OVERVIEW
As Coronavirus fears spread, worries about its implications on the economy and overall effects on global oil demand kicked off the decline in crude prices over the last few months.

On Friday, OPEC talks between Saudi Arabia and Russia broke down, resulting in both parties failing to reach an agreement. Existing production cut quotas that have effectively been holding back 2.1mb/d\(^1\) of production from reaching the market are set to expire at the end of March.

While the market largely expected OPEC+ to recognize the drop in crude demand, and come together with some form of production cuts to help support global oil markets, the cooperation between OPEC and Russia (OPEC+) that has been in place since 2016, now appears to have disintegrated.

The news comes on the back of major producers who currently sit on over 3.5mb/d\(^1\) of excess capacity, are now free to produce at will. The combination of oil supply, already some 1.5mb/d\(^1\) above current expected demand, with unrestrained production and what now appears to be a price war between Saudi Arabia and Russia has jolted oil markets and sent oil prices down 27% to $31.14/barrel – levels not seen since 2016.

As we would expect, energy equities have reacted negatively to the downside, with oil & gas exploration & production companies (E&Ps) seeing declines of 30%\(^2\), while integrated oil & gas players fell 16%\(^3\), and midstream energy sector declined 27%\(^4\) after the closing bell on Monday, March 9th. Looking ahead, we expect oil prices to test and potentially overshoot the 2016 lows ($26), given the algorithmic trading nature of markets.

SUPPLY & DEMAND IMPACT
The spread of Covid-19 is likely to weigh on demand longer than initially anticipated, but in our view, gets back to demand growth over the long-term. The supply picture has definitely changed, as both Saudi Arabia and Russia are out for market share, likely putting near-term pressure on the market. Given the capital markets have abandoned the energy industry, the supply story gets weaker the longer the market holds at these lower oil price levels, and production decline rates kick-in on US Shale while global reinvestment falls, in our view.

In contrast to 2015, US E&Ps are responding surprisingly quickly, dropping rigs and fracking crews in time with the oil price, which we believe is reflective of their newly-announced/increased dividends to protect, along with investor intolerance for deficit spending and a lack of capital market funding. As a result, we believe US supply should be less resilient than in the previous 2014 – 2016 price war, when production took 7-8 months to roll over, and even then, the declines were still marginal. US E&Ps will likely be tested, as the marginal supplier should prices stay in the low-$30’s, forcing those less-well positioned players to adapt quicker than in prior years.

Ultimately, the impact of Covid-19 makes the supply and demand picture more difficult to ascertain, especially with recessionary concerns and Saudi Arabia deciding not to support oil prices, which some argue, might just be a negotiating tactic with Russia.

POSITIONING
Heading into March, Jennison had been defensively positioned, trimming exposures on the margin throughout the prior weeks, across both our Natural Resources and MLP (Master Limited Partnership) strategies, given the uncertainty of Covid-19.
From a midstream energy perspective, the dissolving cooperation of OPEC+ is a game changer in our view, and could potentially result in further capex reductions to address the current environment. We will continue to maintain our preference for the large, integrated midstream companies with high, cash-flow visibility and disciplined management teams with strong corporate governance.

**KEY TAKEAWAYS**

As we look ahead, our analysis indicates that $30/barrel oil is not sustainable for anyone – including Russia, given they have budgeted for $45 oil. As Covid-19 fears subside, we expect demand to eventually come back as in all other oil price cycles when supply and demand is imbalanced.

While we could see oil prices head to $25 barrel in the near term – close to the cash costs of even the best E&Ps – we believe this paves the way for oil prices to reach $60 or higher over the next 12 to 24 months as demand returns and the US supply begins to roll. All of this potentially sets a similar stage to the attractive buying opportunity seen in 2016, in our view.

We are continually reassessing the situation and the potential impact to our portfolios and will position ourselves as new information becomes known. In the meantime, we continue to remain true to our investment strategies and put our clients first.

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1 Source: BNP Paribas
2 S&P 500 Index / Oil & Gas Exploration & Production sub-industry
3 S&P 500 Index / Integrated oil & gas sub-industry
4 Alerian MLP Index
5 Source: Macro Advisory

Source for prices: Bloomberg
Data as of 03/09/2020

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