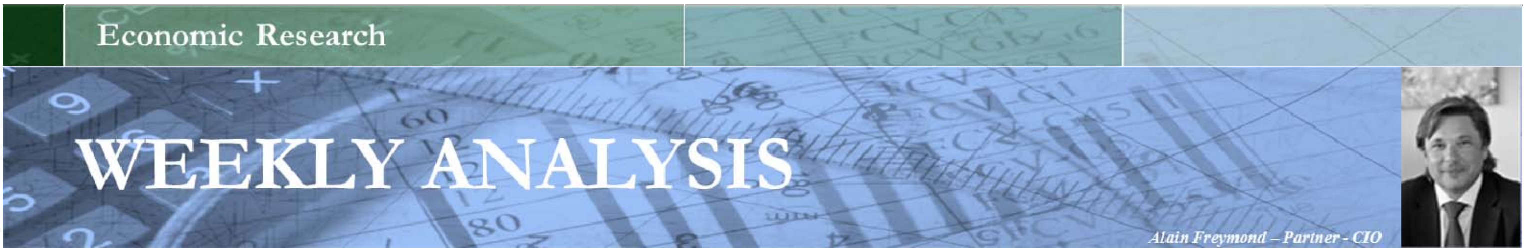


29th October 2015

Saudi Arabia keeps up the pressure on shale oil

Saudi Arabia's strategy is costing it US$ 110 billion and led its rating to be cut to A+, but US production is falling, demand is increasing, and crude oil is benefiting.

Key Points

- Crude oil bounces back +6%, and has its greatest daily increase for 2 months
- Crude oil supply has dropped by 500,000 barrels per day since record levels in June
- Saudi Arabia is paying the price of its strategy with a US$ 110 billion deficit
- Its Standard & Poors rating has been cut to A+ and there has been an increase in CDS
- Saudi Arabia will not change its policy
- The global supply surplus is due to the production of non-conventional oil in the US
- OPEC will not scale back production
- The heat is on for the US oil sector
- The drop in CAPEX is having long-term effects on production capacity replacement
- Global growth is propping up demand
- Crude oil prices should exceed $50-$60

Crude oil prices saw their greatest daily increase (+6%) since the end of August

On the 28th October, WTI (West Texas Intermediate) prices bounced back +6%, whilst activity at US refineries suggested an increase in demand following the summer plateau. As such, crude oil prices tipped back above US $45 per barrel, after having slid a few dollars in the second half of the month. The price per barrel had hit US $50, before uncertainty linked to a surplus in global supply sparked profit-taking by investors concerned that the current surplus supply would continue into 2016.

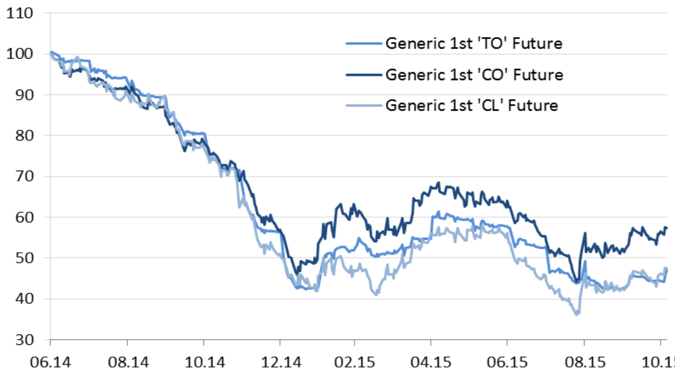
OPEC's statement regarding production would seem to suggest that members are exceeding production quotas at a time when US Crude oil inventories remained high. At close to 100 million barrels, production is a little higher than the 5-year average.

Sentiment may be about to change on the energy market, however. According to the latest comments made by OPEC Secretary General Abdalla Salem El-Badri, demand is increasing, and supply is finally being affected by reduced investment and cuts agreed at the start of the year on the part of oil companies, as well as by a drop in profitability.

