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OPEC'S DECEMBER MEETING: RELEVANT OR JUST LOST IN THE DESERT?

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KEY TAKEAWAYS

The OPEC December meeting will be the most important meeting in years.

No major changes to policy are expected.

There are significant differences within OPEC, but Saudi Arabia will still dictate policy.

The Organization of Petroleum Exporting Countries (OPEC) will have its 168th meeting at its headquarters in Vienna, Austria on December 4, 2015.

The primary goal at this meeting is to set production quotas for each member country, adjusting supply and thereby influencing global oil prices. OPEC does not directly set or maintain target crude oil prices. It is also widely acknowledged that countries have a tendency to cheat—producing over their quota in order to generate more revenue. Few, if any, changes to the current production quotas are expected at this meeting.

CHANGING ROLE OF OPEC

OPEC's importance has declined from its heights in the 1970s, but OPEC countries still collectively produce 40% of the world's oil and 60% of the oil that is shipped internationally.

Thus far, OPEC has not responded to the decline crude oil prices by cutting production quotas. Such cuts were expressly rejected at the last formal meeting on June 5, 2015. A "technical meeting" took place on October 21, 2015, with a number of OPEC and non-OPEC energy producers. At that meeting, an increasingly economically desperate Venezuela advocated OPEC return to its 1980s policy of targeting oil prices directly, calling for an immediate rise in prices to \$88 per barrel. The proposal received limited support, only from Ecuador and Algeria, suggesting how difficult it will be to move from the status quo.

HISTORY OF OPEC

- Founded Bagdad, September 1960
- Original members:
 - Iran, Iraq, Kuwait, Saudi Arabia, Venezuela
- Members joining (some members suspended membership and were reinstated):

Qatar	1961	Nigeria	1971
Indonesia	1962–2009, will be reinstated in Dec 2015	Ecuador	1973–1992, reinstated in 2007
Libya	1962	Angola	2007
United Arab Emirates	1967	Gabon	1975–1994
Algeria	1969		

DECEMBER MEETING: WHAT IS THE END GAME?

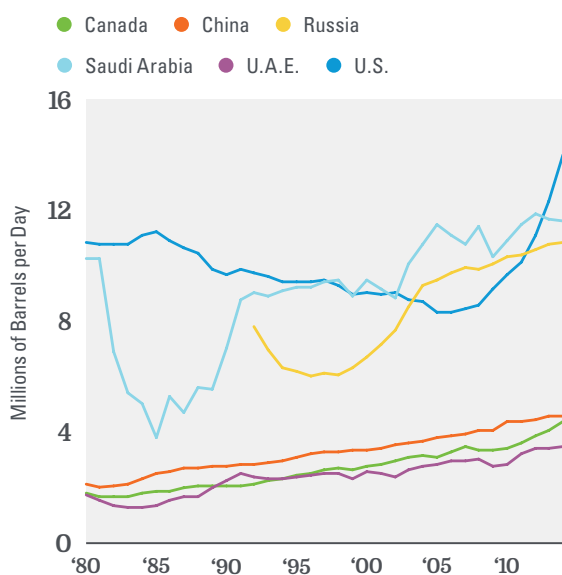
Though OPEC is a singular entity, it has a diverse membership with different needs and agendas. Saudi Arabia has always been the dominant force within OPEC, based on what is believed to be its high level of reserves and low cost of extraction.

Saudi Arabia has maintained a hard line, stating that the global supply imbalance must be corrected by production cuts from non-OPEC producers. Led by Saudi Arabia, OPEC's resistance to production cuts has contributed to the current global oil glut and

SAUDI ARABIA'S OIL RESERVES

Information regarding Saudi Arabia's oil reserves is limited. Its national oil company, Saudi Aramco, is 100% owned by the government. Independent evaluation of reserves—currently claimed to be 280 billion barrels—is not allowed. This secrecy leads to frequent rumors and conspiracy theories regarding Saudi actions and motivations.

1 TOP PRODUCERS OF PETROLEUM



Source: LPL Research, U.S. Energy Information Association 11/16/15

low prices. This has been referred to as protecting “market share,” but from whom? Saudi Arabia does seem to be protecting its status as “swing producer” (see sidebar on page 4) for oil.

Figure 1 shows the changes in global oil production, detailing the extent to which the United States has become a factor in the oil price equation. There is no way to know which are most important to the Saudis, but some factors clearly on their mind include:

- North America.** Driven largely by new technologies, the production of shale, tar sands, and other unconventional sources may present a short-term challenge to Saudi dominance. However, some believe that the relatively high extraction and transportation costs may limit North American production over time.
- Russia.** Saudi Arabia battles Russia not only for sale of oil, but for influence in Islamic regions within the Russian federations and geopolitical influence among the former Soviet republics and across the wider region.
- Iran.** In many ways Iran is Saudi's natural rival. Both countries are Islamic, but Iran is largely Shia, while the Saudi's follow the strict Wahhabi sect of Sunni Islam. Furthermore, though Iran is Islamic, its ethnic heritage is Persian, not Arab.
- Smaller producers.** Saudi Arabia may have no particular agenda with respect to smaller OPEC producers, such as Venezuela and Ecuador, but historically these countries followed Saudi Arabia's lead with little or no need for further actions. The Saudis cannot be pleased that the cartel's junior members are questioning their policies.

