Insights
Geopolitics and Policy

April 3, 2020

Oil and Geopolitics: Worse to Come

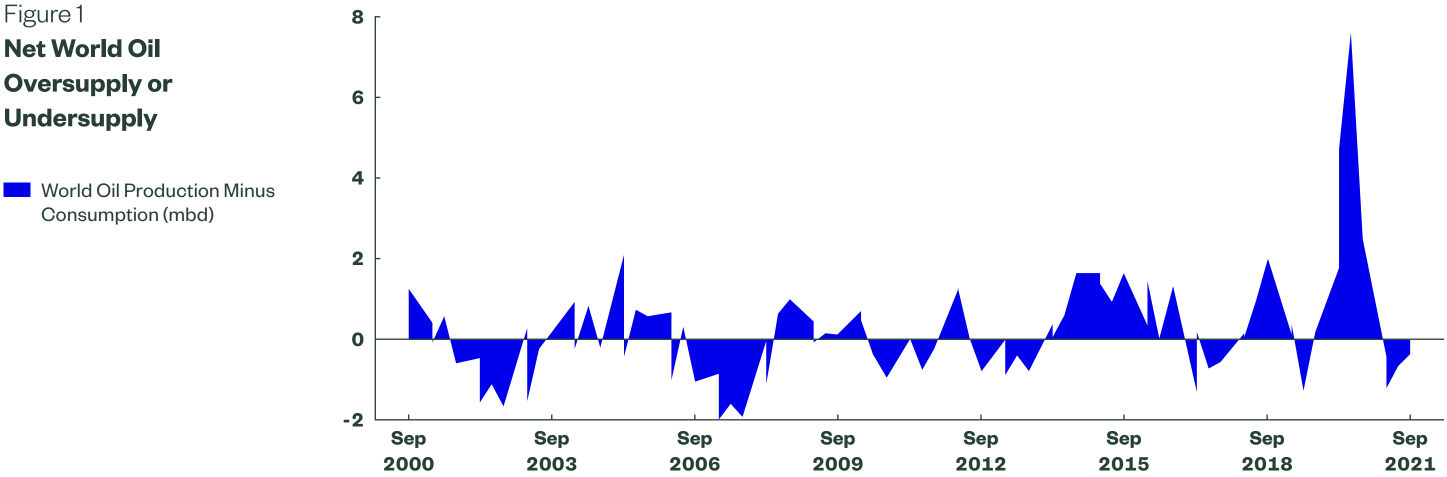
Elliot Hentov
Head of Policy and Research

Four weeks into the oil price collapse, US President Donald Trump has hinted at an imminent production cut among OPEC+ members, but we remain skeptical much will change before later this spring. In our opinion, we have yet to see the full extent of the ramifications of this macro shock on the global economy, financial markets and geopolitics. In the short term, downside risks apply to oil prices and emerging market (EM) bonds.

Global Macro

Notably, this is an unprecedented oil price shock with virtually no beneficiaries. Movements in the oil price typically generate a wealth transfer from producers to consumers or vice versa and are relatively speaking macroeconomically balanced from a global perspective. However, in this instance, the collapse in producer revenue is not matched by consumer gains as the public health measures restrict an increase in (or simply maintenance of) consumption. We forecast a record-breaking oversupply in Q2–Q3 of this year, and that includes relatively optimistic assumptions around the gradual lifting of lockdowns by early May (Figure 1). The rapid dissolution of this oversupply by spring 2021 assumes that as demand recovery sets in, supply cuts become accelerated.

Figure 1
Net World Oil Oversupply or Undersupply



Source: Energy Information Administration data until Q1 2020, SSGA Global Macro Policy.

Supply cuts will not only require intergovernmental agreement between oil producing governments but also US shale production declining substantially. During the oil downturn of 2015, it took 18 months for US production to decline by just one million barrels a day, but oil prices averaged US$45-50 during that period. The current price decline is greater and while US shale has improved its cost curve, the median producer's break-even price is still near US$50. Above all, US shale production is also a function of US financial conditions, which remain tight despite massive policy support. A second crisis within a half-decade period will make it harder for credit spreads to normalize and for marginal producers to maintain production. Industry experts also expect a wave of consolidation across US shale. All in all, US production should come down gradually but meaningfully on account of these factors.

This will add an additional constraint on US growth as oil capex is closely tied to US manufacturing. The latter is likely to therefore undergo less of a V-shaped recovery compared with China and Europe's manufacturing sector. Politically, this will be problematic for the re-election campaign of the president given that the swing states are disproportionately reliant on manufacturing (Wisconsin and Michigan rank No. 2 and No. 4, respectively, for highest share of manufacturing jobs as share of total employment, and Pennsylvania ranks No. 5 in terms of nominal manufacturing jobs) and represent the president's electoral base.

Geopolitics

Considering a very competitive US presidential election and a fragile economy, President Trump could be tempted to divert attention from domestic policy failures. At the same time, Iran has been undergoing severe economic and social distress, with real GDP shrinking close to 10% in 2019 and oil exports at an all-time low of roughly 500,000 barrels a day (about 25% of pre-Trump sanctions levels). This dynamic had already been leading to increased confrontation, including the US assassination of Qassem Soleimani, the most senior Iranian military leader. Together with the botched response of shooting down a civilian airliner, COVID-19 has also dramatically escalated public animosity toward the regime. Following mass protests in late 2019, turnout in February's parliamentary elections was at an all-time low. Worse, the virus originated in Qom (the capital of the regime's ruling clerics) and transmitted widely among government officials, thus exposing the regime's core base to allegations of public health mismanagement. All of this creates an enormous incentive to seek another round of confrontation with the United States (the US) given that the status quo is untenable for Tehran.

In this context, it does not help that other oil producers in the region will be unable to cope with oil prices sustaining at the current levels. Some are likely to experience severe unrest, including Iraq and certain North African countries. In light of the oversupply, there is little market risk from supply shortages, but Figure 2 illustrates that geopolitical events do correlate with major turning points in oil prices. Any large-scale violence or a renewed refugee crisis could be problematic as they could affect neighboring emerging markets or influence general risk appetite.

Figure 2
Brent Oil Spot Price (USD)

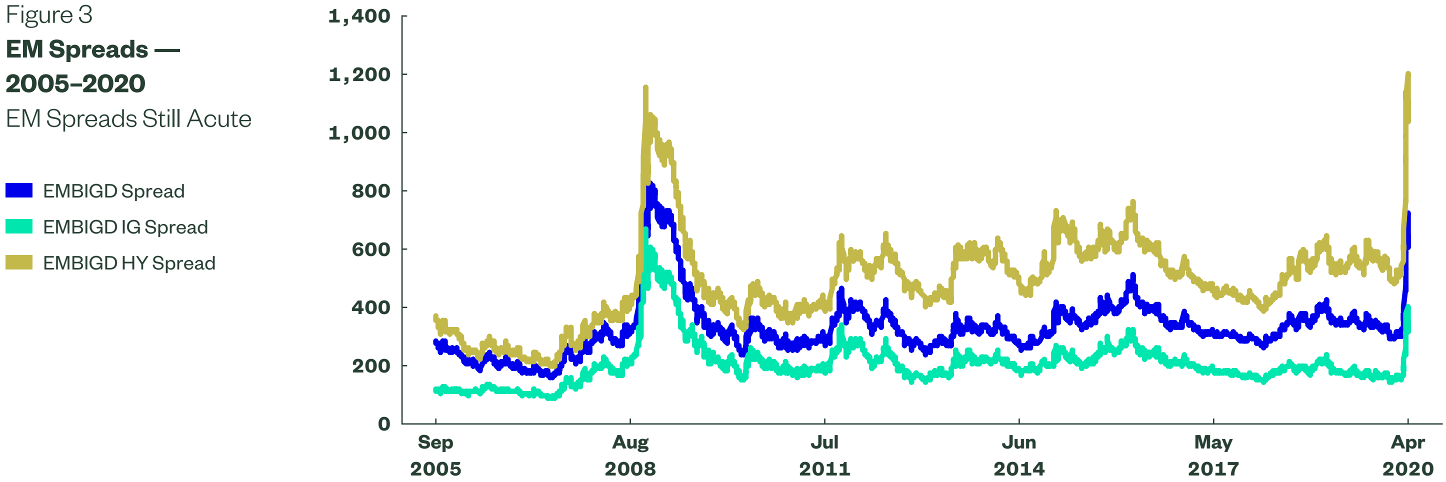
Source: Macrobond, Energy Information Administration, SSGA Global Macro Policy Research, as at 1 April 2020.

Sovereign Wealth and EM Funding

One certainty in the era of even lower oil prices is higher funding needs for all oil producers, including those with higher break-even fiscal profiles as well as large sovereign wealth funds (SWF). A common mistake is that SWFs are assumed to be major drivers of equity sell-offs, but in our previous research we could not find a single year where SWF net equity sales even reached 0.1% of global market capitalization. Even as SWFs will continue to fulfil their role as fiscal stabilizers, the macro effect of the depletion of their assets is negligible, though certain financial service providers may feel the drop in demand.

More importantly, there will remain a major funding gap for most oil sovereigns, including Gulf Cooperation Council members. These states will need to rely on global bond markets to fund their fiscal budgets, so a simultaneous rush of higher borrowing could continue to push up borrowing costs. In particular, given the large borrowing plans in the US, Europe and China, EM sovereigns will need to compete even harder than in 2015–2016 when high-grade sovereign paper was in short supply. Figure 3 illustrates the recent spike in EM spreads, and notably, roughly a third of the Emerging Markets Bond Global Index (EMBIG) is constituted by oil producers. Hence, their exposure to geopolitical tensions is likely to be more sensitive in 2020–2021 and will greatly affect their ability to provide fiscal support to their slowing economies.

Figure 3
EM Spreads — 2005–2020
EM Spreads Still Acute



Source: Bloomberg, SSGA Fixed Income, as at 1 April 2020.

Investment Implications

The COVID-19 crisis has disrupted the supply-demand equilibrium in oil markets, which will not be restored until there is clarity on demand recovery. In the meantime, oil prices are likely to gyrate with disproportionate downside risks in the near term. That said, oil should experience a sharp rebound in the second half of 2020 with prices settling at about 25% lower than their pre-crisis levels by year-end.

SWF asset disposal is not market-relevant, but high borrowing needs should help keep yields up across oil producing EM borrowers. This could be exacerbated by a probable return of conventional geopolitical risks in the aftermath of the COVID-19 crisis, with repeated bouts of flight to safety and sustained dollar strength. However, the US election later this year holds the potential to be the catalyst to upend that trend.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.12 trillion* under our care.

* AUM reflects approximately $43.72 billion USD (as of December 31, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

ssga.com

Marketing Communications

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, Abu Dhabi, United Arab Emirates. Regulated by ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia Services Limited (ABN 16 108 671 441) (AFSL Number 274900) ("SSGA, ASL"). Registered office: Level 15, 420 George Street, Sydney, NSW 2000, Australia. T: 612 9240-7600. F: 612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500 , Montreal, Quebec, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **Dubai:** State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800. F: +971 (0)4-4372818. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345) , Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, One Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

ID190209-3026135.1.1.GBL.RTL 0420
Exp. Date: 30/04/2021