Global Insights

Running Out of Gas

The combined impact of strong demand recovery and declining COVID-19 cases should support oil prices and energy companies in the near term. We also see OPEC+'s efforts to reduce price volatility benefiting the commodity. Although OPEC's July 1 meeting to discuss policy is a supply-side risk, robust demand combined with a drop in oil production could lead to modestly higher prices over the next six to 12 months:

- Oil prices have recovered, but production remains well below pre-crisis levels. Production cuts have helped support oil prices recently and will likely continue to do so, should producing countries agree to hold current levels steady.
- A strong summer driving season and rapid growth in global air travel should provide positive tailwinds.
- For those seeking exposure, we suggest owning the near-month futures contract in addition to the contracts for the following 11 months as a risk-managed approach.
- We recommend companies in the integrated oil and oil & gas equipment & services industries. We see them as lower-beta plays on strong demand as prices climb to multiyear highs.
**Short-term supply.** In April 2020, OPEC+ agreed to production cuts in an effort to stabilize oil markets that were feeling the economic impact of the pandemic and the Saudi-Russia price war. The supply- and demand-side shocks kicked off a series of production cuts as OPEC+ sought to gain control over the oil futures market, which saw contracts exchange hands at negative prices for the first time in history last year.

COVID-19 related production cuts have helped support prices in the near term and will likely continue to, should producing countries agree to hold steady at current levels. For example, Saudi Arabia, one of OPEC’s largest members, is producing 1.5 million fewer barrels per day (bpd) than pre-COVID levels, and Russia’s output is roughly 1 million bpd less than before the pandemic. In the Americas, similar trends have emerged: Venezuela has reduced its capacity from more than 3 million bpd to around 500,000, and Mexico lost slightly more than 1 million bpd.

**Short-term demand.** Driven by strong demand, oil prices have already risen more than 20% this quarter. According to data from the US Department of Transportation, weekly miles driven are back at 2019 levels. A strong driving season in Europe, which is also quickly reopening, could lead to a sharp rebound in European oil imports as well. On a global scale, total miles driven have surpassed pre-COVID levels, according to MS & Co. energy strategists (see Exhibit 1). In addition to economic reopening, structural trends and behavioral changes, such as increased suburbanization and avoidance of public transportation, may also be increasing miles driven.

**Exhibit 1: Miles Driven Rise as Activity Makes a Comeback**

![Miles Driven Index](image)

**Summer air traffic has also surged, powered by leisure fliers flush with cash and emboldened by COVID-19 vaccination progress.** Jet fuel demand is already showing signs of recovery, with airlines in the US and Europe reporting a significant increase in flight activity in recent weeks. According to Bloomberg data, U.S. travelers have increased by nearly 5% on average each week since early May, while flight departures from the Euro Zone countries have increased nearly 7% over the same period. Based on the number of scheduled passenger flights, jet fuel demand will likely average just over 4.2 million bpd over the next four weeks, adding further upward pressure on oil prices.

Putting it all together, we are likely to see a rapid acceleration in oil demand this summer at a time when inventories are not especially high. Therefore, oil prices could break out on the upside in the short term.

**Long-term demand.** After the COVID-19 recovery has run its course, the oil and gas sector will likely face headwinds that will weigh on prices. We see the expiration of federal supplemental unemployment benefit programs on Sept. 6 potentially hurting aggregate demand. Already, 26 states have ended the programs early, meaning that many could lose a substantial portion of their income. Furthermore, consumers now face rapidly rising prices. For example, US regular gasoline prices have increased from $2.26 to $3.07 since the beginning of the year.

The oil futures curve already seems to point to weaker future demand and is currently trading in backwardation. When the curve is in backwardation, the current price is higher than the future price (see Exhibit 2). This compares to 2019 when the curve was in contango, with the current price lower than the futures price, in anticipation of higher future prices for oil.

**Exhibit 2: Oil Market Shifts From Backwardation to Contango**

![Crude Oil Futures Curve](image)
**Long-term supply.** Growing environmental, social and governance (ESG) constraints and limited access to capital mean that US and European oil producers will not hastily drill new wells or deploy new rigs. On President Biden’s first day in office, he signed an executive order pausing oil and gas leasing on federal land. He also aims to eliminate pollution from fossil fuels in the power sector by 2035 and from the US economy overall by 2050. In Europe, at their June 11 meeting of the EU Council, energy ministers pledged to end support for new fossil gas and oil projects but allowed a transitional period until 2029 for funding of gas projects that would be fully converted to hydrogen. This could help put a cap on future supply growth by Western oil firms and support oil prices somewhat.

