NATIONAL BANK OF CANADA
FINANCIAL MARKETS

February 19, 2019

Geopolitics are pushing oil prices higher

By Angelo Katsoras

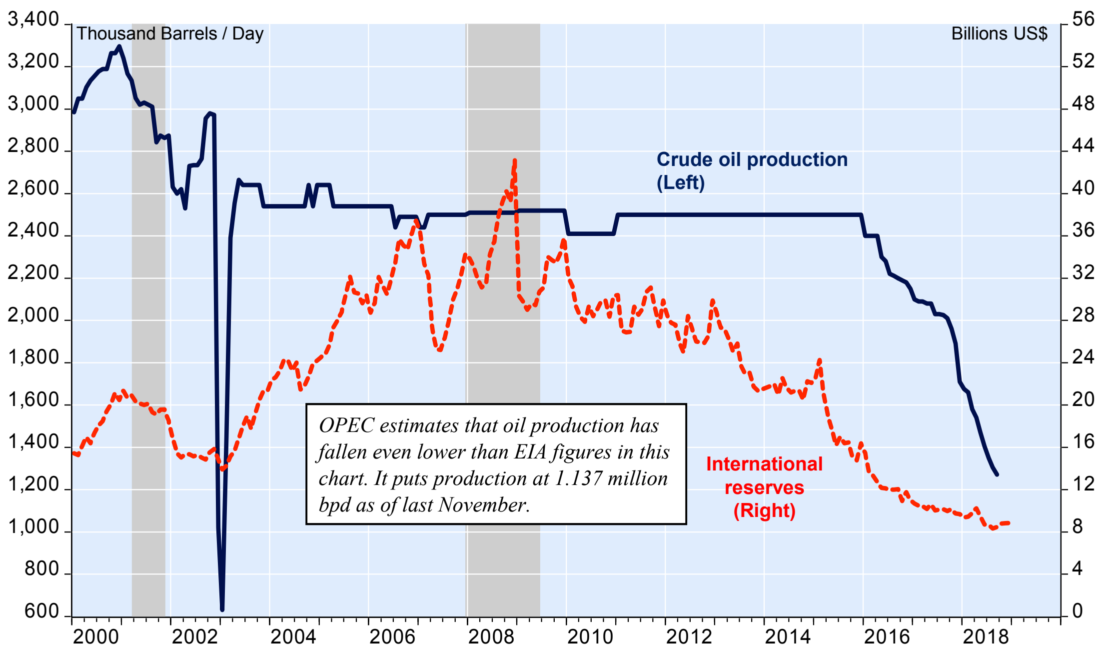
Geopolitically driven events risk having an outsized impact on oil prices over the next several months. These include Venezuela's economic collapse, U.S. sanctions on Venezuela's and Iran's oil sectors, Saudi Arabia's need for higher oil prices to finance its massive spending commitments, and the deal between OPEC and Russian-led allies to cut oil production. While the world's oil market could easily absorb any one of these single events, whether it can cope with all four at once without a price hike is an open question.

Venezuela's economic collapse and freefall in oil production

Venezuela appears to have reached a breaking point. In the past five years GDP has plummeted by about 50% and annual inflation is estimated to have reached 1.7 million percent! There are also widespread shortages of food and medicine. All of this and more has caused three million people to flee the country, with another two million projected to leave this year as well.[1]

According to OPEC, oil production in Venezuela has plunged from a peak of 3.3 million barrels per day (bpd) in 2001 to an average of 1.9 million bpd in 2017 to just over one million today. **We feel the worst-case scenario of seeing oil output sink to a mere couple of hundred thousand bpd in 2019 can no longer be ruled out.** Given that oil accounts for 95% of Venezuela's export revenues, levels this low would threaten the regime's ability to function and continue paying off its core supporters.

