## Macro Observations

In August, the US China trade war took an unexpected and dramatic turn for the worse. Energy stocks were hit more than any other sector, with the XOP falling below the Great Financial Crisis low. The trade war escalation happened just as the global economy began to show some signs of improvement. A surprising number of large economies beat Q2 GDP growth expectations, including the US, Japan (1.8% actual versus 0.5% expected), South Korea, Canada, Brazil, and Russia. China and Germany had weak growth that was in line with expectations. India's GDP growth surprised to the downside, while the United Kingdom posted numbers slightly below expectations. The question now becomes whether the trade war will throw the world into a recession or whether the unprecedented drop in interest rates, fiscal stimulus, and the resumption of QE in Europe and elsewhere will be enough to avoid a dire trajectory.

The outcome of the trade war itself is highly unpredictable. President Trump would likely prefer a deal before the US election, but whether he is willing to compromise is by no means certain. The Chinese would also likely prefer a deal soon, but their best strategy could be to wait until after the US election. The worsening situation in Hong Kong increases the chances of a near-term deal somewhat. The Democrats see Hong Kong as a human rights issue, while President Trump sees it as an internal Chinese domestic issue. As the Democrats bring forth legislation in Congress supporting democracy in Hong Kong, the Chinese could decide that Trump is the lessor evil. The Chinese could just as easily decide that the US President's erratic manner cannot be trusted. After the shocking escalation in August, any outcome is possible, and the path forward is difficult to assess. Better and worse outcomes remain in the cards.

The oil market is in a much better spot today than it was during the previous crises of the GFC and early 2016 when Brent broke $30. In the GFC, the global economy suffered through a systemic banking crisis. Today, a banking crisis is possible in Europe, but the US banks have been recapitalized. Furthermore, the Chinese have shown no hesitation to nationalize their banks. Another Great Financial Crisis scenario is currently not on the table. In 2016, the global economy slowed while OPEC was in the midst of rapidly ramping oil production by 3.5mmb/d. Oil inventories were bloated and growing quickly. Today, global oil inventories are at normal levels and dropping. OPEC+ is in the midst of cutting production by close to 3.0mmb/d and is committed to supporting the oil market. Furthermore, US production growth is slowing much faster than expected. OPEC is very aware of the coming shortage of conventional production, once the very last large projects sanctioned in the $100 oil world ramp over the next nine months. As a result, OPEC has no motivation to let the market go. From here, the main risk to the oil market is a resumption of Iranian exports. However, this is unlikely given that the US is not only asking for Iran to commit to nuclear non-proliferation, but also to completely change their foreign policy.

The oil market is surprisingly tight for its lack of upward direction. The 1-6 Brent spread, the most important current indicator, has been very backwardated for the last month, incentivizing refiners to release inventory. Inventories appear to be draining globally with US crude, gasoline, and distillate inventories now almost at normal levels. For Q3, the current IEA report expects supply to be 0.9mmb/d below demand, while the current OPEC report expects this number to be 2.0mmb/d, both very constructive. Although the IEA revised down the 2019 oil demand growth in their most recent report, they actually took up the absolute level of demand by raising the 2018 base, which caused them to increase their 'call on OPEC'. Over the last four weeks, US oil demand has grown by a strikingly solid 491kb/d y/y. ***Most importantly, US production has shown almost no growth in the first six months of the year according to the EIA's recent monthly report (44kb/d in the first 6 months this year versus 676kb/d in the first 6 months last year.)*** The US rig count and frack spreads continue to drop, suggesting that US production is unlikely to pick up anytime soon. The official agency estimates for US production growth in 2020 now look too high, given the difficult 2019 base effects, making the 2020 oil market tighter than previously thought. If the US continues to show minimal production growth and the global economy does not become unhinged, there will be a big upward move in the oil price. The oil market does not balance without sustained strong US production growth and there was almost no US production growth in the first half of the year.

Industry pundits have warned that US tight oil growth will surprise to the low side. Earlier in the year, Schlumberger cautioned that US tight oil growth will slow and that interference between 'parent' and 'child' wells could cause a downward revision of the resource base. Concho, one of the largest Permian pure play companies, spaced the wells on one of their biggest pads too tightly, forcing them to revert to wider spacing going forward. Parsley Energy, another Permian pure play, increased their spacing assumptions by 100%, effectively cutting locations in half from 2017 to 2019. This 'up-spacing' means the Permian resource has found its limits and is smaller than previously hoped. Scott Sheffield, industry figurehead and CEO of Pioneer Natural Resources, said on Pioneer's Q2 call that the only basin growing in the US after 2024 will be the Midland. According to him, even the Delaware basin in the Permian will stop growing by 2024, meaning that only half of the Permian will be growing in the relatively near future. With a smaller resource base, it makes sense for the whole industry to slow down and focus on free cash flow. Slower growth from the US radically changes the industry outlook as the US and Canada have provided 90% of oil growth for the last decade and OPEC has provided all of the rest. With conventional production set to decline once we get through a last surge of production from Norway and Brazil, oil supply will struggle to meet oil demand in the not too distant future.