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Economic Update

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Oil Markets

Oil prices recover in October, supported by OPEC+ cuts and tighter market outlook

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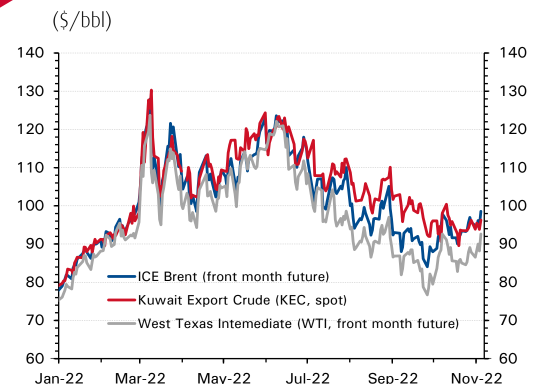
Summary

Oil prices recovered in October, boosted by the OPEC+ decision to cut production by 2 mb/d for 14 months effective November. OPEC+'s announcement has helped put a floor on prices and, in tandem with expected supply shortfalls and moderate supply gains from Russia and non-OPEC countries including the US, respectively, the market should remain tight even as oil demand softens amid weaker global economic activity.

- Oil prices staged a turnaround in October, boosted by the OPEC+ decision to reintroduce production cut quotas for the next fourteen months and amid continued physical market tightness. International benchmark Brent crude ended the month trading at $94.8/bbl, posting a first monthly gain, of 7.8% m/m, in five months. US crude marker West Texas Intermediate closed the month up almost 9% at $86.5/bbl. Local grade Kuwait Export Crude (KEC), in contrast, closed down 2.3% m/m to $93.4/bbl. By the end of the first week of November, prices had increased further, with Brent reaching $98.6/bbl on reports that China could ease some Covid-related travel restrictions. (Chart 1.)
- Prices firmed along the downwardly sloping Brent forward curve in October, where near-term contract prices are above longer-term prices (backwardation). (Chart 2.) The often-watched front month spread (M1-M2) was ranging higher, towards a positive $2/bbl towards the end of the month. Traders usually view this as a sign of a tightening market. The recovery in money manager net length to June levels of more than 200k Brent futures and options contracts (as of 25 October) has been marked, and a sign of the renewed bullish sentiment pervading money managers and speculators. (Chart 3.) Indeed, 'open interest', a measure of the total number of outstanding derivatives contracts, was back at March levels of above 2 million contracts by the end of the month, which is positive for market liquidity.
- October's oil price recovery occurred despite concerns about the health of the global economy amid aggressive central bank monetary tightening, surging consumer prices, the destabilizing conflict in Ukraine and relatively weak Chinese economic activity. The latter has been aggravated by repeated Covid-19 mobility restrictions and a property sector downturn. The International Monetary Fund's (IMF) October World Economic Outlook forecast that world GDP growth would slow from 3.2% this year to a downwardly revised 2.7% in 2023. There is a 25% chance that year-ahead growth could drop below 2%.
- Following on from the weaker economic forecast, the International Energy Agency (IEA) revised down again its outlook for global oil demand growth, by 80 kb/d from its previous report to 1.9 mb/d this year, which should see oil demand average 99.7 mb/d for the year as a whole. (Chart 4.) This is on the back of a heavy downgrade to growth in the current quarter, with the agency seeing oil demand contracting by 340 kb/d year-on-year (to 100.6 mb/d) amid a multitude of 'disruptive market forces' including 'unrelenting inflationary pressure' and higher energy prices that are adversely affecting demand. The OPEC+ supply cut was also cited by the IEA as a contributing factor. Next year's demand growth forecast was also downgraded, by a large 550 kb/d to 1.65 mb/d, with 1Q23 being the weakest quarter (99.45 mb/d). Oil demand should, nevertheless, finally top pre-pandemic levels, at 101.3 mb/d. In contrast, OPEC is more bullish about the prospects for oil demand, even after shaving a sizeable 780 kb/d and 710 kb/d off its 4Q22 and 2023

