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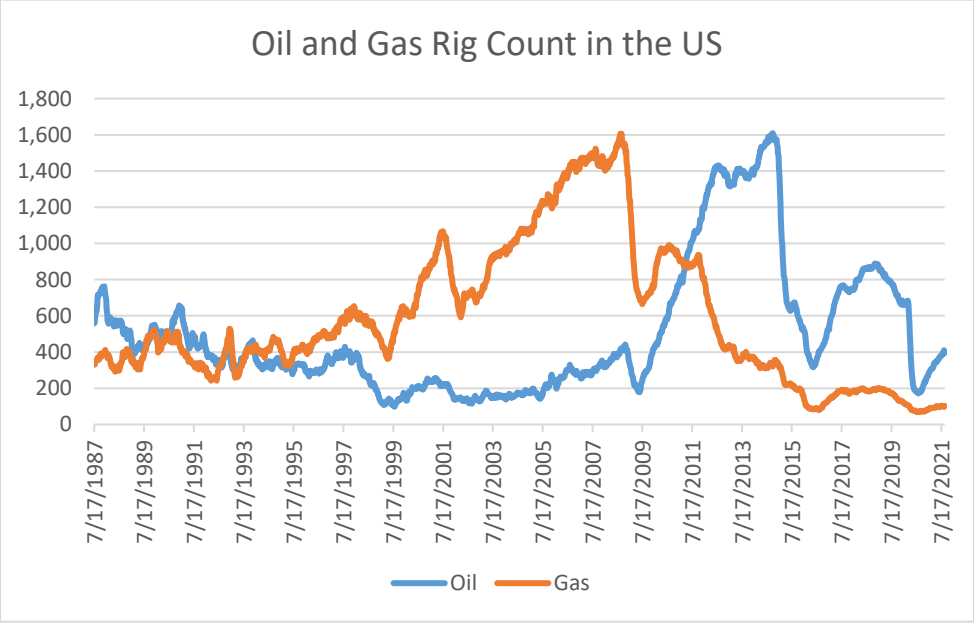
US Shale Oil Recovery, US Car Inventory Decline & its Impact on the US Yield Curve

US Shale Oil Recovery

This week's US Baker Hughes rig count pointed towards a -16 rig decline, which stands in stark contrast to the 5-10 rig increases we have seen over the last three weeks. The reason for this week's decline is due to Hurricane Ida, which led to platform closures in the Gulf of Mexico. If we were to exclude offshore rigs, the oil rig count actually increased by 2, although inland was of course also affected by Hurricane Ida. Overall, drilling activity worldwide is recovering, which is mostly down to US shale oil drilling returning slowly. Total world rig count remains down almost 30% compared to pre-pandemic times, although demand is only down by around 2% currently according to EIA. As mentioned earlier this week here page 4, since drilled, but uncompleted (DUC) wells are declining and oil rig count is increasing, oil production per rig remains relatively stable/declining a touch lately. I expect US oil rig count to increase further over the coming months in order to sustain US oil production at current levels, as DUC wells are approaching their low 2016 levels. Hence, the oil rig count climb should actually start to accelerate now.



Source: Baker Hughes

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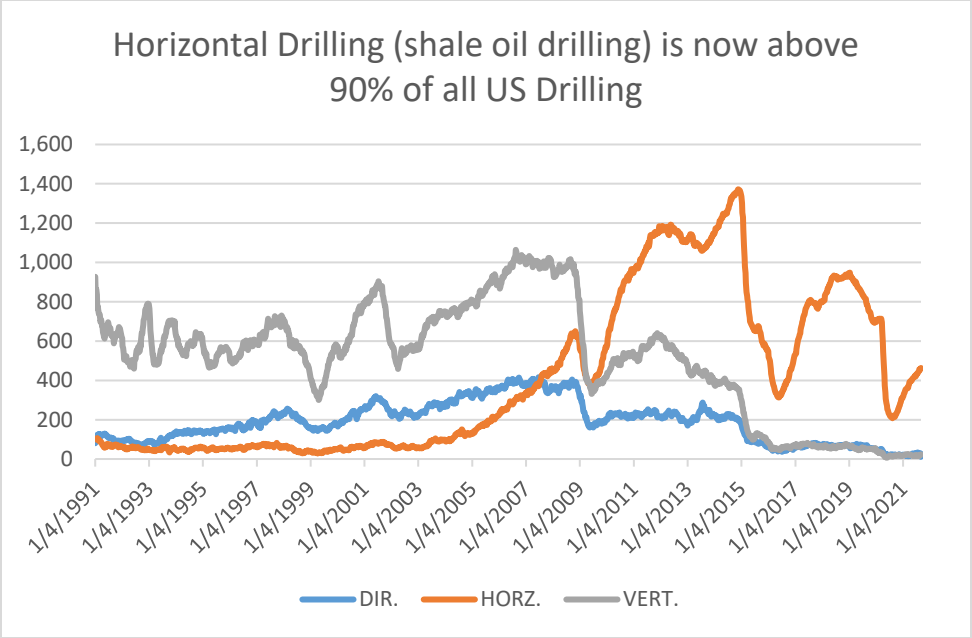
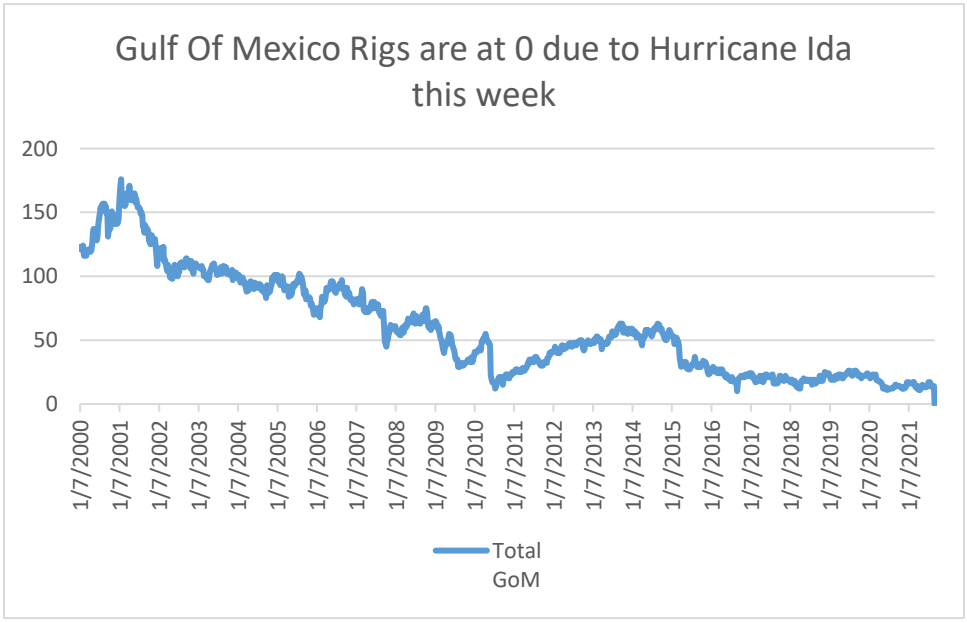


Source: Baker Hughes



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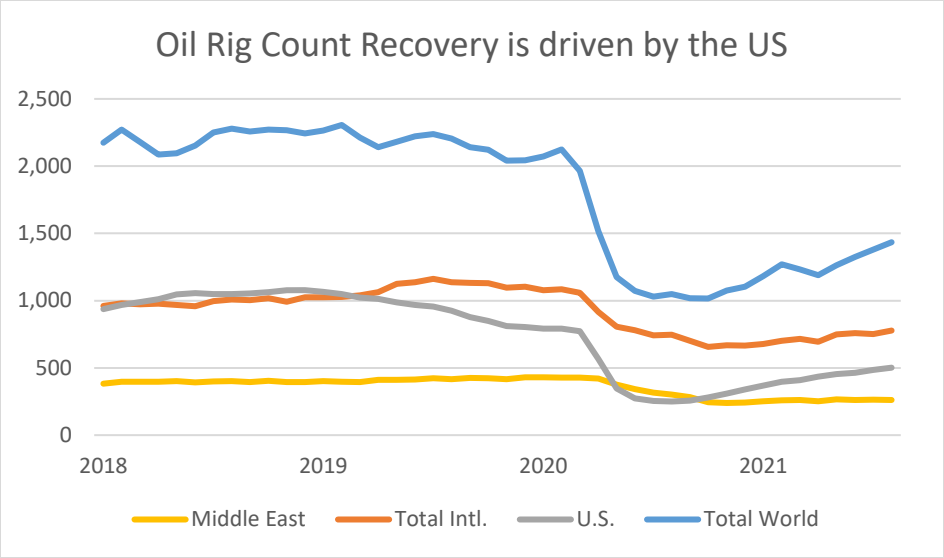
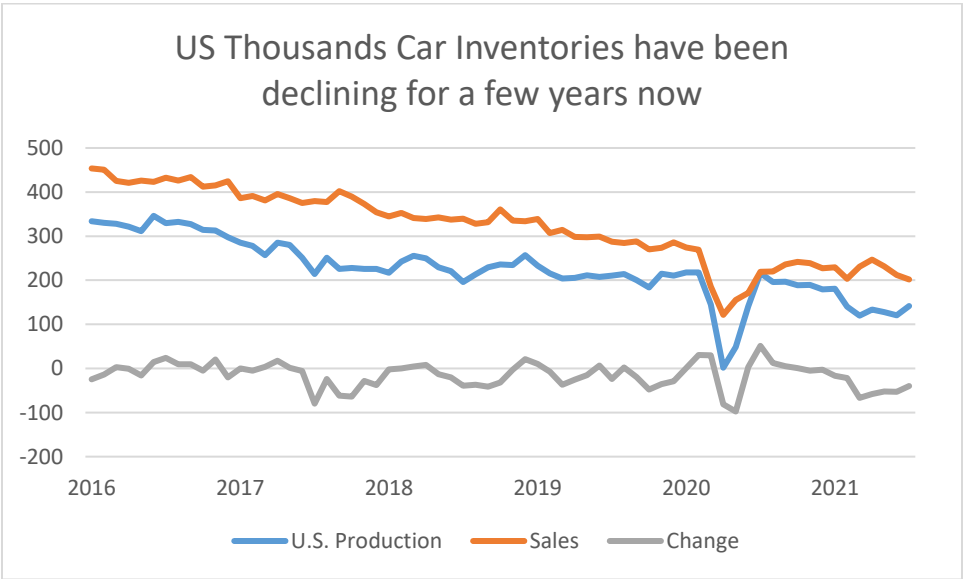