Venezuela: Oil production and international reserves decreasing
EIA oil production figures (September 2018) and Banco Central international reserves (December 2018)



NBF Economics and Strategy (data via Datastream)

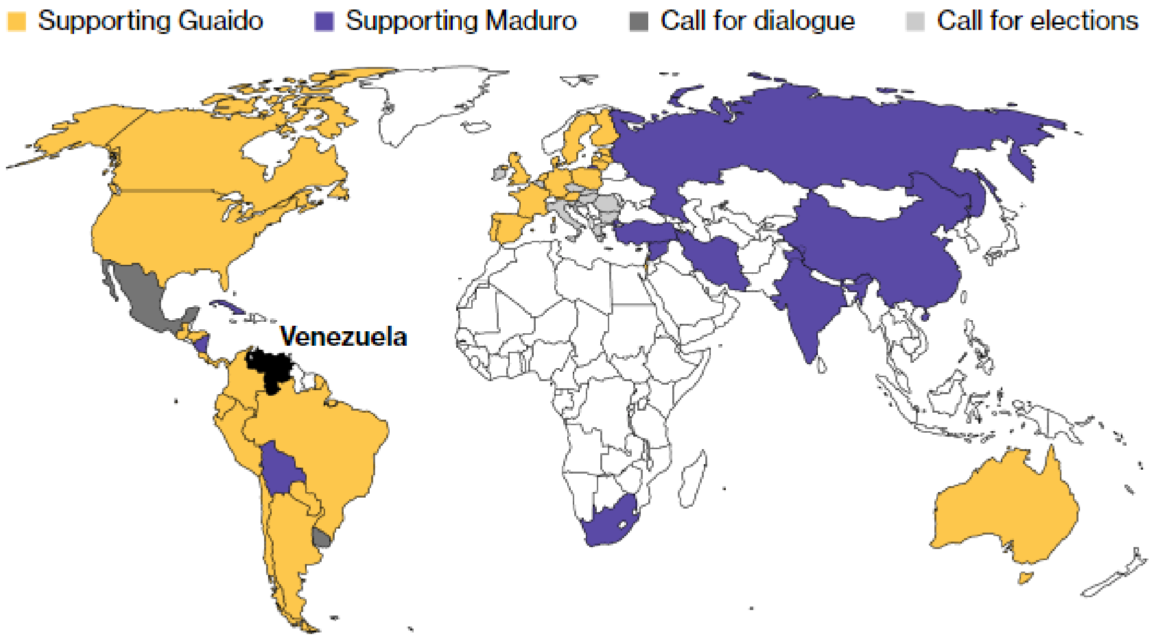
Juan Guaidó, the leader of the opposition-dominated National Assembly, announced on January 23 that he would the assume President's powers temporarily. He invoked a constitutional provision that allows for the head of the legislature to lead a caretaker government until new elections can be held. For the time being, however, Maduro still holds the reins of power. This includes control of food distribution, which is used to ensure loyalty.

To date, more than 40 nations, including the United States, European powers and most of Latin America, have recognized Guaidó as the country's rightful head of state.

[1] "Struggle for Venezuela: will the opposition's bold gamble pay off," The Financial Times, February 1, 2019

Maduro vs Guaido

Global leaders back Venezuela's Guaido as Maduro clings to usual allies



Source: Bloomberg research
Note: As of Feb. 4, 2019; 6:00 p.m. London time

Tipping points that could cause collapse of Maduro regime

Will army turn against Maduro?

Maduro has at least 10 active-duty or former generals as cabinet ministers, and the army runs everything from state-owned oil firm Petróleos de Venezuela to mining operations and food imports.

While there have been a handful of high-profile defections, the top military brass has for the moment rallied behind Maduro. Maduro is accused of turning a blind eye to reports that certain elements of the military are involved in drug smuggling, illegal mining, and money laundering. **Officers implicated in these activities are likely very reluctant to defect for fear that a new government would bring criminal charges against them.**

There have been some revolts lower down the ranks. Last month, two dozen guardsmen raided Caracas military outposts, stealing weapons and holding soldiers captive. The uprising was swiftly put down. About 4,300 members of the National Guard have also reportedly deserted since 2014.

The opposition-controlled National Assembly has passed a law offering amnesty to soldiers and civilians who work to re-institute democracy.

U.S. sanctions imposed on the Venezuelan oil sector

The Trump administration has set April 28 as the deadline by which Americans must cease dealing with Venezuela's state-run oil monopoly. Until then, it will deposit payments for oil to an account reserved for a future democratic government.

