Saudi Arabia and Russia: Who will blink first?

- With the global oil demand deteriorating by the day, only a resolution of the price war between Russia and Saudi Arabia can bring some price relief to the market.
- Since Brent prices below USD 40/bbl do not mean equilibrium for anyone, sooner or later, one of the two or both will have to back down, turn the tap off and push for some collective agreement – something that should happen well-before the June review meeting to have a significant impact on prices.
- If both countries cooperate, OPEC+ will deepen and extend its current output curbs. Otherwise, if Russia refuses to return to the negotiating table, the OPEC+ alliance will likely collapse, forcing OPEC to act alone.

The oil market remains in turmoil. With the coronavirus health crisis rapidly raising the likelihood of a global recession, Brent prices are hovering around the USD 30/bbl threshold – down 45% in just one month (currently Brent is trading at USD 27/bbl). Investors are now wondering whether the next leg will be all the way down towards USD 20/bbl or up towards USD 40/bbl. Since the global demand outlook is deteriorating by the day, only a significant reduction in supply will be able to bring some price relief to the market. Some output adjustment will be inevitable. The least competitive US shale producers will likely be the first to turn the tap off - with the most cash-strapped ones facing the risk of bankruptcy. Equally, some of the most vulnerable OPEC producers will give in if Brent prices remain at current levels or below.

However, any meaningful move towards USD 40/bbl will depend on how the price war between Saudi Arabia and Russia unfolds. The failed OPEC+ meeting on 6 March due to Russian unwillingness to agree on longer and deeper cuts pushed Saudi Arabia to offer aggressive discounts (up to USD 8/bbl) to its European, Asian and American customers and to promise to flood the market with more than 2mb/d when the output curbs expire at the end of March. At the moment, the conflict increasingly resembles the traditional hawk-and-dove game (Table 1). The one who gives in first loses. Saudi Arabia wants to punish Russia for its lack of commitment to the OPEC+ alliance, while Moscow wants to exert as much pressure on American producers in retaliation for Washington's boycotting of the North Stream 2 pipeline. But Brent prices below USD 40/bbl are far below the fiscal breakeven prices of both Russia and Saudi Arabia – and far below the operational breakeven prices of several producers. Sooner or later, one of the two or both will have to blink.

TABLE 1. HAWK-AND-DOVE GAME WITH LIKELY PRICE IMPACT (BRENT, USD/BBL)

		RUSSIA	
		Blink	**Confrontation**
SAUDI ARABIA	**Blink**	OPEC+ agreement (p>45)	OPEC+ collapses, OPEC acts (35<p<45)
	Confrontation	Price war (25<p < 30)	Escalating price war (p<25)

Source: UniCredit Research

Price war scenario

In traditional game theory fashion, Table 1 reports the different moves that each player, Russia and Saudi Arabia, has at its disposal, with the corresponding payoffs. They can either blink or maintain a confrontational stance. The time horizon of the price impact, which incorporates a fragile demand outlook due to a sharp slowdown in economic activity as outlined in the next section, is through the end of April – the period that will likely correspond to the most acute phase of demand weakness when a swift intervention by OPEC+ will be most needed. Right now, both parties seem resolute on provoking each other, with officials on both sides repeatedly stating that their countries are comfortable with prices at current levels. We show this in the bottom-right of the table, which corresponds to a full-fledged price war scenario.

Moscow and Riyadh can endure the pain of the confrontation for several months. Saudi Arabia can produce oil at roughly USD 3/bbl, though it requires USD 83/bbl to balance its budget. At current prices, Saudi Arabia's budget deficit in 2020 would jump to about 20% of GDP from 6.5% currently projected. Riyadh can rely on USD 510bn in reserve assets (65% of its GDP) to wage the price war. Russia, by contrast, pumps oil at a cost of USD 30/bbl, but its fiscal breakeven price is lower at around USD 45/bbl − having spent the last five years tightening its budget. Russian reserves amount to USD 570bn (25% of GDP) and Russia could push for a weaker currency to compensate for low oil prices. Last week, Russia's finance ministry said that it would draw on its USD 150bn national wealth fund in order to supplement the budget if oil prices remain low. All in all, Russia looks slightly better equipped for a price confrontation.

