Economic Update

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Oil markets

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Oil markets roiled by coronavirus as global oil demand projections slashed

Highlights

- **Oil prices pummeled by the coronavirus epidemic, dropping to a more than one-year low of $53/bbl (Brent) in February.**
- **Markets have rallied recently, though, on Libya/Venezuela supply-side concerns and as China unveils economic stimulus measures.**
- **The IEA slashes global oil demand growth projections by a third as the virus impacts Chinese energy demand and economic output, disrupts international travel and global supply chains.**
- **OPEC delivers on compliance, but further production cuts—dismissed by Russia—required to balance demand in 1Q20.**

Viral epidemic spreads to the oil markets

Oil prices have been buffeted by the impact of the coronavirus outbreak, which forced a virtual shutdown of the Chinese economy in early February and disclocated global supply chains in the process. Brent crude, the international benchmark, fell to $53.3/bbl (-19% ytd) on 10 February, its lowest in more than a year, when it looked like the world was on the verge of a pandemic that would cause significant destruction to oil demand, especially in terms of the impact on Chinese consumption and global transportation fuels. (Chart 1.)

Energy agencies and research houses have since responded with a flurry of downward revisions to their global oil demand growth projections, by as much as 50% in the extreme. With oil supply balances threatening to tip into a sizeable surplus, OPEC and its partners looked to convene an extraordinary meeting to discuss deeper crude production cuts in the hope of reining in the glut and propping up the oil price. The group's technical committee suggested an additional cut of 600,000 b/d, but due to Russia's reluctance, the proposal has yet to be actioned. OPEC is scheduled to meet on 5 March.

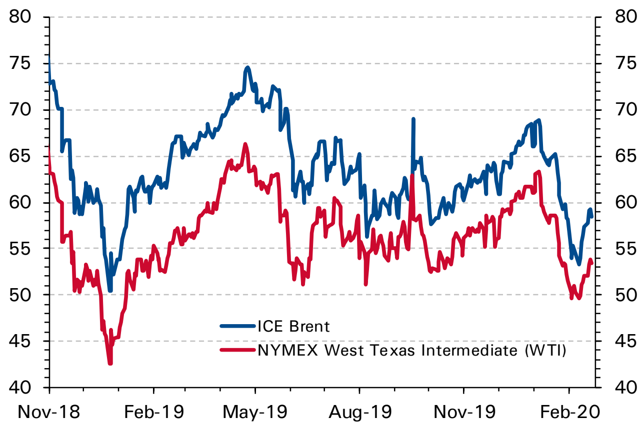
Prices have recovered somewhat

Brent has advanced almost 10% over the last nine trading sessions to around $58/bbl in the longest run of gains in more than a year. Both demand and supply-side factors were at play. On the demand side, it was thought, at one point, that China had got a firmer grip on the virus' spread and that Chinese economic activity would be a little closer to resuming. News over the last weekend that the authorities were having to re-assess how they were calculating infection rates threw the market a little off, pushing oil prices down last Friday. Nevertheless, to boost domestic demand China and other East Asian countries have announced a series of fiscal stimulus measures to kick-start their economies. China's central bank also cut its benchmark interest rate, and the government has lowered corporate taxes as well.

On the supply side, news that Libya's crude oil exports—already laid low due to the ongoing civil war—were further curtailed after forces loyal to General Haftar started shelling the Tripoli port, helped lift oil prices. Only last week, markets were bracing themselves for a possible agreement between Libya's two warring factions that would see more than 1 mb/d of oil exports hit the market once more, which would further exacerbate the supply glut. Supply pressures increased a little further on February 18th when the US sanctioned a subsidiary of Russian oil firm Rosneft for allegedly helping Venezuela skirt US oil sanctions by facilitating the Maduro regime's oil exports.

Chart 1: Crude oil prices

($/bbl)



Source: Refinitiv

Oil demand growth estimates for 2020 slashed

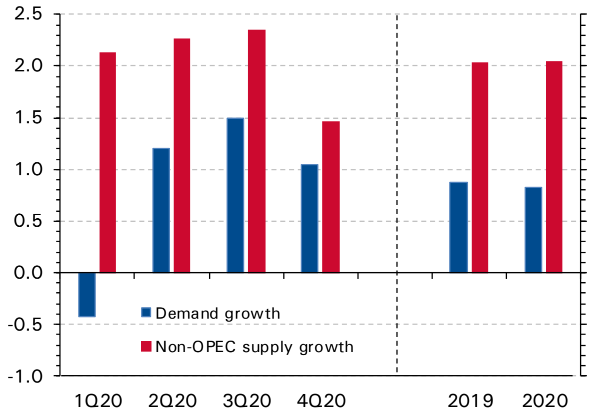
Both major international oil agencies, OPEC and the International Energy Agency (IEA), have slashed their 2020 oil demand growth forecasts in the wake of the coronavirus outbreak. Transportation fuel demand—aviation fuel especially—and Chinese industrial production have been particularly hard-hit, with ongoing knock-on effects on global oil demand. This is not surpising considering that China accounts for more than 13% of global oil demand and was responsible for two-thirds of last year's growth in oil demand.

