Goldman Sachs Exchanges

Why oil and gold prices could keep rising

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Allison Nathan: Just as energy prices seemed to be settling into a lower range, the latest missile attacks in the Middle East have escalated the prospects of a broader war in the region. At the same time, China has unleashed a barrage of stimulus to support its economy. So, what does this all mean for oil prices and the commodity complex more broadly, especially gold?

Daan Struyven: I think the risks in the short term are skewed somewhat to the upside. Not only because of the possibility of supply disruptions in the Middle East, but also because if you look at speculative positioning, you're in the lowest 1 percent of history.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

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Today, I'm sitting down with my college Daan Struyven, our co-head of commodities research for answers. Daan, welcome back to the program.

Daan Struyven: Thanks, Allison, it's great to be on.

Allison Nathan: So, Daan, lots to discuss. Let's dive into the worry that is front and center on all of our minds, the prospects of a wider war in the Middle East. Oil prices, that had moved to the lowest range in three years jumped after Iran's recent missile attack of Israel and the prospect of retaliation, which continues to linger. What's your take on how these developments might impact the oil market from here after this, what we've already seen, as a very large price move?

Daan Struyven: So, the big question, of course, is whether we are going to see any actual disruptions to supply in the Middle East. I think the reason the geopolitical risk premium had been quite modest in oil prices until basically Tuesday of last week is that despite wars, both in the Middle East and also in Ukraine, with Russia, we hadn't really seen any actual, physical supply disruptions. And on top of that, there's a lot of spare capacity. Basically, 6 million barrels per day of production that is currently shutting.

And so, the big question investors are focused on is this escalation in the conflict in the Middle East going to lead to actual reduction in supply, potentially from Iran, perhaps through physical damage to upstream, midstream, or downstream assets.

Allison Nathan: Right, because that is what is being speculated right now, is that there might be a retaliatory attack against oil infrastructure in Iran, right? That's what I've been hearing.

Daan Struyven: Yes, yes.

Allison Nathan: And so, what would the implications of that be?

Daan Struyven: So, I think it depends on which assets are hit. How much of the production is offline? For how long? And does OPEC step in to offset the losses?

But we can make some scenario analyses. If we, for instance, assume that you get a large, 2 million barrels per day disruption in Iran's supply for two quarters, then brand could shoot up to the mid to high eighties or perhaps even the mid nineties if OPEC doesn't offset the production losses. What I think is interesting is that historically when you look at supply disruptions, for instance in the Middle East, that Saudi Arabia and the UAE, which today have more than 4 million barrels per day of spare capacity together, historically they have offset about 80 percent of loss supply within two quarters. So, that will be a key thing to watch if we were to see actual disruptions.

Allison Nathan: But the other risk that we've talked about on this podcast before is that we don't see the retaliation against Iran directly, but in some way, shape, or form we disrupt supplies through the Strait of Hormuz. How would that differ from an attack on Iranian assets if we think about the potential closure of that strait?

Daan Struyven: That would be very significant. First of all, about one fifth of global oil supply is going through the Strait of Hormuz. And second, while on the surface the fact that you have a lot of spare capacity in countries like Saudi Arabia and the UAE is reassuring in terms of limiting the upside, if you cannot deploy that spare capacity because you cannot get to the Saudi or Emirati barrels out of the Middle East to the rest of the world, yeah, then the upside is highly significant and you could go into a triple digit oil price territory.

Allison Nathan: And what has to happen, do you think, in order for us to see a disruption of that strait, though, at this point?

Daan Struyven: I think it would probably require several escalation steps because you could argue that it is not in the rational economic interests of the major actors here involved to see oil prices spiking and seeing a prevention of barrels coming out of the regions. China is a big oil importer. It would not benefit from higher oil prices. While the US is basically self sufficient in terms of energy now, we think that the short-term impact from higher oil prices is still very negative. And that would be likely undesirable from the perspective of the Biden/Harris administration as well, just four weeks ahead of the US elections.

Allison Nathan: So, OPEC has been in focus. They just agreed to a temporary continuation of voluntary cuts. What are they doing amid all of this? How are they likely to respond amid this elevated risk?

Daan Struyven: I think history shows that when supply from Iran drops significantly or other geopolitically supply-driven disruptions, that typically the core OPEC countries such as the UAE and Saudi Arabia step in. But with a lag. And typically, the rising production from OPEC plus tends to be slower than the drop in the disrupted supply. So, it'd probably mean a tighter market and higher prices until the market rebalances eventually.

