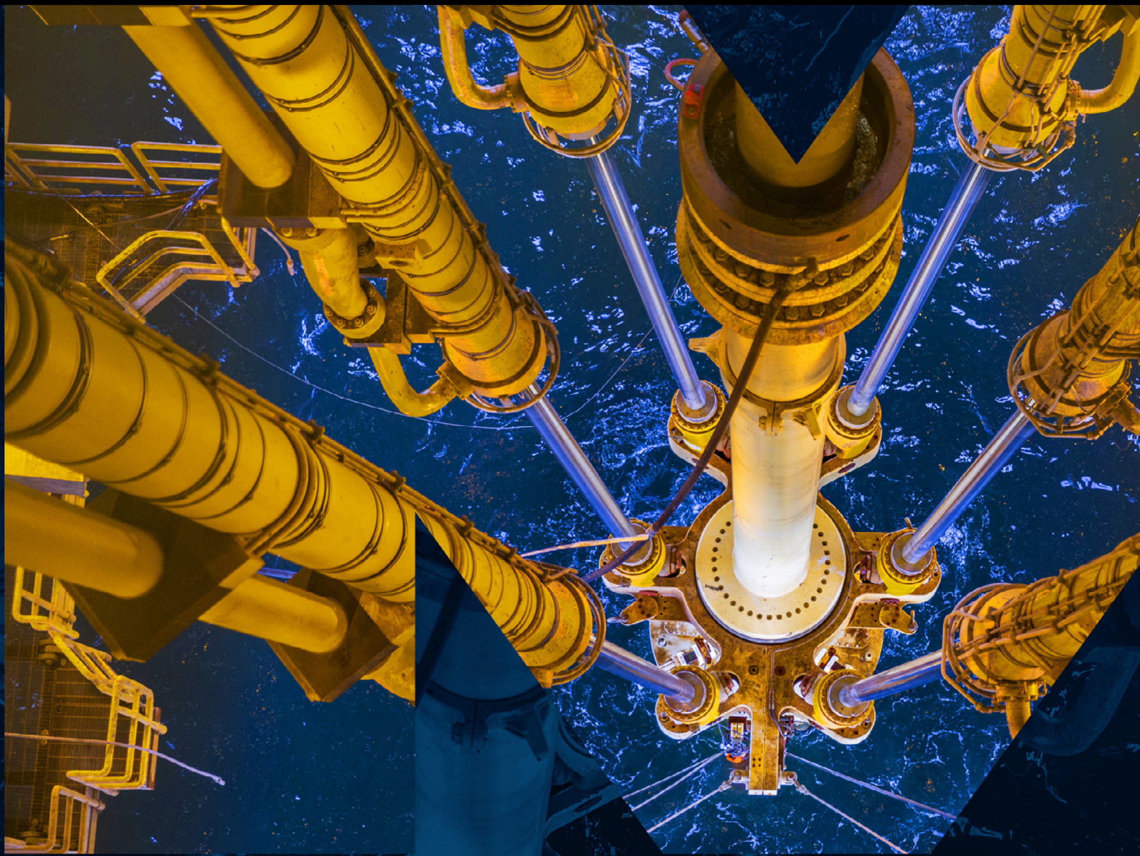

Where Will the Oil Price Go?

October 2021

Time to read: 4 minutes

After a year in which the oil price went negative, it might feel difficult to predict the future path of oil prices. In partnership with the Good Judgement Project, we decided to make use of the wisdom of a wise crowd to cut through the noise, and get a sense of where prices might actually go.

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Introduction

In April 2020, the world learned what only a few commodity futures specialists had bothered to think through – that physical delivery of crude in an oversupplied system with inadequate storage could result in negative front-month oil futures prices. On 17 April 2020, front-month West Texas Intermediate ('WTI') traded to -$40 per barrel. Since then, it has comfortably eclipsed pre-pandemic highs, topping more than +$80 per barrel.

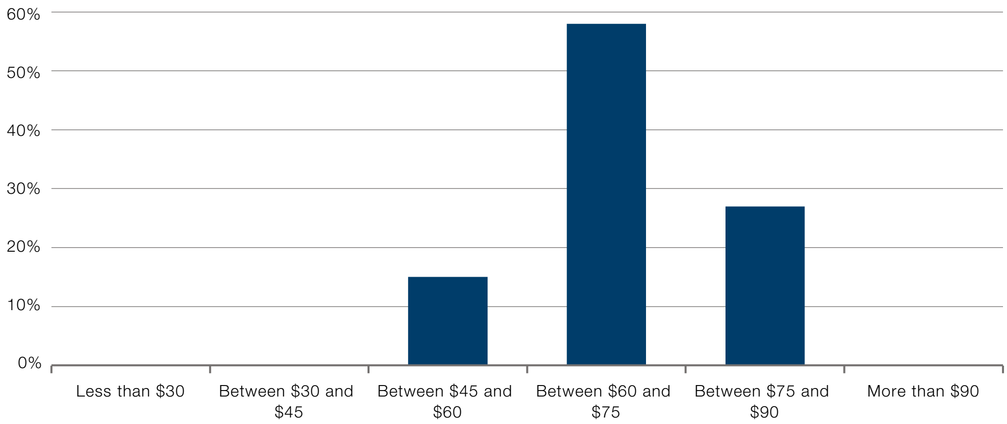
In August, in partnership with Good Judgement, we asked respondents their expectations for WTI prices for the end of 2021, against a backdrop of prices in the mid-1970s.