After that date, refiners in the United States, which imported an average of 580,000 bpd of Venezuelan oil last year (40% of its exports), will be prohibited from buying any more oil. The United States is one of the few purchasers of Venezuelan crude that actually pay for it. Countries such as Russia and China accept Venezuelan oil as debt repayment. Venezuela sends about 350,000 bpd, one-quarter of its output, to China. **Venezuela will probably have to offer hefty discounts on its oil to entice buyers in other countries to purchase what the United States stops buying.**

U.S. sanctions also prohibit the export of: 1) ultra-light oil that Venezuela needs to mix with its heavy oil in order to allow it to flow through pipelines; and 2) refined products. Venezuela's declining refining capacity has left it increasingly reliant on Citgo, the Houston-based refining arm of PDVSA, to refine its oil and ship it back as gasoline. Finding a replacement for these imports, particularly in the near term, will be difficult and costly. Further, many tanker companies will be wary of signing contracts with Venezuela's government due to the risk that U.S. sanctions will be extended to them.

Taken together, these measures look set to both starve the regime of funds and make it harder for it to continue oil production. Fuel shortages are expected shortly.

Up until recently, the United States was worried that if it targeted Venezuela with harsh oil sanctions, it would trigger an even worse humanitarian crisis. However, growing fears that the chaos in Venezuela is allowing the country to become a haven for criminals and guerrilla groups and that Maduro has allowed generals in his inner circle to become involved in international drug trafficking has likely changed America's risk equation.

Lawsuits by international companies looking to be compensated for expropriated assets

One key court case looms large over Venezuela's future: The country is appealing a U.S. ruling that granted Crystallex, a bankrupt Canadian mining company, the right to collect on an arbitration award of $1.4 billion by seizing shares of PDV Holding, the Delaware corporation through which PDVSA controls U.S.-based Citgo. The award was compensation for having its mining assets expropriated in 2008. A decision on the appeal is expected in the next few months. **A ruling in favour of Crystallex would set a legal precedent that would encourage other creditors to follow suit in seeking compensation for expropriated assets or defaulted bonds (of which there are $60 billion worth and counting).**

China and Russia are major investors in Venezuela

China, Venezuela's biggest foreign creditor, has lent the country more than $50 billion over the past decade, mainly in exchange for oil supplies. About $20 billion is still outstanding. In a recent email interview with the South China Morning Post, Guaidó sought to extend an olive branch to China, stating: "China is a crucial global player, and we want to establish a productive and mutually beneficial relationship." There are reports that China has hedged its bets by opening a channel of communication with the Guaidó government.

As for Russia, Venezuela owes it more than $3 billion. In addition, Russia now owns significant parts of at least five oil fields in Venezuela and has secured 49% of the state-owned oil company, Citgo, as collateral for a loan.[2] While Guaidó has also made a gesture of reconciliation in this case, Russia's lack of geopolitical influence in the region and its highly adversarial relationship with the United States makes it likely Russia will lose control of many of these investments if the Maduro regime falls.

The Venezuelan end game

The positive scenario

Even in the event of a peaceful transition of government, Venezuela would face many challenges. It would need to remove price controls, rebuild a social safety net, restructure its debt, and negotiate an IMF bailout package. It will probably also take years to rebuild the country's oil industry and reverse oil production declines. A reasonable benchmark for recovery in the medium term would be 1.9 million bpd, a production level that Venezuela managed at the end of 2017 (current production is 1.1 million bpd).

In an attempt revive the oil sector, Venezuela's government-in-waiting intends to scrap requirements that state-owned oil giant PDVSA keep a controlling stake in joint ventures.

The negative scenario

A long-term standoff between the opposing sides would sink Venezuela even further into internal conflict and thus provoke an even greater exodus of refugees. The scenario would not only cause Venezuela's oil industry to grind to a complete halt, it would subject its infrastructure to even further long-lasting damage.

Iran: rough economic times

Not so long ago, things were looking up for Iran. The 2015 nuclear deal signed with the United States, the United Kingdom, France, Russia, China and Germany lifted tough sanctions on Iran in exchange for curbs on its nuclear program. This, among other things, permitted a sharp increase in Iran's oil production and a return to strong economic growth.