Allison Nathan: If we could just take a step back. You know, we hear so much about the US as a very large producer of oil and that that has diminished somewhat reliance of OPEC oil. But can you put that in perspective for us? Because you're still talking about 6 million barrels per day of excess capacity globally. And just to be clear, that excess capacity primarily resides still in OPEC, even if the US has become a large producer. So, we are still facing a potentially large disruption to our global supply that we couldn't compensate for outside of OPEC.

Daan Struyven: Yes. That's correct. The US is now the biggest producer. Roughly 20 percent of global supply is provided by the US. But spare capacity, basically the insurance against supply disruptions is very much concentrated in the Middle East. The three countries: the UAE, Saudi Arabia, and Kuwait together drive about 80 percent of spare capacity. And so, the key question is if we see escalation, will they be able to get the barrels to the market? And second, will they be willing to bring the barrels back to the market?

Allison Nathan: Interesting. So, if we focus a bit on the demand side, I mean, the supply risks, I think, are what's incredibly in focus. But we've also had this big development on the demand side if we think about the pretty large stimulus that now seems to be coming into China from its government to help shore up its economy. How does that factor into the calculus for oil demand? And does that move the needle on the demand side?

Daan Struyven: Not so much. So, I think China has been the big driver of oil demand growth in the five or ten years before the pandemic. The big driver of demand growth on the metal side. But today, you know, the US remains the largest consumer of oil. And we think that the upside risk from China's stimulus to China oil, our China oil demand forecast, which is basically that oil demand next year in China grows 200 KBD, that's still 2 to 3 times slower than the average rate before the pandemic. We think the upside limited.

For one thing, the actual high frequency China demand data remains quite soft. Second, our China economists think that the stimulus package announced so far will only boost growth by 40 basis points. And in a sense that the stimulus is a response to the very weak domestic demand data. And basically, reduces the downside risk as opposed to creating a lot of very significant upside risk. And I think the third reason to pushback against a lot of upside from the China stimulus is that the Chinese policy put is likely a green policy put. If you think about the practical measures that China policymakers may implement, it could be measures that accelerate the shift away from oil. For instance, accelerating the build out of EV recharge infrastructure, encouraging consumers to swap their gasoline driven car for an electric car. And so, I think the boost to green metals demand such as copper would likely be more significant than the boost to oil demand.

Allison Nathan: But in the meantime, we got this very large payrolls number in the US. US growth seems to be humming along at +3 percent. So, much better than I think consensus expectations. How much does that boost oil demand globally?

Daan Struyven: So, we have pretty constructive demand views. I think the key factor is that over the last couple of years, oil demand has surprise to the upside, especially in the US, but also in places like EMEA, except in China. China demand has really disappointed expectations this year. But the trends for oil demand growth in developed markets is now negative because of energy efficiency gains and the roll out of EVs. But we forecast positive oil demand growth, both in the US and the OECD more broadly, precisely because we have above consensus, above trend US GDP forecasts. We also think that Fed cuts will be helpful to support demand, not only in the US, but also elsewhere in the world, especially if faster Fed cuts were to lead to a cheaper dollar, which is sort of relevant for the cost of oil products outside of the US.

Allison Nathan: So, Daan, you've talked us through some price scenarios. If we think about where demand is today, where supply is today, what does that mean for your baseline price outlook? And then what is the upside case and the downside case from here?

Daan Struyven: So, base case is that brands will remain in the 70 to 85 range. Our 2025 brand forecast is 70 - 76. I think the risk in the short-term are skewed somewhat to the upside, not only because of the possibility of supply disruptions in the Middle East, but also because when we look at the fundamentals at the level of inventories, they are somewhat below the historical average. And they're consistent with a price that's a few dollars higher than what we currently see, even after the geopolitical driven rally. Very much consistent with very low positioning data.

If you look at speculative positioning, you're in the lowest 1 percent of history. That said, when I look ahead at 2025, assuming no major escalation in the least, I do think the risks to our 70 to 85 call are skewed to the downside because we have so much spare capacity. And we could in certain scenarios go to the low sixties. For instance, if OPEC were to bring its barrels back to the market for longer than what we expect. There's also some downside risk from potential trade tariffs and a negative impact on global GDP and global demand.

But I think that high spare capacity probably limits the upside over a longer horizon because if you give OPEC enough time and if they can bring the barrels back, that should limit tightening effects from the various upside scenarios we talked about.

Allison Nathan: And so, Daan, I always ask you this, but crude oil prices are one thing and the price of oils that we actually consume, like gasoline and diesel are another.

