under the assumption that the worst of COVID-19 is felt in 2Q20, and massive fiscal and monetary stimuli boost the global economy, if supply is not restricted, prices will most likely remain subdued.

Table 1. **Crude oil price forecasts** (average, USD per barrel)

	Brent	WTI
2018	71.1	64.9
2019	64.4	57.0
2020	**39.3**	**35.2**
2021	**49.8**	**47.0**
2022	**56.5**	**54.2**

Source: BBVA Research

Figure 5. **Crude oil price forecasts** (quarterly average, USD per barrel)



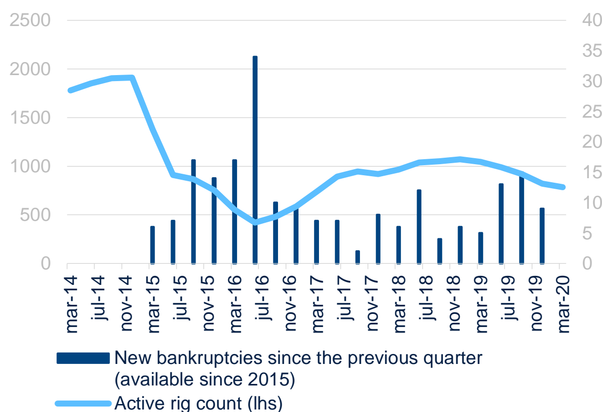
Source: BBVA Research

Implications for the U.S.

For the U.S. oil and gas industry, the situation is worse than the 2014-2016 crisis that led to consolidation and more than a hundred bankruptcies. Back then, the industry weathered a supply glut by consolidating and increasing efficiency amid robust financial conditions and risk appetite. For example, in the Permian region, new well oil production increased from 204 barrels per day in 2014 to 649 in 2016. Although several companies exited the market and nearly a hundred thousand jobs were lost, production eventually resumed an upward trend.

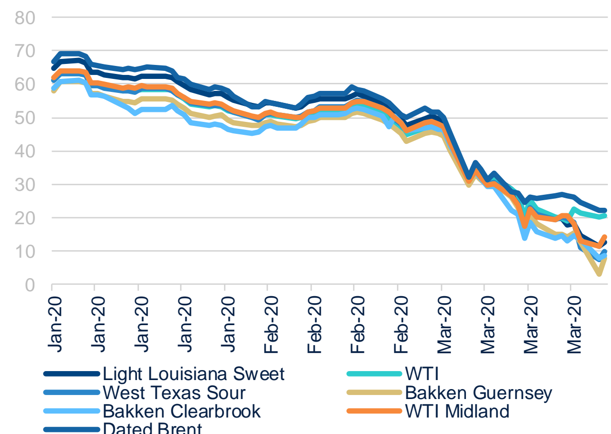
However, in today's environment, efficiency measures may not be enough to prevent a decline in production. This is because the industry is facing tremendous pressure from both demand and supply, amid tight financial conditions. WTI prices below $40/b would make many U.S. shale wells uneconomic to drill. Production, which reached a record high of 13 million b/d on February 14, may not immediately decline since it has been hedged at higher prices. In fact, production was 12.9 million b/d by late March. But drastic reductions to capital expenditures will result in less output going forward. In this environment, imports could increase, and the country could push back on energy independence.

Figure 6. **North America E&P bankruptcy filings**



Source: BBVA Research with bankruptcies data from Haynes and Boone

Figure 7. **U.S Benchmark regional prices**



Source: BBVA Research and Bloomberg

Moreover, if prices remain too low for too long and financial pressures continue, the financial position of highly leveraged companies will worsen. Energy companies comprised about 11% of the high-yield market in the U.S. Low energy prices imperil the ability of companies to generate cash flow, which could also result in a massive wave of downgrades of energy companies with investment grade.

Long-term implications for the industry

In a business-as-usual scenario, once the pandemic is over, businesses and individuals should resume their activities helped by government intervention. Around the world, consumer subsidies and the rescue of strategic industries, together with the relaxation of environmental rules would boost the demand for crude oil and clear the portion of excess supply generated by the coronavirus outbreak. From the supply side, the price war would become

unsustainable in a relatively short period, and top-producers (potentially involving the Texas Railroad Commission) would have no option but to negotiate an output deal. The U.S. shale industry struggles at first but, thanks to government support along with its business and technical savvy companies, it becomes resilient to lower prices.

However, a less optimistic scenario is also possible. Fiscal packages could be used to advance a “climate change” agenda, excluding the oil and gas industry from the list of enterprises able to be rescued. It could also force bailed out companies (e.g., airlines) to invest in sustainability projects. On the supply side, the role of OPEC as a market stabilizer could be undermined, making the market depend on more volatile and temporary ad hoc deals. This, together with the looming prospects of peak demand and the increasing number of investors trying to decarbonize their portfolios, could result in permanent damages to the industry as it would make several projects economically unattractive. For the U.S., this means that some of the production lost during the crisis may never come back.

The most likely outcome will likely fall between these two alternatives. However, one thing is sure; the market won’t be the same anymore.

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