Should the price war continue, the burden of the adjustment would fall on the weakest producers worldwide. The first producers likely to throw in the towel are the Americans. There are too many of them and they are too small to orchestrate a coordinated response to the current market situation, but among producers, they are the ones who enjoy the highest degree of flexibility in turning the tap on or off thanks to rather contained fixed production costs. According to Rystad Energy, WTI breakeven prices for US shale producers generally lie in the range of USD 40-50/bbl, with a high degree of price volatility within the same basin and among wells belonging to the same operator.

The least competitive producers will be pushed out of the market while the most indebted ones risk bankruptcy. According to Energy Aspects, several US operators have already announced cuts to their 2020 budget and activity. Among traditional producers, with crude production in Libya, Venezuela and Iran already constrained, Nigeria and Iraq are likely next in line to adjust. Together these two countries account for about 20% of OPEC production and low oil prices might exacerbate existing domestic political tensions, with repercussions for the functioning of these countries' oil industries.

Such output corrections might help balance the physical market somewhat without necessarily relieving oil prices, as investors would still be worried about the absence of a true market balancer like OPEC or OPEC+. For this reason, and given the intensifying weakness of the global macroeconomic outlook, Brent prices would likely move close to USD 20/bbl. Equally, if Russia showed willingness to return to the negotiating table (blink) but Saudi Arabia refused (confrontation), Brent would likely remain below USD 30/bbl because Moscow lacks the convening and coordinating power enjoyed by Saudi Arabia thanks to its OPEC hegemony. This remains the most unlikely scenario of the four outlined in the table.

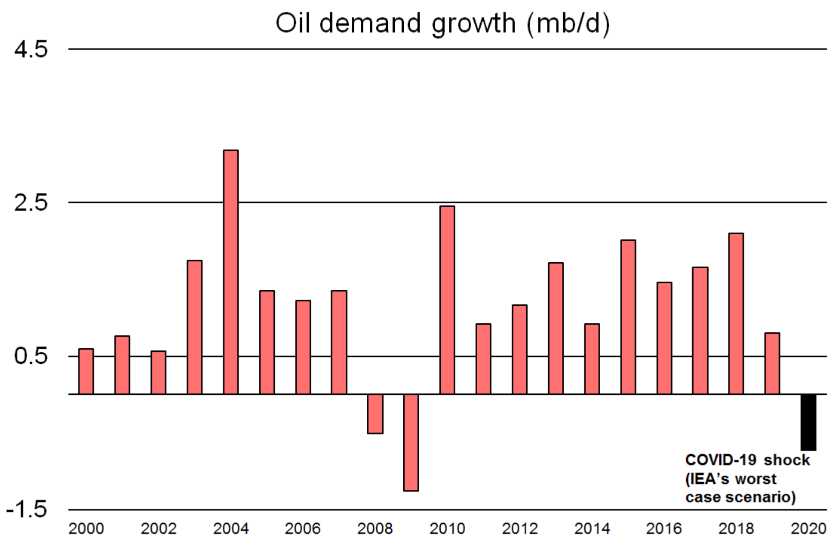
Bad timing for a risky strategy

Although Russia and Saudi Arabia can wage the price war for some time, affording Brent below USD 30/bbl through April, such strategy could dangerously destabilise the market, exposing the most vulnerable producers to growing financial tensions. Also Moscow and Riyadh risk compromising the health of their public finances and could be forced to revise down several publicly funded projects that are essential to preserving domestic consensus. But, more importantly, the timing of such a risky brinkmanship strategy could not be worse. In just ten days since the failed OPEC+ agreement, the global demand outlook has dramatically deteriorated, with the virus having now hit all the largest advanced economies, forcing most governments to adopt massive containment measures. Neither Russia nor Saudi Arabia were probably ready for such a sharp deterioration when they started their brinkmanship — considering how optimistic demand forecast provided by OPEC were last month.

In its March update, the International Energy Agency (IEA) revised down its demand forecast for a second consecutive month, penciling in a contraction of 90kb/d for 2020 — the first annual decline since 2008. In its baseline scenario, the main source of demand weakness remains China, while negative spillover due to a global slowdown in economic activity remain limited. But IEA warned that this might still be a benign scenario for a couple of reasons. First, China's January and February figures for industrial production, retail sales and fixed asset investment were deep in the red − more than expected. Second, even if domestic demand and production recovered fast, the Chinese recovery − and, as a result, global oil demand in general − might be partially impaired by the virus-induced slowdown in advanced economies.