However, we see elevated risks from Iranian oil, shale and China. At present, US sanctions restrict the export of Iranian oil, but negotiations in Vienna this month over Iran’s nuclear deal may result in the US lifting these sanctions, allowing Iran to resume exports of crude oil. Additionally, China stockpiled crude oil at low prices during the pandemic, allowing it to exit the market if prices rise too high. Lastly, uncertainty surrounding crude demand in India, the world’s third largest importer, is far from resolved, as COVID-19 cases remain elevated.

MS & Co.’s oil analysts believe that lifting Iranian sanctions would cause supply from the country to rise to 3.5 million bpd in 2022, from 2 million in 2020. This outlook is supported by Iran’s oil minister, who was quoted in May suggesting that Iran should target 1970s-era oil output levels of 6.5 million bpd. In the US, shale activity has begun to ramp up after falling due to COVID-19 restrictions. According to MS & Co.’s analysts, US oil producers have added 170 rigs since August and crews are operating 36% below pre-COVID levels. As a result of the various supply and demand imbalances heading into 2022, the US Energy Information Administration has revised down its 2022 energy outlook from 2021 levels (see Exhibit 3). These developments, while more important for the long term, will likely be in the back of investors’ minds as they enter the oil market.

### Exhibit 3: US Energy Information Administration Short-Term Outlook

<table>
<thead>
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<th>Energy Category</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
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<tr>
<td>WTI ($/bl)</td>
<td>$39.17</td>
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<td>Brent Spot ($/bl)</td>
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<td>Jet Fuel ($/gallon)</td>
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<td>Gasoline Regular Grade ($/gallon)</td>
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<tr>
<td>Natural Gas ($/thousand cubic ft)</td>
<td>$2.11</td>
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<td>$3.05</td>
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</table>

Source: U.S. Energy Administration, Morgan Stanley Wealth Management Global Investment Office as of June 3, 2021

### Investment Implications

Supply and demand dynamics support a bullish near-term outlook for energy prices. With the global economic recovery underway, we see a potential spike in oil prices as expectations for a strong summer driving season and below-trend crude oil production gain momentum. We recommend owning the near-month futures contract in addition to the contracts for the following 11 months as a risk-managed approach. By owning 12 monthly contracts connected as a strip, investors can maintain exposure to the commodity while mitigating potentially adverse spot price moves. Additionally, with oil prices at multiyear highs, we see the integrated oil and oil & gas equipment & services industries as lower-beta plays as prices climb to multiyear highs.
Charts You Can't Miss

**US Petroleum Stocks Are Back at Pre-Pandemic Levels**

[Graph showing US Crude Oil and Petroleum Product Barrels (including strategic petroleum reserve) from Aug '12 to Aug '20]


**Senior Loan Officer Survey Indicates Stronger Demand for Auto Loans**

[Graph showing Net Percent of Domestic Respondents Reporting Stronger Demand for Auto Loans from Jan '19 to Jan '21]

Source: Federal Reserve, Morgan Stanley Wealth Management Global Investment Office as of April 30, 2021

**Miles Driven Accelerate as COVID-19 Fears Subside**

[Graph showing One-Year Change in Federal Highway Administration of Vehicle Miles Traveled Index from Jan '20 to Apr '21]

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of April 30, 2021

**Energy Sector’s Share of the S&P 500 Index Has Pushed Higher Recently**

[Graph showing Energy Sector/S&P 500 Index from May '15 to May '21]

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 31, 2021
Current Readings From Our Quantitative Framework

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Levels:
- Favorable
- Neutral
- Unfavorable

Changes:
- Improving
- Unchanged
- Deteriorating


Ongoing Development Spotlight

Strengthening US Dollar a Headwind for Rising Oil Prices

The US dollar and oil prices have historically been negatively correlated. Easy US fiscal and monetary policy and a rebound in global growth have led to a 13-month decline in the US dollar. But Morgan Stanley’s currency strategists expect the dollar to rebound by mid-2022, primarily driven by normalization of Fed policy. A normalization of US policy sooner than the rest of the world could lead to a rise in US interest rates, thereby increasing the yield advantage of dollar-denominated assets and supporting a stronger dollar. This could lead to a pullback in oil prices, which have traditionally fallen with a strengthening US dollar. – Vibhor Dave

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 31, 2021
Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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