[2] "Venezuela's political turmoil sparks investor fears," The Financial Times, January 25, 2019

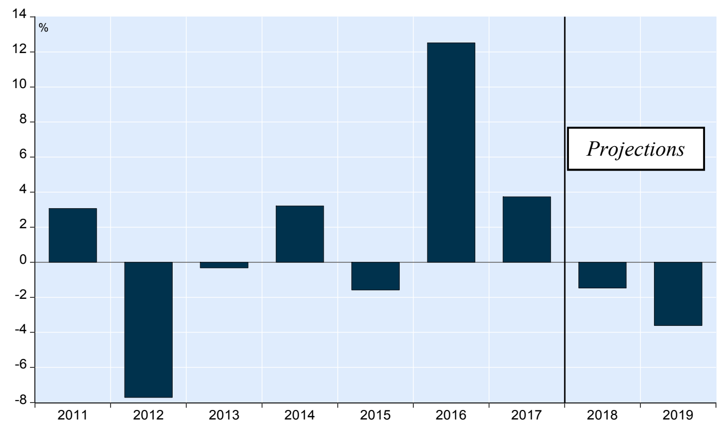
Iran's good fortune extended also into the geopolitical sphere. ISIS, a serious enemy of Iran, has been all but defeated. The Assad regime in Syria, a close ally of Iran, has been saved. Iraq, once a fierce geopolitical rival, is now a de facto ally since the overthrow of Saddam Hussein. Hezbollah, an Iranian proxy, is literally the power behind the throne in Lebanon.

However, Iran's winning streak came to an abrupt halt in May 2018 when U.S. President Donald Trump followed through on his threat to withdraw from the nuclear deal. Since the U.S. imposition of new sanctions, the economy has taken a major hit. The IMF projects Iran's economy will contract more than 3% in 2019. This is in stark contrast with projections of 4% growth before sanctions were re-instated.

Another direct result of the sanctions was a 60% drop in the value of its currency last year and a 40% inflation rate. As if this was not bad enough, the United Nations estimated that Iran has seen the most severe drought in more than 30 years, meaning Iran must import more food from abroad just when its currency has been severely devalued. There have even been reports that food has become so expensive that the government has begun rationing food imports.

While the Iranian government is in no immediate danger of collapse, more Iranians are asking why tens of billions of dollars are being diverted from pressing domestic needs to finance foreign ambitions.

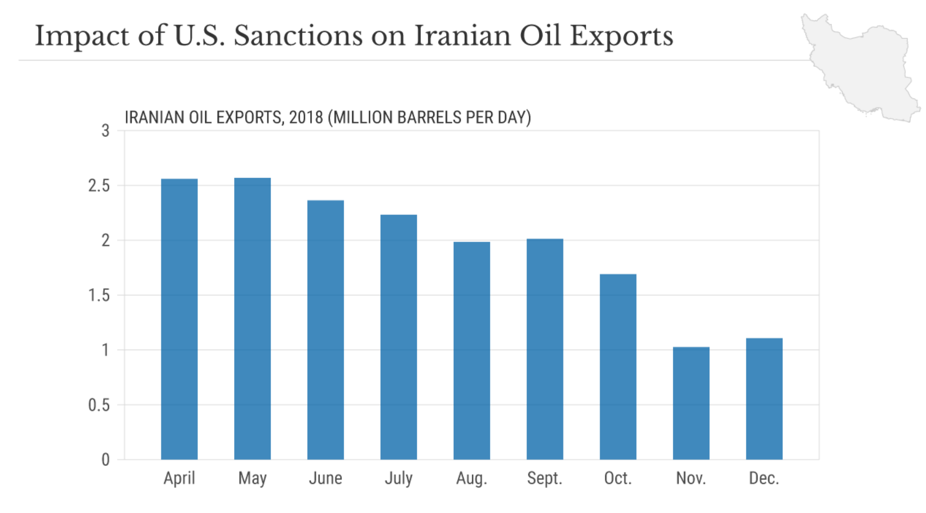
Iran: Perspective on gross domestic product
Real GDP year over year



NBF Economics and Strategy (data via IMF WEO)