Source: Baker Hughes

US Car Inventory Decline

US car sales have declined more rapidly than expected in August, as mentioned here page 5. The semiconductor shortage and Covid related shutdowns affect the supply of new cars. Moreover, this will also likely slow down the transition to electric vehicles, since fewer new (electric) cars are being produced and used (combustion engine) vehicles stay in hot demand. The decline in vehicle sales in August is, therefore, not a demand issue, as demand remains strong for both electric & combustion engine vehicles, but purely based on supply. On February 3rd, 2021, GM released a statement regarding production impacts due to the chip shortage here. In below chart it is visible how this translated into lower production and a resulting decline in inventories, while demand stayed strong.



Source: Bureau of Economic Analysis

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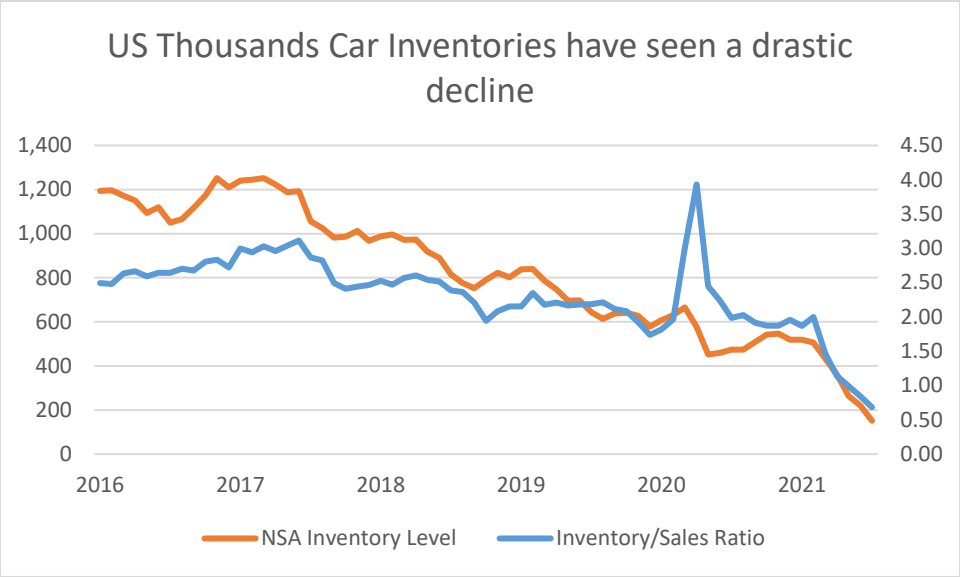

Source: Bureau of Economic Analysis

Impact on US Yield Curve

In a research note in June 2021 (here) I compared the US yield curve over the last decade to point out the similarities of the current Fed liquidity, tapering prospects and the dot plot with 2013. Back then, similar to now, the Fed ensured to keep ample liquidity in the system while tapering its purchases, which led to the overnight repo facility being in constant use at $200-500bn daily. Different to 2013, however, we are experiencing supply chain constraints that led to inventories drawdown, such as in US automobiles, and energy & raw material shortage, again due to a decline in supply, while at the same time a higher than expected return in demand. The transitory features of inflation seem to be gone, but the real risk is a broader inflationary environment, in which the Fed will raise its dot plot faster than expected and increases the pace of tapering to $10bn or more (to finalise in 8 months or less), announcement expected in November to start in December. By August 2022 tapering will then be finished, the Democrats will be eager to push through their public spending before Mid-Term elections, which would then mean higher treasury issuance, lower Fed buying, and lead to higher US Treasury yields. While the bull flattening might have stopped for the moment, the trend towards higher yields is not as clear as it might sound, as we have risks from a slowdown in China and the potential of credit agency actions on sovereign debt, which could lead to a risk sell-off similar to that in August 2011. Especially at current equity valuations, the supply chain issues and resulting input price inflation, at a time when inventories are low, could lead to lower margins, lower equity prices. There is only one time period that was similar to the current one – the forgotten depression of 1920 where corporate profits declined by -92%.

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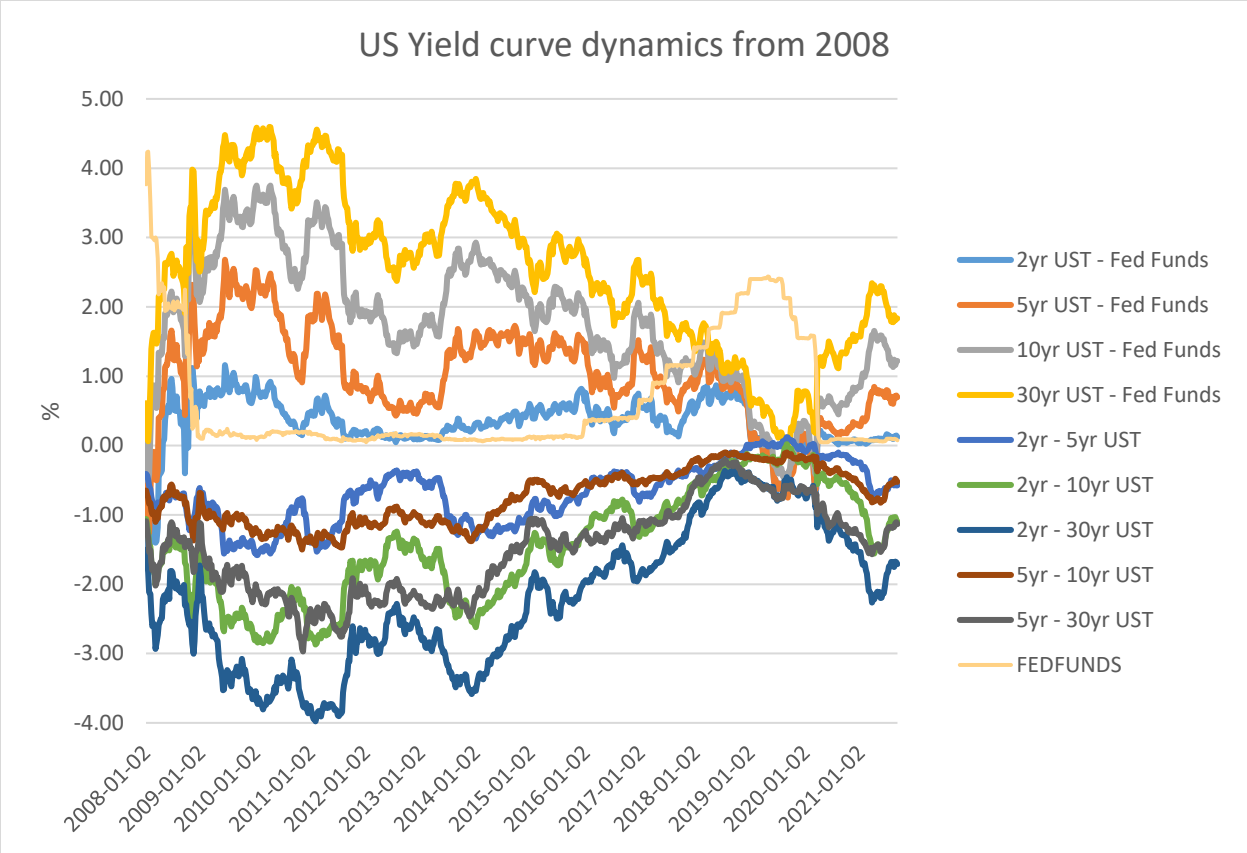

Source: FRED St. Louis

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