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2022 Oil Market Outlook

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Oil prices recovered significantly during 2021, primarily due to the reopening of economies that had been shut down due to the Covid pandemic. Western Asset Research Analysts René Ledis and J. Gibson Cooper spoke with Product Specialist Robert Abad to drill down on their analysis and outlook for oil in 2022 and beyond. They discuss the drivers of oil supply and demand, OPEC+, price volatility, risks facing the energy space and more.



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KEY TAKEAWAYS

- The gradual reopening of the global economy in 2021 drove crude oil demand throughout the year nearly back to pre-Covid levels.
- In 2022, oil cost inflation of approximately 5% to 15% should help buoy prices amid lower productivity and efficiency gains.
- Public policy has clearly accelerated beyond the reality of the ability to satisfy energy demand with other non-fossil fuel forms of energy.
- After experiencing two OPEC-induced cycles, waves of bankruptcies and ratings downgrades, as well as the pandemic, US oil companies are understandably reluctant to commit capital and ramp up drilling activity even given today's higher oil prices.
- Even with the push for lower-carbon energy sources, we believe the demand for fossil fuels will remain but on a smaller scale than it is today.

2022 Oil Market Outlook

By J. Gibson Cooper, René Ledis, Robert Abad

Continued Supply Discipline Amid Recovering Demand Supports Oil Price Resilience in 2022

RA: What have been the main factors driving oil prices over the past year?

JGC: The gradual reopening of the global economy in 2021 drove the crude oil demand recovery throughout the year to a point near pre-Covid levels. The demand recovery, management of supply by OPEC+ (OPEC plus Russia) and continued US shale producer capital discipline resulted in meaningful inventory drawdowns and higher crude oil prices throughout the year, but not without significant volatility. The spot West Texas Intermediate (WTI) oil price saw seven +/- 10% swings during 2021, largely driven by varying economic and vaccination data as well as by OPEC policy. A key development in oil pricing in 2021 was the decision by OPEC+ to curtail the members' production quota initiated back in the spring of 2020 to counter the collapse in oil demand caused by COVID-19. The decision in July by OPEC+ calls for the gradual increase of production by member countries of 400,000 barrels per day (bbl/d) each month starting in August 2021 and until the previous production cuts are fully reversed. This amount is in addition to production increases already initiated through July 2021, including the full reversal of Saudi Arabia's voluntary production cut of an additional 1 million bbl/d. OPEC+ also agreed to extend the production agreement through the end of 2022 in order to further manage production targets as necessary given continued COVID-19 risks to demand. We believe OPEC will be the overarching risk factor for oil prices to watch in 2022, no matter the direction of the pandemic, alongside US producers continuing to exercise production discipline in favor of cash flow generation and shareholder returns. The cartel has been the key balancing mechanism in the oil market and has demonstrated its effectiveness in mitigating the shock of the unprecedented drop in oil demand in 2020.

RA: What is Western Asset's view of oil prices for 2022 and beyond?

RL: We acknowledge we cannot predict prices, but with the backdrop of the rising risks, demand recovering to almost pre-Covid levels and continued conservative behavior of the global producers, oil prices should remain relatively resilient absent a material event. Oil price direction is clearly becoming more a function of supply than demand at this point. Rebalancing will be ongoing through 2022 but balance is likely to be maintained and managed by OPEC+. To add to support, cost inflation of approximately 5% to 15%, according to industry participants, should help buoy prices amid lower productivity and efficiency gains. However, in our view capital budgets in excess of such inflation would fuel some production growth. Consequently, we believe that the spare capacity and US shale producer ability to ramp up production would keep the prospect of higher future prices at bay and we would continue to see backwardation in the oil price curve. As we look at portfolios, we contend the energy trade has become a carry trade over a total return trade of the prior 18 months and one in which the larger, better capitalized exploration and production companies can survive the prospect of increased volatility, while midstream companies continue to benefit from the maintenance of domestic production and the longer-term, fee-based contracted nature of their business.

RA: What risks are you most concerned about in the energy space?

RL: The risks we observe are both positive and negative and can be categorized within the context of OPEC+ behavior, non-OPEC supply response, the macro environment and subsequent demand, and energy transition. As noted earlier, we believe the key near-term factor that provides stabilization in the global oil market remains the behavior

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of OPEC+. The discipline, resolve and cohesion of OPEC+ members in addition to the potential return of higher Iranian production (subject to a deal) are in focus. OPEC+ has, for now, cooperated to maintain market balance, but a slower return of spare capacity or underproduction relative to targets (which has occurred in the past) would place upward pressure on prices. Underinvestment potentially impacts production capacity, which would limit the ability to increase future production. On the flipside, any lack of cohesion and competition within the group would adversely impact market prices and again challenge industry dynamics. Non-OPEC producers, specifically US shale producers, have demonstrated continued capital discipline despite the higher realized prices as they focused on free cash flow generation, balance sheet restoration, liquidity preservation and now shareholder returns. This capital discipline has resulted in a sharp drop in reinvestment rates and underinvestment, which has implications for future supply. We continue to watch how this group reacts to the higher pricing environment and potential to reignite production growth aspirations. Budgets are expected to increase in 2022 given the observed cost inflation, despite increased capital efficiencies (at a decreasing rate) and productivity gains, which may translate into production growth. If this were to occur, OPEC+ would take notice and react accordingly, something US shale producers have witnessed in the recent past. We also observe that restraint from this group factors in the higher cost of capital, as the sector has fallen out of favor with investors alongside increased regulation and energy transition agendas of governments globally resulting in future demand uncertainty. As a result, we believe the market is now more vulnerable to supply disruptions and increased price volatility.