"The vast majority expect prices to be broadly where they are today."

Where Might Prices Go?

Unsurprisingly, perhaps, given this short forecast window, the vast majority expect prices to be broadly where they are today. More interesting, though, is that the skew of other responses was almost twice as high for materially higher prices than for lower prices (Figure 1).

Figure 1. What Will Be the Closing Price per Barrel for West Texas Crude on 31 December 2021?



Source: Good Question/Good Judgement and Man Group.
Note: Survey was conducted between 1-31 August. The price of oil at the beginning of the forecast period was $74 per barrel.

Perhaps this just reflects recency bias – after all, an estimate of $76-89 captures price history in early July 2021. On the other hand, since Good Question (Man Group's partnership with good Judgement) is all about harnessing the wisdom of a wise crowd, it is probable that this response captures something of the material longer-term supply challenges that have been building in the oil market for some years. Prior to the pandemic, the resource replacement ratio stood at just 14% – for every seven barrels consumed, one was added to producers' resources. In 2013, before the Saudis unleashed a price war and upended the operating environment for onshore US producers, this ratio was closer to 35%. Producers have gone from a golden environment where price supported new exploration in higher cost supply, to one where access to new capital is deeply restricted. In a recent Dallas Fed survey[1] of the local oil and gas industry, one of the respondents remarked (emphasis added, as if it were needed…):

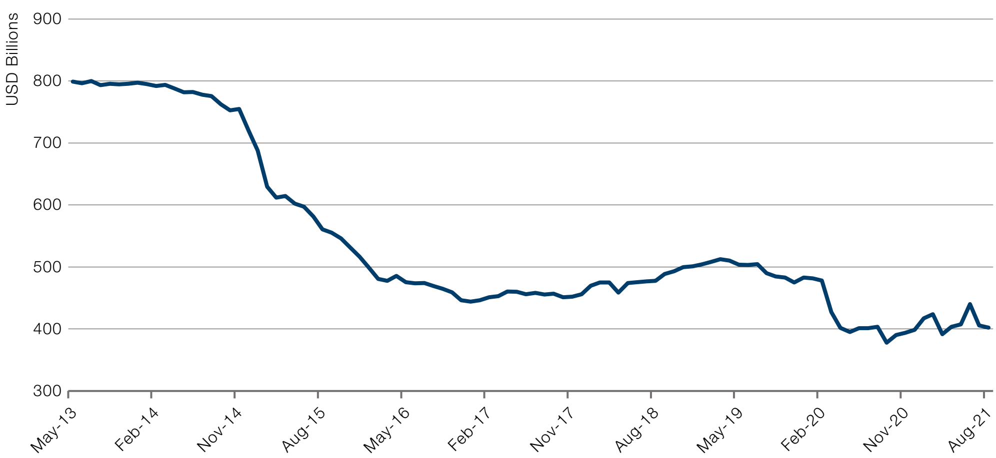
"Producers have gone from a golden environment where price supported new exploration in higher cost supply, to one where access to new capital is deeply restricted."

"We have relationships with approximately 400 institutional investors and close relationships with 100. ***Approximately one is willing to give new capital to oil and gas investment****. The story is the same for public companies and international exploration.* ***This underinvestment coupled with steep shale declines will cause prices to rocket in the next two to three years****. I don't think anyone is really prepared for it, but US producers cannot increase capital expenditures:* ***the OPEC+ sword of Damocles still threatens another oil price collapse the instant that large publics announce capital expenditure increases****."*

1. www.dallasfed.org/research/surveys/des/2021/2102.aspx#tab-comments

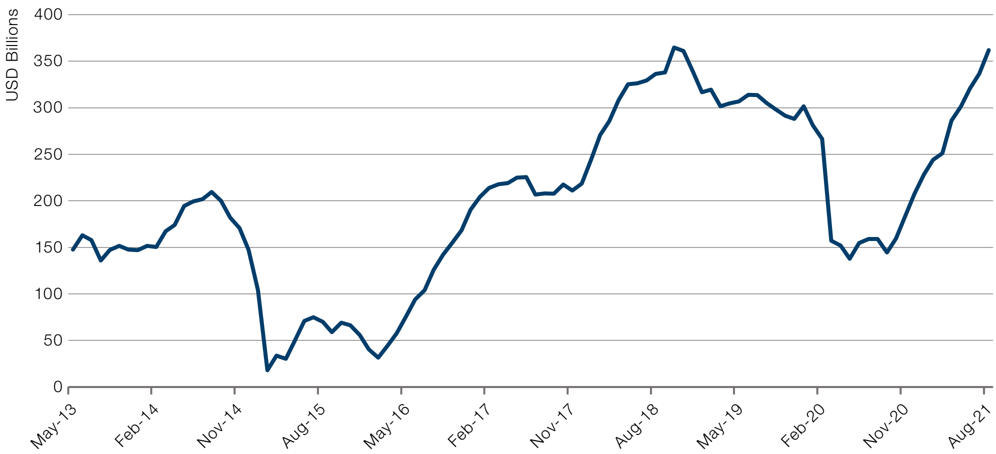
What this respondent did not mention, but many others in the same survey do, is that access to capital is severely impacted by ESG policies – regulators are leaning on commercial banks to factor climate change into lending decisions and investors are deeply concerned that investment into carbon projects that can become 'stranded' risks a negative NPV. As a result, industry capital expenditure intentions have collapsed (Figure 2). And, against the backdrop of high oil prices, this is resulting in elevated free cash flow generation (Figure 3).

Figure 2. MSCI ACWI Oil & Gas Estimated Capex



Source: Bloomberg; as of 31 August 2021.

Figure 3. MSCI ACWI Oil & Gas Estimated Free Cash Flow



Source: Bloomberg; as of 31 August 2021.

> "Substitution is clearly happening, but with around 1.5 billion vehicles in the global car park (versus only around 8.5 million electric vehicles), and no existing non-carbon solutions for shipping or aviation yet, that process will not be fast."

Conclusion: Structural Price Support

Oil demand continues to grow: pre-pandemic global crude demand grew at around 1.2% over three, five and seven years compounded. We see no scope for ESG policies and regulations to loosen. Substitution is clearly happening, but with around 1.5 billion vehicles in the global car park (versus only around 8.5 million electric vehicles), and no existing non-carbon solutions for shipping or aviation yet, that process will not be fast. The release valve over the short-to-medium term, absent a recession, will likely be price. Paradoxically, public equity in many oil producers has rarely been supported by so many positive factors. Companies are deleveraging and their unencumbered balance-sheets and free cash flow could present opportunities.

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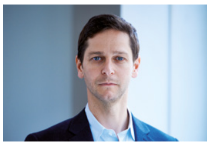

Edward Cole is Managing Director of Discretionary Investments at Man GLG. He is responsible for the development of investable strategies, and provides market strategy insight for the portfolio managers and the firm's clients. He joined Man Group in 2015, co-managing emerging-market equity strategies until the end of 2018. He started his career in 2001 working for specialist Eastern European-focused investment banks as an equity strategist during the period of EU accession for former communist-bloc countries, and moved to JPMorgan in 2005 as a global emerging market equity strategist. He has worked in investment management since 2007, managing long-only, long/short and multi-strategy emerging market funds. Edward graduated from the University of Bristol with a BSc in Politics and from the London School of Economics with an MSc in International Development.

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Professor Campbell R. Harvey, a leading financial economist, has been an Investment Strategy Advisor to Man Group since 2005 and has contributed to both research and product design. He is a Professor of Finance at Duke University and Research Associate at the National Bureau of Economic Research in Cambridge, Massachusetts. He served as Editor of The Journal of Finance from 2006 to 2012 and as the 2016 President of the American Finance Association. Professor Harvey received the 2016 and 2015 Bernstein Fabozzi/Jacobs Levy Award for the Best Article from the Journal of Portfolio Management for his research on differentiating luck from skill. In January 2021, he was named 'Quant of the Year' by the Journal of Portfolio Management for his outstanding contributions to the field of quantitative finance. He has also received eight Graham and Dodd Awards/Scrolls for excellence in financial writing from the CFA Institute. He has published over 150 scholarly articles on topics spanning investment finance, emerging markets, corporate finance, behavioural finance, financial econometrics and computer science. His book co-authored with Sandy Rattray and Otto van Hemert, Strategic Risk Management, is forthcoming in 2021 (John Wiley and Sons). Professor Harvey teaches both an advanced asset management course, as well as an offering that focuses on DeFi or blockchain enabled decentralised finance. He has served on the faculty of the University of Chicago, Stockholm School of Economics and the Helsinki School of Economics. He has also been a visiting scholar at the Board of Governors of the Federal Reserve System. He holds a PhD in Finance from the University of Chicago.

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