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The oil bubble implosion

Louis-Vincent Gave | GaveKal | 04 March 2015

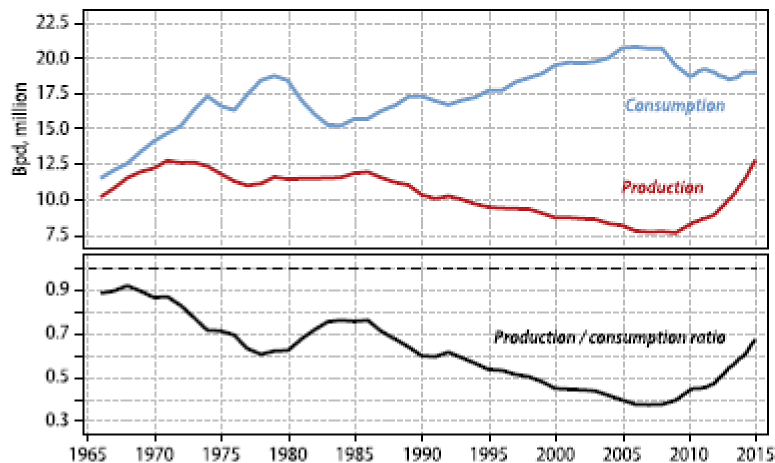
Since the late 1980s, oil prices have only collapsed 50% or more over a six month period on two occasions: during the 2008 crisis and in the period since last August. In itself, this begs some interesting questions. Does the sudden drop in the WTI and Brent price mean that the world economy is falling apart? Or that oil is set to bounce back? Or, finally, that oil was in a bubble which has now imploded?

At this juncture, the first option seems to be a non-starter. Indeed, with most PMIs around the world above 50, with unemployment coming down almost everywhere, with wages starting to pick up in the US, with most large equity markets making new highs, and with US bond yields creeping back up, the world economy is clearly not imploding. This simple truth thus leaves us with two possibilities - either oil prices were in a bubble which has now imploded, or oil is set to bounce back in the near future.

As our more faithful readers know, we have long argued that oil, and commodities in general, were displaying all the typical attributes of a bubble (i.e. "This time, it's different" talk with the hard core belief in "Peak Oil", massive retail participation through poorly understood exchange traded funds, etc...), although the interesting question is why did the bubble take so long to burst? After all, it has been obvious since at least 2011 (see our book Too Different for Comfort) that US oil production was on the rise (Figure 1) along with production in the likes of Brazil, Kazakhstan, and Iraq.

So why did the market take so long to adjust? If, to a hammer everything looks like a nail, then the temptation for a guy sitting in Hong Kong and living and breathing "China" (sometimes breathing in a little more than one might wish given recent pollution readings) is to find the explanation for the sudden shift in energy prices in something done by China. This is what we did last September in a piece arguing that President Xi Jinping's ability to capitalise on Russia's international isolation by cutting China a rather sweet energy deal, transformed China from a price-taker to a price-setter in the energy markets, thereby completely upending the oil market.

Figure 1: US oil production is outpacing consumption (=less oil imports)
BB annual Statistical Review of World Energy data up to 2010, JODI monthly data (w/12mma)



Sources: GavKal Data/Macrobond

But, with the benefit of hindsight, this might not be the only way in which China impacted the energy markets last year. Indeed, one of the single most important drivers of the Chinese economic and political sphere was Xi Jinping's anti-corruption campaign. When the campaign was launched, most (including ourselves) assumed that it would last six to nine months and would prove most useful in getting rid of Xi's political rivals. However, we are 18 months in and the campaign is still going strong. Meanwhile, we have lost count of the number of PetroChina executives now behind bars or under house arrest. Which brings to mind Charlie Munger's pithy observation on corporate behavior: "show me the incentives and I will tell you the outcome".

For years, executives at PetroChina and other state owned enterprises were tasked with finding commodity deals outside of China's borders, with little regard for the price paid. Is it a stretch to think that some deals were done on un-economical terms? But, change the incentives from a few tens of millions of kickbacks in a Swiss/Singapore/BVI bank account to house arrest - or, even worse, a bullet to the back of the head - and all of a sudden, the willingness of Chinese SOE management to do foreign commodity deals melts like this winter's California snow. This is all the more so now that the urgency of securing commodity assets (because of "peak oil", or "peak copper", or "peak iron-ore"...) has disappeared. In that respect, Xi Jinping's anti-corruption drive could have been as much of a catalyst for the sudden implosion of the oil market as Vladimir Putin's late June visit to Beijing.

To put things another way, a lot of the money that flowed into the commodity sector was Chinese because not only did China buy into the premise of the bubble, but also there was a hidden incentive for Chinese decision makers to buy into its premise (the old story of how

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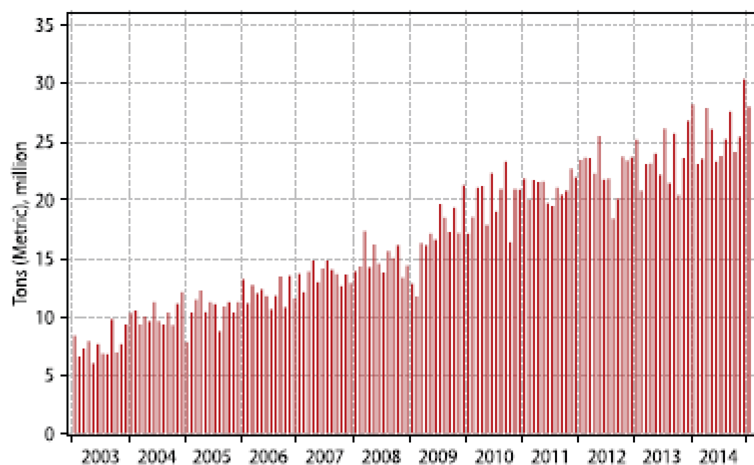
when it is in the interest of someone to look away, they usually end up looking away!). Once this condition changed, the money stopped flowing – and, presto, the bubble imploded.

And, if this is right, then the question becomes: "what changes from here?". In China, the current winds favor a consolidation of SOEs, especially in the energy sector. This, combined with record highs in Chinese energy imports (visible through the rude health of the VLCC market) as well as record high US oil inventories seem to point to a complete absence of upward pricing pressure in the near term pipeline. Simply put, everyone has been using the past few months' dip in prices to stock up and build inventories. Meanwhile, production continues to make new highs, raising the question of where the excess production will go once the ability to store excess oil is all filled up.

Figure 2: Chinese appetite for oil is unabated

Chinese imports of crude oil, volume



Sources: GavKal Data/Macrobond

The conclusion seems obvious enough. We have reached the phase of the cycle when energy producers will try to make up with volumes what they can no longer hope to make through higher prices. Which means that prices will struggle to rebound until some capacity is retired. And, at this stage, it looks like that will take large bankruptcies (in the US? In Venezuela? In Iran? In Russia?...) across the energy sector. Oil was a bubble which has now burst; which means that the next phase of profits in the oil cycle are more likely to belong to lawyers than to investors.

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