All reports prior to the upcoming December 4, 2015, OPEC meeting suggest that there will be no change in policy. This has been said by Saudi officials for some time, and was recently repeated by the oil minister of OPEC member United Arab Emirates (U.A.E.). The weakness in oil prices in November 2015 can be at least partially attributed to the market absorbing this news. There is some

chance that OPEC might announce insignificant cuts in production or make some other technical concession to allow Saudi Arabia, the U.A.E., and the other OPEC leaders to appear magnanimous. However, any change should be viewed as related to harmony within OPEC, not a fundamental shift

HOW MUCH LONGER CAN PRICES STAY THIS LOW?

Fundamental analysis suggests that oil prices may remain relatively low in the near term; and while prices likely will rise next year, any appreciation may be subdued. **Figure 2** shows how sharply prices can move when excess capacity among oil producers is tight. But that is not the case today; it is believed that production can come on and offline quickly depending on market prices.

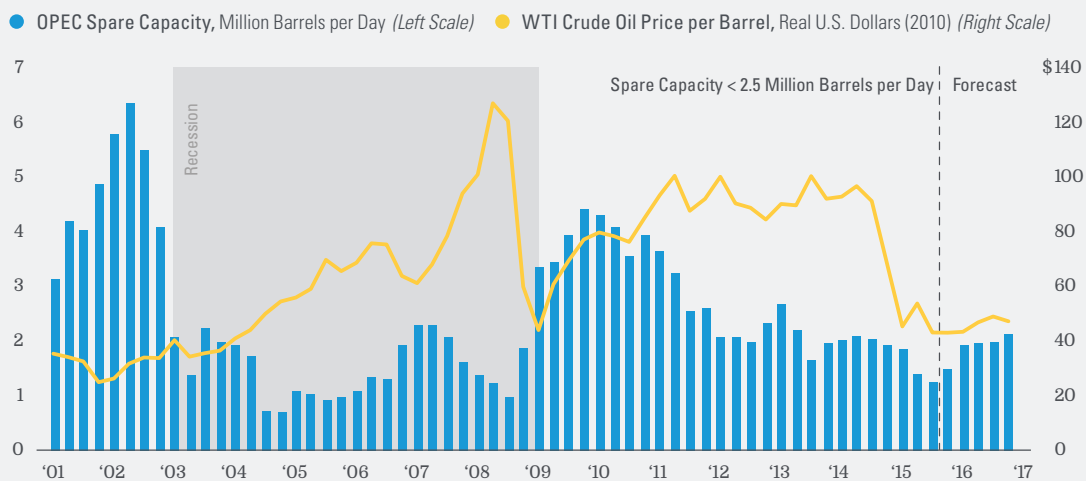
The real question is not what will happen in December, but how long can the Saudis maintain such a hard line. All countries have a limited supply of oil; every barrel sold today at a low price is a

barrel that cannot be sold next year potentially at a higher price. Countries like Saudi Arabia, Kuwait, and the U.A.E., with large reserves and lower extraction costs, are best positioned for this environment. Lower oil prices are hurting all of Saudi Arabia's rivals, either by driving production offline or by reducing revenue to their rivals.

WHAT PRICE IS TOO LOW FOR SAUDI ARABIA?

Saudi Arabia is not immune from the pain low oil prices are causing. Despite some attempts to diversify, the Saudi economy is highly dependent on the government redistributing oil wealth, which accounts for 80% of the Saudi budget on social programs. This summer the country borrowed \$4 billion—its first government bond issue since 2007—to cover its budget deficits, and plans to borrow as much as \$27 billion. These are not huge numbers in the grand scheme of the global economy, but have already resulted in the country being downgraded (though still considered

2 OPEC SPARE PRODUCTION CAPACITY AND WTI CRUDE OIL PRICES



Source: LPL Research, U.S. Energy Information Administration, Thomson Reuters 11/10/15

investment grade) by the credit agencies since repaying these debts is dependent on higher oil prices. Further borrowing may also raise the ire of some Islamic hardliners, who believe that the use of debt instruments violate the Sharia prohibitions against the usury.

Ultimately, we know the prices for oil must go higher; at under \$50 per barrel, too much production falls below the total extraction costs. Production cuts, which have already started

in North America, are expected to deepen and extend to other high production cost regions. This will inevitably lead to rising prices as supply and demand balance out. The price of oil has frequently been subject to non-economic influence as oil can be a tool, or a weapon, of many countries' foreign policy. This creates a level of uncertainty in the market. In our view, that uncertainty today is abnormally high, even as the price of oil is abnormally low.

SWING PRODUCER

A supplier or a close oligopolistic group of suppliers of any commodity, controlling its global deposits and possessing large spare production capacity. A swing producer is able to increase or decrease commodity supply at minimal additional internal cost, and thus able to influence prices and balance the markets, providing downside protection in the short to middle term.

CONCLUSION

The consensus view for next year is that prices will average in the mid-\$50s for the year, likely ending 2016 around \$60. This is well above current prices but still below the average prices for the past few years. The underlying assumption is that OPEC will not materially change policy either in December or at their meeting in June 2016 and that non-OPEC sources will continue to cut production begrudgingly. While this is the most probable outcome, the government of Saudi Arabia is under pressure internally and from its OPEC partners to act sooner and more decisively to get prices higher. How they deal with this pressure will likely be the most important factor in oil prices next year. ■

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OPEC is an organization consisting of the world's major oil-exporting nations. The Organization of Petroleum Exporting Countries (OPEC) was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries.

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