US crude oil production is finally showing signs of weakening, as demonstrated by an estimated average 120,000 barrel a day drop in production in September, and an estimated average 500,000 barrel a day drop in production since maximum production levels in June. Crude oil production from non-OPEC members could also drop by 500,000 barrels per day in 2016 according to the IEA. This should go some way to reducing surplus production, which is currently estimated at a total of around 200 million barrels.

We therefore believe that WTI (West Texas Intermediate) prices in the United States should benefit from the overall improved market sentiment and once again head above the US $50 mark before the end of the year; the upward trend looks set to continue into the new year.

Brent (CO), WTI (CL) and Dubai Light (TO) Prices



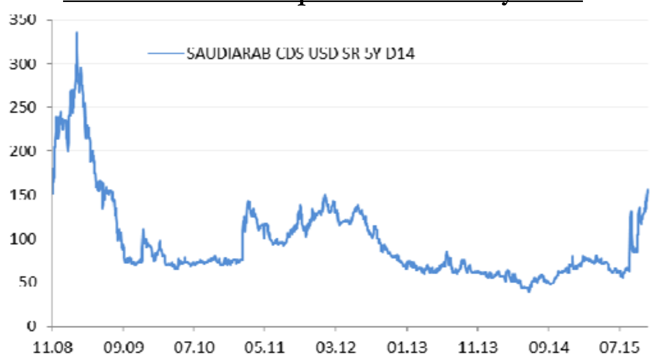
Sources: Bloomberg, BBGI Group SA

The ratings agency Standard & Poors has cut Saudi Arabia's rating to A+, though this will have no effect on Saudi Arabian policy

The ratings agency Standard & Poors cut Saudi Arabia's credit rating to A+ this weekend. In doing so, they have underscored what they perceive to be an increased risk of the kingdom defaulting. It is true that in 2015, the Saudi government's finances have been hit by the drop in oil revenues due to the ongoing decline in oil prices. In 2015, the deficit will undoubtedly hit 16% of GDP, which is equal to US $110 billion. Even though the public debt to GDP ratio (2%) remained one of the lowest in the world, the risk of a deterioration of public finances is perceived to have increased starkly. However, the deficit should gradually drop to 5% per year by 2018 according to Standard & Poors. In the meantime, the public debt to GDP ratio could rapidly shoot above 20% or 30%. The IMF has already pointed out that if Saudi Arabia keeps up their current pace in terms of its deficit, its coffers of currency reserves will have run dry in just five years' time. It is also true that net foreign assets have slumped by a further US $7.7 billion, standing at US $646.9 billion in September- the lowest level since 2012.

In the end, the agency's decision is of no great significance, as the perceived risk of a Saudi default had already increased, as can be seen from Saudi Arabian CDS prices over 2015.

Credit Default Swap Saudi Arabia 5y USD



Sources: Bloomberg, BBGI Group SA

This should not lead to a change in Saudi Arabian strategy. Saudi Arabian budgetary dependency on crude oil prices is nothing new. Oil exports still represent more than 80% of the country's revenue. The deficit is perhaps unusual this time in terms of its scope. Even after five years of surplus (the last deficit was in 2009, when crude oil prices had also slumped dramatically due to the bottom having fallen out of world growth), the situation is of concern to the authorities, who have created a special bureau to monitor ministries' spending. Saudi Arabia has also considered the option of raising fuel prices on the local market and decreasing subsidies. Indeed, in 2014, the World Bank estimated that Golf countries were spending US $160 billion dollars on subsidies, half of which could be accounted for by Saudi Arabia alone. Although in theory this leaves the Golf governments room for manoeuvre, they will undoubtedly find it difficult to make significant changes quickly.

The considerable impact of the drop in crude oil prices on the Saudi Arabian economy cannot be ignored. However, it is not the only economy suffering the effects of decreased oil prices. Most of the Golf economies that are dependent on crude oil exports are in a similar boat. In the United Arab Emirates, the second biggest oil producer, the budget now shows a considerable increase in oil revenues, thanks to a forecast +30% increase in production by 2020.

Despite these difficulties, there will be no change in Saudi Arabian strategy.