From a macroeconomic and demand perspective, resilience has been demonstrated and demand returned from Covid lows. We continue to watch the impact of new Covid variants and potential to reinstitute restrictions, but the severity and length of time implemented for such restrictions seem so far to be shorter than what was initially implemented. Higher levels of vaccination rates may negate some Covid impact, have aided improvement in mobility trends and may enable continued support of demand growth. GDP forecasts remain healthy at this juncture but other macroeconomic risks we monitor include higher geopolitical tensions in Europe and Asia, political events in the US and Europe and uncertainty over inflation expectations. We're also monitoring how changes to monetary policy will be implemented and the resulting demand impact. Finally, the topic of energy transition continues to be at the forefront and breed uncertainty over future energy demand expectations; the path and speed at which the energy transition will occur remains subject to debate with the power and transport sectors key to the discussion. Public policy has clearly accelerated beyond the reality of the ability to satisfy energy demand with other non-fossil fuel forms of energy. The focus on ESG considerations including emission reductions in line with the Paris Agreement, increasing renewable investments, and lowering carbon intensity/carbon footprints has caused capital be reallocated and even delayed amid a return of energy demand. We acknowledge the transition is occurring and incremental supply is being satisfied by renewables, which is also taking more market share. This does not necessarily mean the demand for fossil fuels is dead, but risks in this sector remain.

RA: How has the US oil industry changed in light of the current environment?

JGC: After experiencing two OPEC-induced cycles, waves of bankruptcies and ratings downgrades, as well as a pandemic (or endemic), US oil companies are understandably reluctant to commit capital and ramp up drilling activity despite today's higher oil prices. Over the last two years, energy companies have maintained an extraordinarily conservative investment strategy aimed at maintaining stable production and operations, exploiting efficiencies to lower cost rather than focus on growth. The oil demand interruptions caused by Covid mobility policies resulted in significant oil price volatility, which has only further instilled industry capital discipline. Company strategies heading into 2022 still indicate a strong preference for capital discipline and the generation of free cash flow in order to complete deleveraging goals and initiate shareholder return programs. There is no question the energy transition theme is playing a role in reducing investment in traditional fossil fuel production capacity. While the US oil rig count has begun to gradually move higher, rig additions have been very slow compared to previous oil

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upcycles. The main concerns of energy companies today focus instead on the direction of OPEC policy, further improving company financial conditions, and the evolving energy transition landscape (including investor concerns about establishing and adhering to policies). On the latter point, companies remain very focused on broad energy transition initiatives, with nearly all large and medium-sized energy companies establishing zero carbon targets. Industry consolidation is a rational and expected response to the varied challenges the industry is facing and enables further scale, lower costs and greater financial flexibility. We believe consolidation will continue to be a major theme throughout 2022.

RA: What effect will decarbonization or zero-carbon public policy initiatives have on future oil prices and supply?

JGC: Historically economic growth has required increasingly greater quantities of energy, supplied at the lowest possible cost, and primarily satisfied/sourced by the coal and oil industries. Today, the global economy faces a significant dual challenge of continuing to provide affordable energy to growing populations around the world while at the same time reducing greenhouse gas emissions in order to limit global temperature increases. Through various subsidy programs and mandates, government decarbonization efforts have encouraged investment in renewable energy projects, with the focus on the electric power generation sector. These mandates and subsidies, along with technological improvements and costs reduction, will enable the production of energy from renewable sources to grow at a high rate. However, these incentives are beginning to have the second order effect of reducing capital flows into traditional fossil fuel energy sources, resulting in limited supply growth over the intermediate term, even despite recent strong oil prices. While we expect OPEC policy will ultimately drive intermediate-term oil prices, the lack of investment in traditional oil and oil-related energy could lead to higher spikes in prices if renewable sources are not able to fill demand. National decarbonization goals have also pushed to the forefront the issue of global energy inequality (energy consumption per capita) between developed and emerging market economies. This issue will complicate the process of meeting longer-term climate targets globally. However, limits to renewable energy reliability and inherent supply intermittency issues likely mean continued reliance on fossil fuels for electricity generation. The pandemic and resulting energy crisis of 2021 have revealed the relative importance of fossil fuel supply stability, particularly in countries that are net importers of energy. Achieving country-level carbon neutrality will require considerable investments in multiple renewable energy sources for decades to come, and related projects will require significant government subsidies and/or the pass-through of higher energy costs to consumers in all forms in order ensure a return on capital for renewable investments. We believe there will likely be a place for fossil fuels in the future but, admittedly, on a smaller scale than in the present day.

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