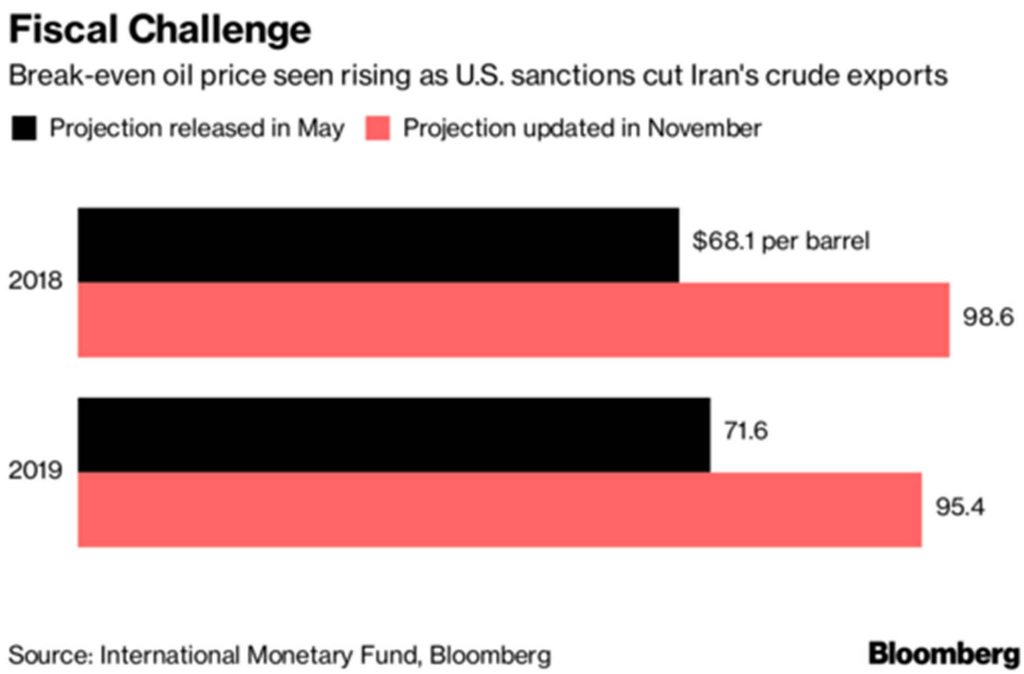
The impact of U.S. sanctions

While the United States is the only country officially re-instating sanctions, the size of its economy and the importance of its financial system gives it considerable leverage. A large corporation forced to choose between doing business with Iran and having access to the U.S. market/financial system will almost certainly choose the latter. Case in point: U.S. sanctions caused oil exports to drop from 2.5 million bpd last April to about 1.1 million bpd in January. The oil that Iran does manage to export to countries such as China through mostly smaller companies with no exposure to the United States will likely be sold at a heavy discount.



Source: "Iran: Retrospective on a Revolution," Geopolitical Futures, February 11, 2019

Another indication of how devastating the impact of U.S. sanctions has been is the IMF's upward revision of the oil price that Iran needs in order to balance its budget.



Will U.S. waivers on Iranian oil exports be extended?

Last November, in a surprise move, the United States granted 180-day waivers to eight countries allowing them to continue buying Iranian crude so long as they gradually reduced their purchases. These countries include China, India, South Korea, and Japan.

In our view, the most likely scenario is that the United States will reissue waivers in May allowing certain countries to continue importing oil, but in smaller quantities than before. This could reduce Iranian oil exports by a few more hundred thousand bpd in the second half of 2019.

The degree to which the waivers are tightened will depend on economic conditions. If the global economy slows down and oil prices remain relatively low, the Trump administration may seize the opportunity to significantly narrow the waivers or remove them altogether. If, on the other hand, the global economy outperforms and oil prices rise substantially, the White House is likely to be less aggressive.

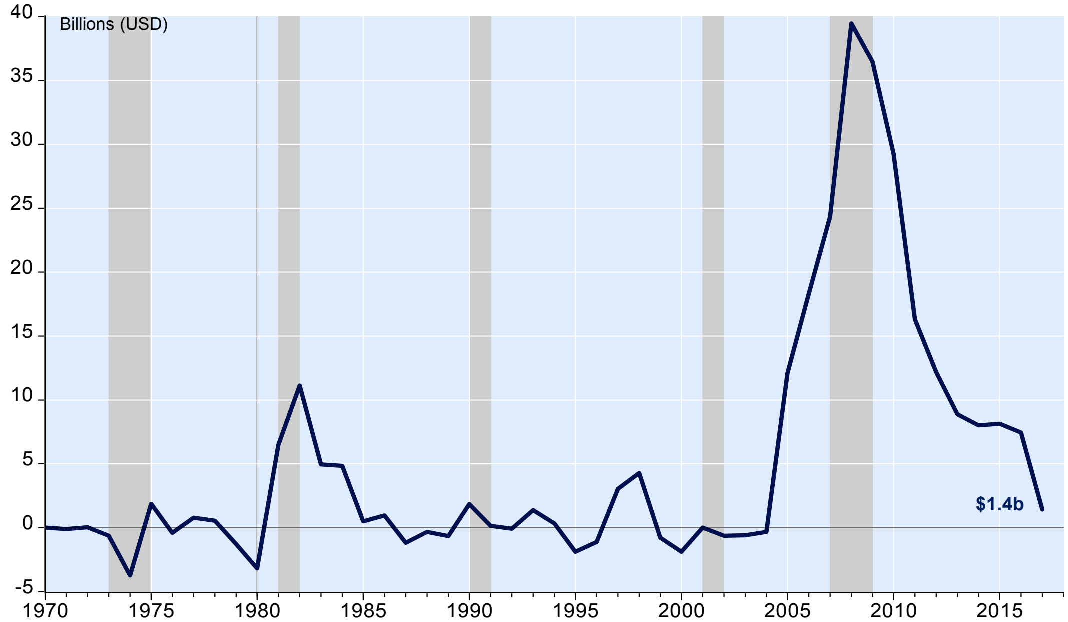
The high financial cost of Saudi Arabia's goals