Saudi Arabia is keeping up the pressure on the shale oil industry

Saudi Arabia's position may seem risky in the current context, but it is far from being the only country to have to accept a difficult situation due to their trade policy. Most oil-producing and –exporting countries are currently facing the same dilemma. No country, OPEC member or otherwise, seems prepared to take the blow of a decrease in production volume in order to optimise global crude oil supply and reduce current surpluses. No country seems willing to bear the costs of rebalancing a market which is currently producing surplus by reducing the quantity produced.

Saudi Arabia refuses to curtail production to reduce surpluses and boost crude oil prices. It believes that the blame for global surplus crude oil production can for the most part be laid at the feet of the United States, which, alone, should shoulder the responsibility for decreasing production.

The increase in global crude oil production over the last few years has not been driven by OPEC countries. Instead, it is largely due to an increase in US conventional and non-conventional oil production. In 2009, and then again in 2013, OPEC countries slowed production, allowing crude oil prices to increase, but US and Russian oil production increased in parallel, which naturally caused some dissatisfaction among OPEC members.

Shale gas and oil production in the United States all but doubled between 2009 and 2015. The 4 million barrel-a-day increase in production alone is enough to explain current global surplus production.

Saudi Arabia's two-stage strategy

However, the United States' professed desire to become the leading world crude oil exporter only becomes feasible at a price level which makes the production of non-conventional oil profitable. Saudi Arabia has clearly understood the rules of the game and has been moved to action, unilaterally refusing to buoy up oil prices.

The strategy was simple- let crude oil prices drop low enough and for long enough to affect producers with higher production costs in the long-term.

The war against US producers of non-conventional oil had already been deliberately started by autumn 2014 and has continued in 2015.

Saudi Arabia had thus predicted a sharp drop in its oil revenues. The country hoped to rapidly pull down supply to start with, and then weaken the long-term production capacity of actors in the sector. Saudi Arabia therefore sparked a psychological shock and a gradual slide in prices. The crux of the operation, then, lay in the scope and the duration of the desired decrease. The scope of the drop had to be just enough to eliminate or ward off non-conventional actors, but low enough not to drag down the country's own oil revenues too much.

The strategy therefore aimed first of all to hobble the non-conventional oil industry and then reduce its production capacity for the future.

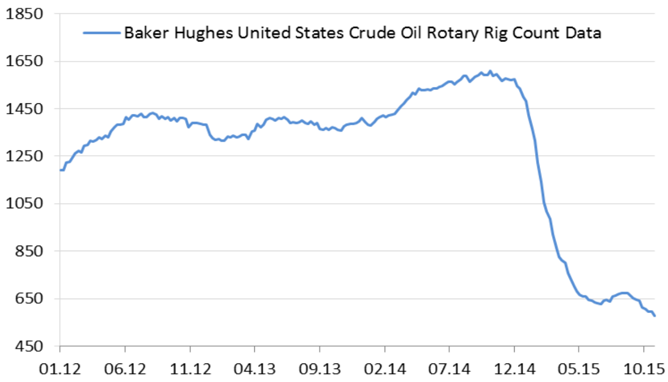
But there were a few unknown variables within this strategy. The first lie in the industry's resistance, as it was difficult to predict exactly how producers would react as their profits and revenues fell. US $60-80 is often cited as the minimum price level for shale oil production to be profitable. It seemed, then, that crude oil prices must drop below this level in order to alter supply. This aim was achieved in December 2014, and then surpassed in the 1st quarter of 2015, when WTI prices hit US$ 42. It seemed that all of the pieces of the puzzle were in place to push shale oil production volumes in the United States downwards.

Production finally slowed in the USA

The effects of the -60% drop in crude oil prices on US oil companies' investments first started to bite in 2015. Many companies announced drastic cuts to their investment spending. The US oil industry then adjusted to the new WTI prices by gradually closing oil wells that had been in operation. There is now the same number of wells in operation as in 2010, following a -60% fall in the number of wells in use.

If oil prices do not bounce back over the next few months, it could hamper drilling activity and the number of wells in operation.