Therefore, in our view, it is more informative to consider the worst-case scenario provided by IEA that is consistent with our baseline of a more pronounced global slowdown than the one implicit in IEA's own baseline. This assumes a contraction in global demand of about 0.7mb/d in 2020 due to the global spread of COVID-19 and a slower recovery in oil demand. As shown in Chart 1, this would be the first demand decline in a decade and output losses in terms of oil barrels would be slightly above those recorded during the 2008 financial crisis. However, while we consider this risk scenario the baseline currently, the probability of further downward revisions in the coming months remains extremely high given how fast and hard the global health crisis is affecting the global real economy.

CHART 1. DEMAND SET FOR A SIGNIFICANT CONTRACTION



Source: IEA, UniCredit Research

Time to cooperate?

Only Saudi Arabia is in the position to provide the leadership and direction that the market needs at the moment. And it is in its interest to do so. Low oil prices hurt the Saudis economy more than they hurt the Russian economy. After all, until ten days ago Saudi Arabia was the country most committed to the OPEC+ agreement and was playing the role of swing producer, cutting production twice as much as it had agreed to. Moreover, if its aggressive pricing strategy was meant to reassert the Saudis pre-eminence in the oil market and force Russia to decide where to stand with respect to the OPEC+ alliance, it has amply achieved the goal given the volatility caused in financial markets by its brinkmanship strategy. This leads us to consider the upper row of Table 1.

If Saudi Arabia blinks, Russia can either do the same or keep a confrontational stance. In the first scenario, OPEC+ would, at a minimum, keep in place the current output curbs (2.1mb/d), while trying to increase it by an additional 1.5mb/d as was proposed at the last meeting (a total of 3.6m/bd). Since the existing production deal expires at the end of March, OPEC+ should ideally strike a deal before that day in order to prevent the physical market from being overwhelmed with the barrels currently cut, thus likely pushing Brent above USD 45/bbl. Waiting until the June meeting would be too late given the current market situation. Iran, for example, has just asked for an OPEC+ emergency meeting and other producers are becoming vocal in this sense. Last week, Russia Energy Minister said that “the doors aren’t closed” to future cooperation between Russia and OPEC.

In the second scenario, in which Russia refuses to back down, OPEC+ would collapse, while OPEC would go it alone (with less firing power, of course) removing barrels from the market (at least 2m/bd), likely pushing Brent towards USD 40/bbl. Given the fractious diplomatic relations between the countries at the moment, which led to the cancellation of the Joint Technical Committee meeting scheduled for today, this second scenario looks more likely. While Russia would benefit from this initiative as a free rider, it would pay the price of losing the economic influence in the Middle East that is attached to its OPEC+ membership. And Saudi Arabia would no longer need to share the scepter of oil king.

Edoardo Campanella, Economist (UniCredit Bank, Milan)
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

Disclaimer

Our recommendations are based on information obtained from or are based upon public information sources that we consider to be reliable, but for the completeness and accuracy of which we assume no liability. All information, estimates, opinions, projections and forecasts included in this report represent the independent judgment of the analysts as of the date of the issue unless stated otherwise. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice. This report may contain links to websites of third parties, the content of which is not controlled by UniCredit Bank. No liability is assumed for the content of these third-party websites.

This report is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as marketing material within the meaning of applicable prospectus law . The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Fluctuations in exchange rates may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank AG, UniCredit Bank AG London Branch, UniCredit Bank AG Milan Branch, UniCredit Bank AG Vienna Branch, UniCredit Bank Austria AG, UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia, UniCredit Bank Czech Republic and Slovakia Slovakia Branch, UniCredit Bank Romania, UniCredit Bank AG New York Branch nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This report is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

This report was completed and first published on 18 March 2020 at 16:21.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst’s remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst’s views, which have not been influenced by considerations of UniCredit Bank’s business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 19/3

UniCredit Research* — Macro Research


Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu


Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research


Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research


Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de


Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu


Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at


Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu


Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu


Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at


Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu


Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

International Economics Research


Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research


Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu


Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu


Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de


Florin Andrei, Ph.D.
Senior Economist, Romania
+40 21 200-1377
florin.andrei@unicredit.ro


Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru


Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr


Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu


Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk


Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg


Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

MR 20/1

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.