Even before the fallout over the killing of journalist Jamal Khashoggi, Saudi Arabia's Crown Prince was already facing numerous monumental challenges:

- Attempting to transition away from an oil-based economy
- Curtailing the power of the religious establishment
- Waging an intensified proxy war against Iran across the Middle East

Add to these challenges is the failure to attract FDI to help implement its Vision 2030 economic reform plan to wean the country off its dependence on oil announced with much fanfare two years ago. In fact, FDI fell sharply from $7.45 billion in 2016 to $1.42 billion in 2017.

Saudi Arabia: Perspective on foreign direct investment
Foreign direct investment, net inflows (BoP, current USD) (2017)



NBF Economics and Strategy (data via World Bank)

Planned Aramco IPO (now pushed back to 2021) still faces many hurdles

Despite the fact that the results of an audit of its oil reserves (which for decades have been a closely guarded secret) were published in an effort to revive interest in stalled plans for a stock market float of state-owned oil producer Aramco, an international IPO still remains highly unlikely in the foreseeable future:

- Reports have surfaced that Aramco's market value could be much lower than the government figure of $2 trillion.
- Should Aramco be listed on the NYSE, it could be vulnerable to legislation passed by the U.S. government in 2016 allowing Americans to sue Saudi Arabia for the alleged role of certain Saudi nationals in the 9/11 attacks.

In our opinion, the most likely scenario remains forgoing an international IPO in favour of a private sale to Chinese investors. There are several advantages to going this route:

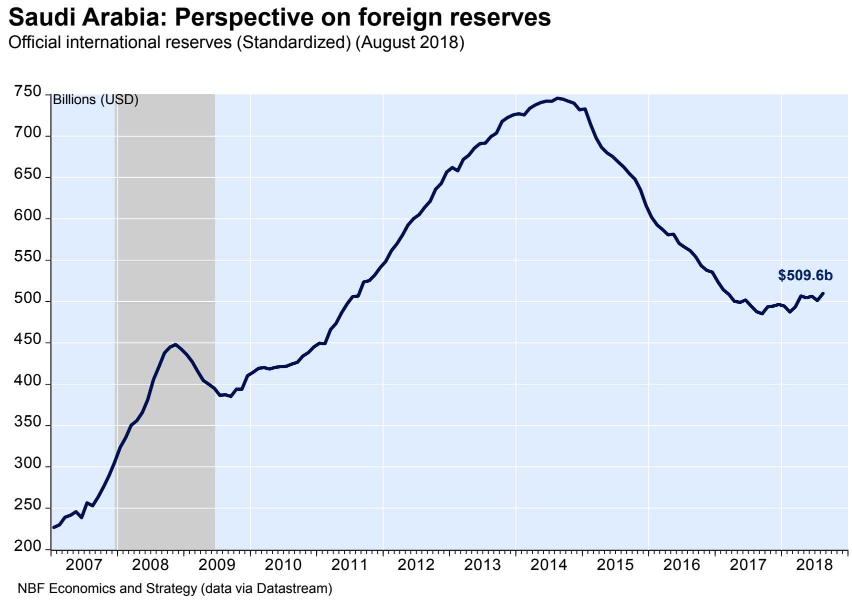
- If the sale price is disappointingly low, the figure could remain secret.
- Aramco would not have to reveal the extent to which it is entangled with the government.
- A private placement with Chinese investors would further cement ties between the world's largest oil producer and the world's largest oil consumer. China would insist on paying for Saudi oil with its own currency. The recent fall-out with over the killing of journalist Jamal Khashoggi and growing criticism of the Saudi-led war in Yemen has strained ties with the West, and increased the odds of a private sale to Chinese investors.

As go its foreign reserves, so goes Saudi Arabia

While possessing just over $500 billion in foreign currency reserves is, by all accounts, very impressive, this figure must be assessed against Saudi Arabia's massive financial commitments listed below:

- **Defence spending:** Saudi Arabia has one of the world's largest military budgets as a percentage of GDP: 10.3% ($69 billion).[3] This stands in stark contrast with the 3.1% of GDP that the United States spends on defence.
- **Public sector employment:** Two-thirds of Saudis are employed by the state (versus an OECD average of close to 20%).[4]
- Other costs include generous social programs, heavily subsidized energy, and significant financial support for allied countries throughout the Middle East, not to mention military involvement in Yemen.

[3] "Trends in World Military Expenditure, 2017," SIPRI Fact Sheet, May 2018
[4] "Saudi Arabia raises the alarm over rising unemployment," The Financial Times, April 24, 2018



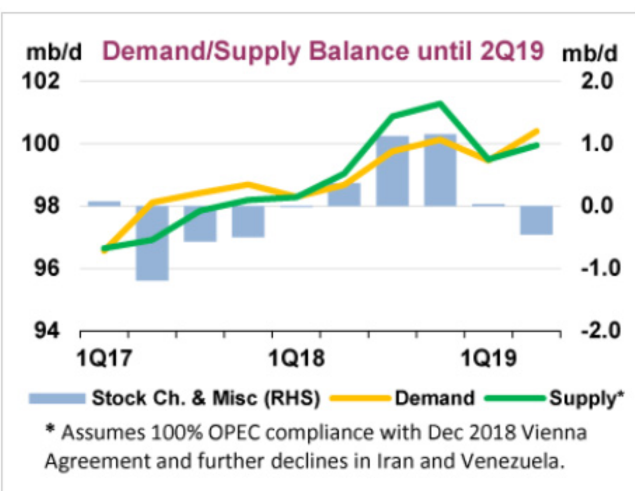
The IMF estimates that the kingdom needs about $88 per barrel to balance its budget, up from $70 per barrel last year. Public debt as a percentage of GDP went from less than 2% in 2014 to almost 20% in 2018. The government projected the deficit in 2019 to be 4.2% of GDP, compared with a shortfall of 4.6% in 2018. While its debt level is still very low, it is important to note that the country's borrowing power is predicated on its reserves not falling to dangerously low levels. Since the end of the era of oil at $100 a barrel in 2014, the country's reserves have plunged from a high of $730 billion in August 2014 to just over $500 billion today.

The lack of success of its economic reforms to date, the high price of oil needed to balance its budget, and the importance of stemming further declines in its foreign reserves means Saudi Arabia will not only agree to maintain its OPEC production target cut of 250,000 bpd, but it will probably overshoot it in 2019, even if it requires tolerating cheating by other members of the deal. Saudi crude output was down 350,000 bpd in January.

Global supply and demand

In December, OPEC and a group of 10 producers outside the cartel led by Russia agreed to cut oil production by 1.2 million bpd for the first half of 2019. OPEC member states agreed to assume about two-thirds of the cut. OPEC reduced its production by 797,000 bpd in January (compared with the last month before), just short of its goal of 812,000 bpd.

The International Energy Agency has projected that the combination of a further decline in Iran's and Venezuela's oil production and strong compliance with the production-cutting agreement among OPEC and other countries could bring the oil market back in balance in the first half of 2019.



Source: "Oil market report," International Energy Agency, January 18, 2019

Conclusion

The combined effects of sanctions on Iran's and Venezuela's oil sectors, Saudi Arabia's need to push oil prices up in order to get its finances in order, and of the recent agreement by OPEC and other countries to cut production means that geopolitics could have an outsized impact on oil prices over the next several months. **These developments support a $65 (WTI) oil forecast by the NBF Economics and Strategy Group.**

World: Geopolitics favour higher oil prices
Price of West Texas Intermediate

NBF Economics and Strategy (data via Refinitiv)

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