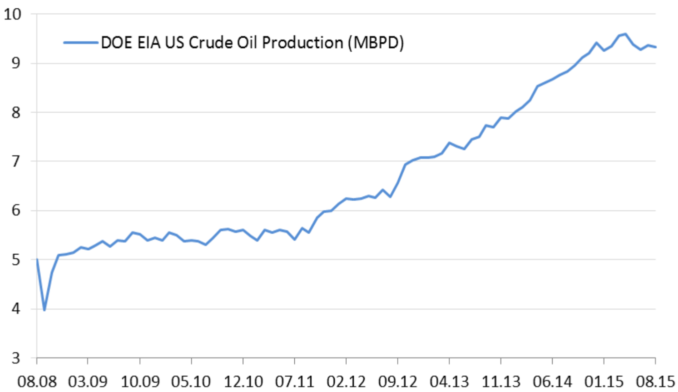
Baker Hughes USA Crude Oil Rotary Rig Count



Sources: Bloomberg, Baker Hughes, BBGI Group SA

Despite the rapid plunge in the number of wells in operation in just a year, to date, production has yet to cave in, but it is showing some very encouraging signs of slowing down.

US Oil Production According to the EIA



Sources: Bloomberg, BBGI Group SA

In its latest figures, the EIA (US Energy Information Administration) revealed that production in the United States remained closed to 9.1 million barrels per day. It has therefore not dropped off considerably, undoubtedly due to optimisation strategies put in place by producers aiming to focus on the most profitable wells.

However, the trend has taken root, and we should see production in the United States continue to drop over the coming winter.

Will the pendulum in this tug-o-war finally swing in Saudi Arabia's favour?

US production seems to be losing steam, and Saudi Arabia is finally seeing some positive results from the strategy it put in place in 2015. It is also enjoying the indirect effects this is having on two other oil-producing countries, Iran and Russia, whose policies stand in contrast to that of Saudi Arabia. These two countries have been weakened by the drop in oil prices. Although today Saudi Arabia is not sat in as comfortable a position as it could hope for, it is still considerably more comfortable than its competitors. The ratings agency S&P has highlighted the deterioration of the state of the country's finances, but it can weather this situation thanks to the reserves that have piled up over the last few years. The increase in CDS has sparked fears that the country's capacity to borrow has decreased, but the current situation has nothing in common with the situation in Russia, Iran, or even among US non-conventional oil producers, whose ratings are generally lower.

We would predict that the vast majority of non-conventional crude oil producers will find it difficult to turn a profit in 2015, despite their efforts to rationalise and focus production on more profitable units.

The shale oil industry is trying to stand strong, but current prices may be pushing it to its limits.

The risk of a default is on the rise, and financing their activities will only become more difficult as time goes by.

Increased demand expected for 2016

Supply is waning and the IEA predicts that global demand could increase by 1.5 million barrels per day, hitting 96.8 million barrels per day in 2016. The resilience of demand is one of the reasons for this forecast, but a 3.5% increase in global GDP will also prop up energy demand.

We must remember that in the medium term crude oil supplies drop by 5% per year on average purely due to the reduced productivity levels of the wells in operation. This must be balanced out by investments in exploration and new production.

In the long-term, the drop in the Capex will affect how easily current production capacity, which is on the decline, can be replaced. In 2015 alone, the oil industry scrapped or postponed development and production projects estimated to be worth almost US$ 200 billion. This represents almost a third of the total necessary annual investment.

We believe that overall, the increase in global crude oil consumption could exceed the IEA's expectations from 2016 onwards, if we see a global economic recovery. An increase in demand should gradually strengthen prices. However, the size of the reserves accumulated over the last few months could stall the oil price revaluation process.

Conclusion

Market sentiment is starting to change.

Saudi Arabia's strategy will cost them US$ 110 billion in 2015, but it now seems to be having the desired effect. The slump in US production should continue.

Global demand should be buoyed up by the global economic recovery and should contribute to reducing production surpluses.

The context is favourable, and oil prices should rise back above US$ 50 and then US$ 60.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch