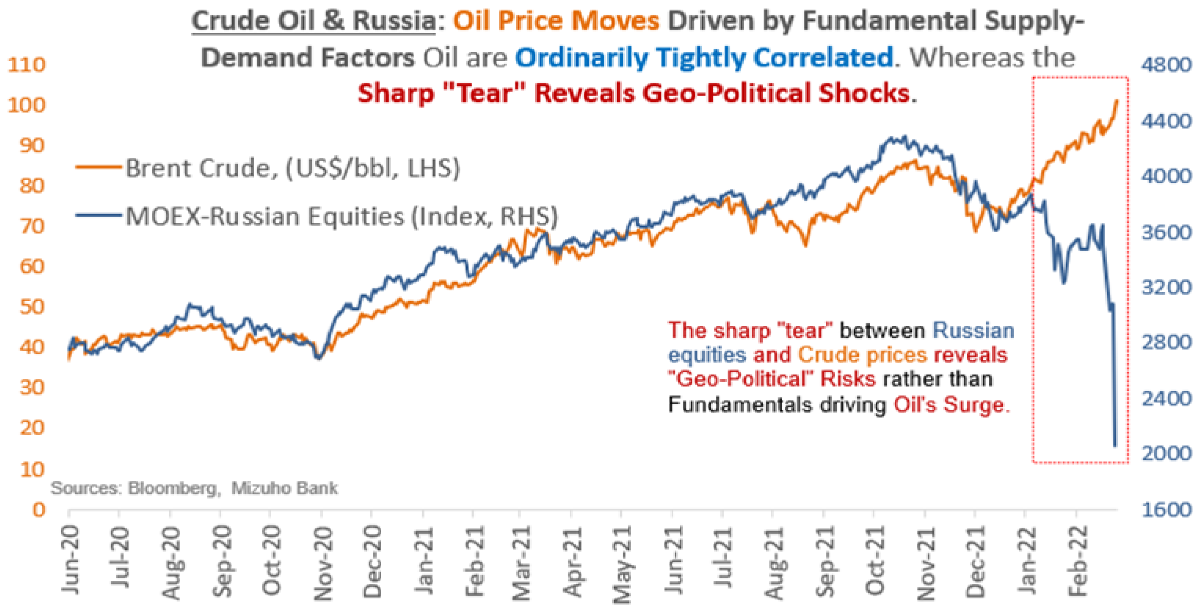
Mizuho Flash: Russia-Oil

Economics & Strategy | Asia ex-Japan

February 25, 2022 | Vishnu Varathan | Head, Economics & Strategy

Oil & Russia's Geo-political Trigger



	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Brent Oil	\$77 - \$115	\$88 - \$138	\$80 - \$120	\$72 - \$100	\$70 - \$96	\$70 - \$93
	\$104	\$112	\$98	\$86	\$78	\$80

Question of Peak Risk Premium & Persistence

Following Russian attack on, and invasion of, Ukraine, **triple-digit Oil is the new reality with geo-political risk premium getting entrenched**. Questions though are; i) how much higher Oil may go on geo-political risks (peak risk); ii) how long it may persist at elevated levels from geo-political risk premium, and; iii) where it is likely to settle thereafter (as and when geo-political risk premium fades).

$100+ Not the Fundamental Default

The pre-supposition is that **$100+ Oil is not the default for the underlying demand-supply condition**s. Point being, ***even with an emergence from the pandemic expected to restore a greater degree of Oil demand,*** the **coincidence of OPEC+ restoration** (gradual as it may be into Q4 2022) from self-imposed COVID curbs, prospects for **re-introduction of Iranian Oil** (~2.0MBpD) to global supply, and expectations of **some supply response from Shale** (even if more muted) is consistent with Oil settling below, not sustaining above, $100 [See Box on Oil Supply Factors overleaf].

Fundamentals Hijacked

But that said, **fundamentals are temporarily hijacked** by a **conspiracy of Russia-Ukraine conflict**, **patchy OPEC+ capacity restoration** and **cartel conundrums/constraints**; imposing significant further upside risks to crude prices. And of these, **Russia rules the roost for now**.

Russia Risks Rule the Roost

Specifically, **with Russia as the second (pre-pandemic)/third (2020) largest exporter of Oil**, the scale of disruption and corresponding *difficulty in readily substituting for Russian supply-at-risk from acute geo-political risks* mean that **price sensitivity to Russian oil disruptions are high**.

As a rough gauge if 30-40% of Russian exports are impacted (corresponding to 3-5% of global supply), prices could jump by 15-30%; which means that **Oil as high as $115-130 is not unimaginable amid elevated risks of a head-on conflict between Russia and the West**. Of course, the *instinct for market over-reactions means that this is a guide, not necessarily a limit.*

Geo-Political Fade?

The **consolation is that geo-political risk premium tends to fade within 8-24 weeks** so long as worst case outcomes are averted and conflicts are contained; as has been the experience of recent decades. Admittedly, it is still ***difficult to gauge the evolution of geo-political risks until Russia's end-game on Ukraine attacks/invasion surfaces to light***. Nonetheless, **while crude may soar, it will likely not sustain at $115-130 indefinitely**.

Capacity to (Eventually) Curtail …

Instead, **as OPEC+ capacity restoration normalizes into Q4 2022**, and Shale responds to extraordinarily elevated Oil prices, we expect Crude prices to peak into mid-2022 and *gradually decline to $75-95 into H2 2022 and 2023* [See Table Above]. **Gradual being the operative term**.

But Compensation & Cartel Taboos Constrain Near-Term

Thing is**, even if Saudi and UAE have spare capacity on paper**, the **ability to unilaterally exploit this spare capacity within OPEC to offset Russian risks** *and* **under-production elsewhere in OPEC+ is compromised**. To say the least this will **involve prohibitively high political costs** entailing cohesiveness within the cartel and the wrath of Russia that is the defacto co-chair.