Chart 1: Oil prices

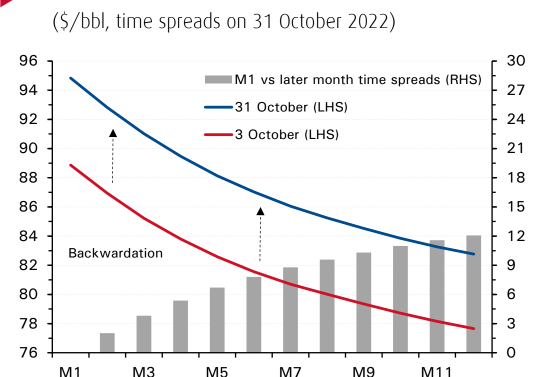
($/bbl)



Source: Refinitiv, Bloomberg

Chart 2: Brent forward curve and time spreads

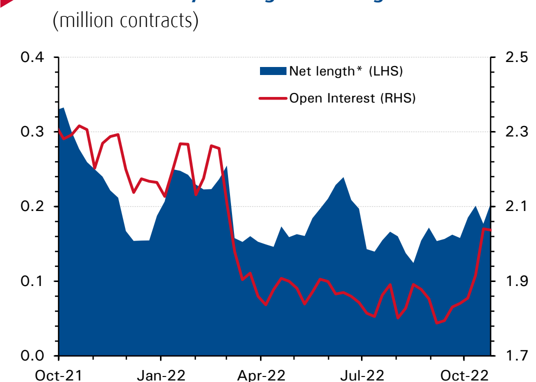
($/bbl, time spreads on 31 October 2022)



Source: Refinitiv

Chart 3: Money manager net length

(million contracts)



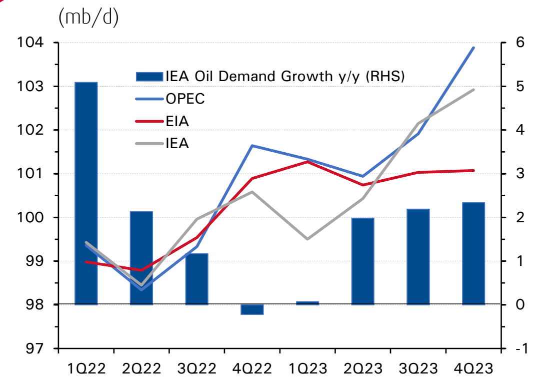
Source: ICE, Bloomberg, Refinitiv; *futures and options

demand growth estimates, respectively. It pegs growth at a robust 2.64 mb/d (to 99.67 mb/d) in 2022 and 2.34 mb/d (to 102.2 mb/d) next year.

- In terms of global stock movements, the IEA reported a net increase in oil inventories (OECD) as of end-August, with a second consecutive monthly build in commercial oil stocks (+15 mb), as supply outran demand during the summer period. At 2,736 mb, however, industry stock levels still remained well below the five-year average by a considerable 243 mb. The IEA noted that commercial levels would have been even lower had it not been for the release and transfer (through auction) of 185 mb of government strategic oil stocks to industry. The US administration has overseen the bulk of these drawdowns from its strategic petroleum reserves (SPR).
- According to the latest US Energy Information Administration (EIA) release, SPR levels had fallen to 399 mb—their lowest since 1984. This has raised concerns that the government's SPR drawdown policy, which is focused on lowering fuel prices for consumers, is trading short-term electoral gain for longer-term energy insecurity—and ultimately higher prices. Critics point out that the SPR was designed for emergency use, to minimize oil supply disruptions rather than as a tool to manage prices at the pump. Following the recent sale of the final tranche of 15 mb of the current program, further SPR drawdowns are likely after the Biden administration indicated that it could continue to tap reserves to stabilize gasoline and diesel prices. It also said that it would begin replenishing the SPR when oil prices fall to the $67-72/bbl range, essentially providing some of the price guidance that US oil companies were looking for to incentivize their own production.
- US crude production continues to underperform, falling back down to 11.9 mb/d in the week-ending 28 October, with year-to-date production gains standing at a meagre 100 kb/d, or 0.8%. (Chart 5.) The US administration has grown increasingly frustrated at the lackluster post-pandemic US oil supply response—output had topped 13 mb/d on the eve of the Covid-19 pandemic in early 2020. It recently criticized US oil companies for what it sees as an unbalanced focus on dividend distribution at the expense of capital investment and supply maximization following a year of record profits.
- Also drawing the ire of the Biden Administration was the OPEC+ decision in October to cut output quotas by 2 mb/d from this month to end-December 2023, which it framed as one of pre-empting the weakening in global oil demand. This was the second output cut announcement in a row, following the move in September to reverse the summer's 100 kb/d supply increase. The OPEC+ output target for participating members is 40.1 mb/d (excluding Mexico). Actual cuts are expected to be in the 0.7-1 mb/d range at most, however, given that a substantial portion of OPEC+ members have struggled to hit their quotas (shortfall estimated at 3.5 mb/d in September) on the way up due to underinvestment and supply outages. (Chart 6.)
- The outlook for the oil market is mired in uncertainty. While oil demand is softening in line with weakening global economic growth, it is the supply side that has the greatest potential to spring surprises. The impending EU oil embargo on Russian seaborne crude and refined products could lead to the shutting-in of substantial volumes of Russian supply—even after barrels are diverted at a heavy discount to Russia's largest customers China, India and Turkey. In tandem with OPEC+ supply cuts, the market is expected to tighten in 2023, with stock draws expected from mid-2023 onwards—the IEA sees the 'call on OPEC' in 2023 higher than the group's likely production during the year, especially in the absence of higher Iranian or Venezuelan supply. We expect risks to oil prices to be on the upside.

