The Organization of Petroleum Exporting Countries (OPEC) has been in existence for nearly 60 years. OPEC is the textbook definition of a cartel, but cooperation between member nations has been inconsistent. OPEC’s production targets have generally served as a gentlemen’s agreement, with member nations often prone to producing more than their allotted quota of crude oil.

Two years ago, Saudi Arabia formally abandoned production targets and began pumping massive quantities of crude, which was seen as an attempt to regain market share lost to rapidly growing North American shale producers. Since then, lower crude oil prices have forced shale producers to cut over one million barrels of daily US crude oil production.

But the shale industry responded with grit and ingenuity – cutting costs and improving drilling technology and efficiency. While there have been bankruptcies and layoffs along the way, many of the more efficient shale producers remain profitable. In Saudi Arabia, falling oil prices have hurt the standard of living across the socioeconomic spectrum, dampened economic growth and put Saudi Arabia’s sovereign credit rating at risk. Saudi leadership is now under extreme pressure to revive OPEC production targets and support the continued recovery of crude oil prices.
OPEC members struck a tentative deal in late September to reduce crude oil production. Although final terms have yet to be inked, our most insightful sources lead us to believe that Saudi Arabia will ultimately move forward with or without concessions from Iran.

Here’s why:

- The Saudis are facing significant political pressure at home, due to budget cutbacks that have reduced the standard of living for every part of the kingdom’s society.
- Saudi Arabia needs to avoid a downgrade to its sovereign credit rating before coming to market with another $15 billion debt offering aimed at covering a yawning fiscal gap.
- Saudi Arabia is facing the upcoming initial public offering of its state oil company, Aramco, and needs to maximize the proceeds of the equity offering.

The seven-year commodity cycle and crude oil prices

Since the abandonment of the gold standard in the early 1970s, commodities have cycled through strength and weakness within a consistent seven-year timeframe. In February, I wrote that commodity fundamentals and price action appeared to signal the advent of the next seven-year commodity cycle – historically, a period of significant opportunity for commodity investors. When crude oil prices reached $50 per barrel in May, we at PowerShares maintained our constructive stance on commodities as a whole, but were wary of crude oil fundamentals. We reasoned that crude oil prices were likely to backfill over the summer and trade near $50 per barrel by the fourth quarter. Much of the boost in oil futures at that time was clearly short-term in nature – the result of wildfires adversely affecting Canadian oil sands production. Oil producers in the US rushed to sell crude between $50 and $51 while they had the chance, but it was a temporary phenomenon.

Now the story is different.

OPEC deal could reduce crude oil production, boost prices

If OPEC agrees to cut production, as we believe the cartel will, crude oil production could be slashed by 900,000 barrels per day and prices may begin to stabilize in the low- to mid-$50 per barrel range possibly between now and mid-2017. Against this backdrop, some prudent near-term producer hedging will undoubtedly occur. However, the same savvy that drove many to opportunistically hedge production at $50 per barrel early in the year may result in the patience to let crude prices grind to higher levels before the current rally is capped.

Indeed, we have not yet seen the increase in 2017 crude oil futures open interest (outstanding contracts) that one would expect if hedging activity had picked up following OPEC’s recent proclamations. This suggests that crude oil prices still have room to run before producer hedging blows a headwind into the market.

Investors seeking to gain access to the energy markets may wish to consider PowerShares’ lineup of commodity ETFs – some with targeted energy exposure. PowerShares ETFs offer a cost-effective and
convenient way to invest in commodities and feature a rules-based, optimized yield strategy that seeks to optimize futures roll yield.

**Important information**

Roll yield is generated by rolling a maturing futures contract to a later-dated futures contract.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

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*On second thought: Saudis under pressure to reverse course and cut crude oil production by Invesco*