Geo-politics Lopsided & Overwhelm Initially

Admittedly, there may be compelling moral suasion by US and European allies for OPEC Saudi and UAE to alleviate acute energy shock risks. But a **token output increase to placate US/Western calls to alleviate Oil risks, rather than tectonic shifts that materially subdue prices and jeopardize the OPEC+ partnership**, appears to be the **middle ground reality in the near-term** (3-6 months).

As a result of which, **upside risks to oil are likely to dominate in the coming 2-6 months as geo-political risks to Oil** (rather than pipeline supply buffers) **are likely to overwhelm initially**.

Box: Supply Factors Set to Subdue Oil's Upside

OPEC+ Supply Restoration: To be sure, an **unfettered restoration of OPEC+ capacity** to "base" (Oct '18) levels ought to **consistent with $70-95, rather than triple-digit Oil**. With about another 3-4MBpD of OPEC+ crude output curbed to be eased at a gradual 400KBpD monthly step-up, even with global re-opening demand, demand-supply conditions should turn conducive for inventory building rather than rolling supply crunch.

Iranian Supply in the Pipeline: Moreover, *crude price containment will be more effective if Iran's 1.5-2.0MBpD supply is restored* with a nuclear deal reinstated.

Shale Desensitized, Not Defunct: What's more, **while Shale output is admittedly considerably constrained** by more exacting *profit demands* and *ESG impediments,* it is **not entirely de-sensitized to soaring Oil prices**. And so, even with profit and environmental/emissions restraints, prices above $100 are likely to see rising US output dampening the amplitude and persistence of price shocks.

Important Information
This publication has been prepared by Mizuho Bank, Ltd. ("Mizuho") and represents the views of the author. It has not been prepared by an independent research department and it has not been prepared in accordance with legal requirements in any country or jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Disclaimer
Unless otherwise stated, all views or opinions herein are solely those of the author(s) as of the date of this publication and are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, and are subject to change without notice. This publication has been prepared by Mizuho solely from publicly available information. Information contained herein and the data underlying it have been obtained from, or based upon, sources believed by us to be reliable, but no assurance can be given that the information, data or any computations based thereon are accurate or complete. This publication provides general background information only. It is information in summary form and does not purport to be complete. This publication has been prepared for information purposes only and is not intended by Mizuho or its affiliates to constitute investment, legal, accounting, tax or other advice of any kind and all recipients of this publication are advised to contact independent advisors in order to evaluate the publication, including, without limitation, the suitability of any security, commodity, futures contract or instrument or related derivative (hereinafter, a "financial instrument"), product or strategy herein described. This publication is not intended to be relied upon as advice to investors or potential investors and does not take into account investment objectives, financial situation or needs of any particular investor. It is not intended for persons who are Retail Clients within the meaning of the United Kingdom's Financial Conduct Authority rules nor for persons who are restricted in accordance with US, Japanese, Singapore or any other applicable securities laws.

This publication has been prepared for information purposes only and is not intended by Mizuho to market any financial instrument, product or service or serve as a recommendation to take or refrain from taking any particular course of action or participate in any trading or other strategy. This publication is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or any of the assets, businesses or undertakings described herein, or any other financial instrument, nor is it an offer to participate in any trading or other strategy, nor a disclosure document under applicable laws, rules, regulations or guidelines. Nothing contained herein is in any way intended by Mizuho or its affiliates to offer, solicit and/or market any financial instrument, product or service, or to act as any inducement to enter into any contract or commitment whatsoever. Neither the author, Mizuho nor any affiliate accepts any liability whatsoever with respect to the use of this publication or its contents or for any errors or omissions herein.
Mizuho and its affiliates, connected companies, employees or clients may take the other side of any order by you, enter into transactions contrary to any recommendations contained herein or have positions or make markets or act as principal or agent in transactions in any securities mentioned herein or derivative transactions relating thereto or perform or seek financial or advisory services for the issuers of those securities or financial instruments.

All of the information contained in this publication is subject to further modification without prior notice and any and all opinions, forecasts, projections or forward-looking statements contained herein shall not be relied upon as facts nor relied upon as any indication of future results. Opinions stated in this publication are subject to change without notice. Future results may materially vary from such opinions, forecasts, projections or forward-looking statements. The information contained in this publication may not be current due to, among other things, changes in the financial markets or economic environment. Mizuho has no obligation to update any information contained in this publication. Past performance is not indicative of future performance.

This is a strictly privileged and confidential publication. This publication contains information addressed only to a specific individual and is not intended for distribution to, or use by, any person other than the named addressee or any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation. Save with Mizuho's prior written consent, you may not disclose, divulge, reproduce or furnish any information contained herein to any other party. Please notify the sender immediately if you have mistakenly received this publication.

Singapore: Mizuho is licensed as a bank under the Banking Act (Chapter 19) of Singapore, and is regulated by the Monetary Authority of Singapore.

Japan: Mizuho is authorised and regulated by the Financial Services Agency of Japan.

United Kingdom / European Economic Area: In the UK, Mizuho is authorised by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of MHBK's regulation by the Prudential Regulation Authority are available upon request. This publication may also be distributed by Mizuho International plc ("MHI"). MHI is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

United States: This publication is not a "research report" as defined in Commodity Futures Trading Commission ("CFTC") Regulations 1.71 and 23.605. The content of publications distributed by Mizuho Securities USA Inc. ("MSUSA") is the responsibility of MSUSA. The content of publications distributed directly to US customers by Mizuho is the responsibility of Mizuho. US investors must effect any order for a security that is the subject of this report through MSUSA.