The IEA cut its estimate by 31% (365 kb/d) to 825 kb/d—the slowest growth rate since 2011—while the OPEC Secretariat shaved a fifth (250 kb/d) off its projection and has global growth averaging around 1 mb/d this year. (Chart 2.) Meanwhile, Goldman Sachs caught the headlines when it cut its estimate by almost half. Naturally, Q1 sees the the bulk of the hit, with the IEA estimating that global demand growth could, by the end of the quarter, post its first year-on-year decline (-430 kb/d) since the financial crisis in 2009.

All the major reporting agencies base their oil demand growth projections on the assumption that the viral epidemic is brought under control in 2Q20 and that oil demand normalizes thereafter, boosted by the above stimulus measures. The International Monetary Fund, while agreeing with the eventual economic acceleration narrative, just reported that coronavirus could reduce global economic growth by 0.1%, though it is also looking at 'more dire scenarios'.

Chart 2: Oil demand and non-OPEC supply growth

(annual change, mb/d)



Source: International Energy Agency (IEA)

Stockbuilds likely amid non-OPEC supply gains

Demand destruction has exacerbated a preexisiting supply overhang due to surging non-OPEC supply. Even with OPEC+ production cuts, markets were already nervous about the supply glut. Neither the IEA nor OPEC expect the coronavirus outbreak and recent falls in oil prices to lead to a curtailing of supply from non-OPEC oil producers. The IEA pegs non-OPEC supply growth this year at just over 2 mb/d. (See Chart 2.) This is little changed from 2019, and driven primarily by the US but also increasingly by Brazil, Norway and Canada. This is almost double the expected rate of oil demand growth for the year, leading to a rise in global crude and petroleum product inventories, the bulk of which are expected to accumulate during this quarter. The supply overhang could be in the order of 150 million barrels if OPEC production remains at Janaury's levels and demand and non-OPEC supply come in as per the IEA's estimates. Global stocks will only begin to draw down in 2H20 as demand recovers to reach its traditional northern hemisphere summer peak in the third quarter.

OPEC delivering, but further cuts dismissed by Russia

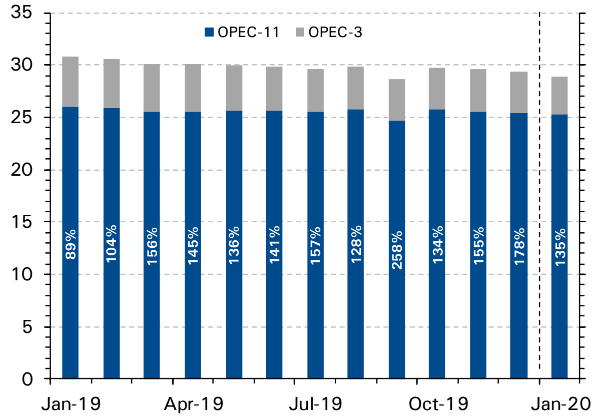
With oil demand drastically impacted and non-OPEC supply growing robustly, attention has shifted once again to how OPEC and its allies will respond to the situation. Achieving oil demand and supply parity for 1Q20, the IEA estimated, would require OPEC to cut another 1.7 mb/d off its January production level of 28.86 mb/d to 27.2 mb/d.

While Saudi Arabia appeared willing to consider paring back production after the group's Joint Ministerial Monitoring Committee suggested cuts in the region of 600 kb/d to help rebalance supply and demand, Russia was less obliging. It preferred to extend rather than deepen existing cuts into 2Q20.

OPEC secondary source data for January showed that the producers' group was bringing down production in line with December's agreement, which called for further cuts of 372 kb/d from OPEC and 132 kb/d from non-OPEC, effective January 2020. OPEC-11 output fell by 157 kb/d to 25.2 mb/d, once again thanks primarily to Saudi Arabia, Kuwait and Angola. Overall OPEC-11 compliance was 135%, with the UAE, Iraq and Nigeria among the big producers yet to comply with the new quotas.

Chart 3: OPEC-11 production

(mb/d)



Source: OPEC; OPEC-3 refers to Iran, Venezuela and Libya

Some optimism despite preponderance of downside risks

It remains to be seen how badly oil demand has been hit—and how OPEC will respond once they meet in March. There is some grounds for optimism, however, that a combination of rebounding demand, extended OPEC+ production cuts and continued supply outages will minimize the oil supply overhang. The hope is that these factors keep oil prices afloat in the $60-$70/bbl range.

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