Daan Struyven: Yeah. We have the price of refined products such as diesel and gasoline ticking up somewhat. We think that the recent sharp decline in refining margins is basically the difference between the prices of gasoline and diesel on the one hand and crude oil on the other hand. We think that some of that sell off was excessive, driven for instance by very negative positioning. We fundamentally think that the global refining system remains quite tight.

In contrast to global crude production where there's a lot of spare capacity, there is very little spare capacity in the global refining system. And so, we look for a widening in refining margins. And that's, ultimately, what matters for consumer prices.

Allison Nathan: You mentioned positioning, Daan. Positioning, meaning investor positioning in oil was very, very low. Very, very short given some of the fundamentals that we have been discussing prior to the risk of these supply disruptions. Where does that stand today after this big run up?

Daan Struyven: Yeah. So, we have data through Tuesday of last week. So, the data missed the latest rally. But through last Tuesday you're still in the bottom 1 percent of history. In September, net positioning of global investors turned negative for crude and product markets for the first time in history. That's 50 years of data. We went negative for the first time. And so, I think that helps to explain why we saw such a big rally last week. 10 percent despite the fact that we haven't seen any actual supply disruptions so far.

So, if positioning is very negative, the risk of a reversal, risks can create a very amplified, very exaggerated response to news.

Allison Nathan: Right, but we don't have a great sense of how far that reversal has gone at this point. But starting at 1 percent seems like there could be a ways more to go.

Daan Struyven: I think you're definitely still in the bottom, bottom 5 percent.

Allison Nathan: Let's talk for a moment about another area of the commodity complex that's gotten a lot of attention lately amid these risks: gold. I mean, gold was on an absolute tear. Does it have much upside from here?

Daan Struyven: We still think there is quite a bit of upside for gold. So, gold prices are now around 2,650 dollars per troy ounce. Our forecast for early next year is 2,900. So, nearly 10 percent of upside from here.

I think what's interesting about gold is that the structural story is quite attractive with central banks realizing since the freezing of gold reserves for Russia in 2022 that you need to diversify your reserves away from the dollar. The dollar can be frozen away by other countries. And so, we think that this big trend we have seen, namely a sharp tripling in purchases by central banks of gold, that this trend is not going to go away any time soon. So, that's the very bullish structural backdrop.

Then on the cyclical side, we're entering a global easing cycle. The Fed is cutting. We look for six additional 25 basis point cuts. China, perhaps in part because of Fed cuts, decided to also ease monetary policy. And so, you're basically lowering the opportunity costs for investors to hold gold if global interest rates come down. And so, the cyclical boost from Fed cuts and global rate cuts for gold is very significant and it's not in the price yet. It's different from bond markets which can really price forward the easing cycle.

In the gold market, we find that ETF holdings of gold tend to rise only very gradually when the actual policy rates in the world come down. So, I think it's structurally cyclically a very interesting investment opportunity. And then last but not least, I think it gives you a lot of hedging opportunities against alternative scenarios where equities and bonds would perform less well.

Allison Nathan: Right. So, it sounds like you are more bullish on gold and oil, unless we do see a major supply disruption ahead.

Daan Struyven: That's the perfect summary.

Allison Nathan: But just to that point on diversification. So, gold is the diversifier? I mean, sometimes we think of oil as a diversifier in these moments as well. But gold is more likely to play that role in a portfolio today than oil?

Daan Struyven: I think that the fact there is so much spare capacity on the oil side limits, to some extent, you know, the inflation hedging benefits from oil relative to its traditional very strong capability to protect investors in portfolios against unexpected inflation shocks. Now, if you were to see a major supply disruption on the oil side in the Middle East, oil would be a very effective hedge. But we think that the benefits for gold are potentially broader.

So, if you think about what are the global macro risk scenarios that investors worry about, I think many of those concerning scenarios are scenarios where gold would do quite well. For instance, if we were to see an escalation of trade tensions, what we saw in 2018 is that when tariff increases were announced, that gold typically rallied while the stock market dropped. Another potential concern is if you get unified government in the US after the November elections with sharper then expected fiscal easing, markets may start to worry again about sovereign debt sustainability issues. Gold would likely do well. If we were to see the next US president potentially trying to influence monetary policy more significantly, what would happen? I think gold would perform well.

So, if you sort of go through the various risk scenarios that macro investors can worry about, I think in many of those non-central, more adverse downside scenarios, gold is your good hedge.

Allison Nathan: Thanks so much, Daan, for joining us.

Daan Struyven: Thank you, Allison.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Monday, October 7th, 2024. I'm your host, Allison Nathan.

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