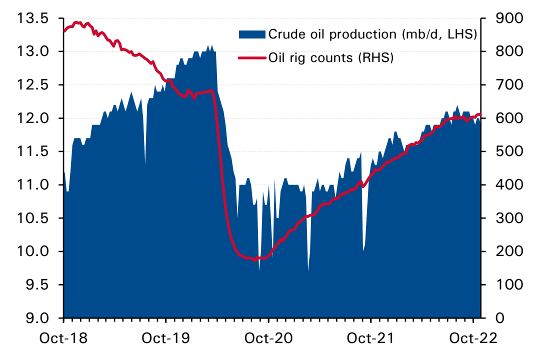
Chart 4: World oil demand estimates

(mb/d)



Source: IEA, OPEC, US Energy Information Administration (EIA)

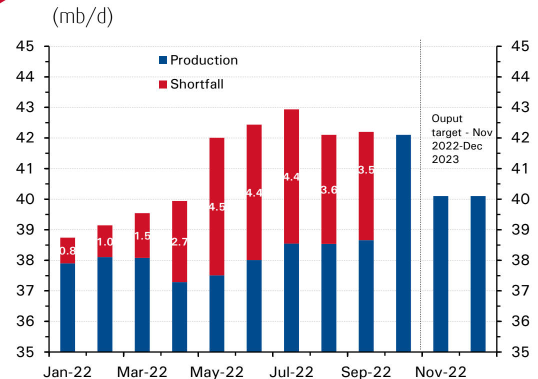
Chart 5: US crude production and oil rig counts



Source: EIA, Baker Hughes

Chart 6: OPEC+ output targets and shortfall

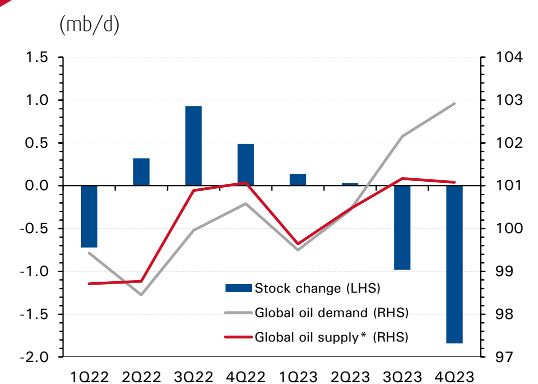
(mb/d)



Source: OPEC, IEA, S&P; *excludes Iran, Libya, Venezuela & Mexico

Chart 7: Global oil demand and supply*

(mb/d)



Source: IEA, NBK estimates, *assumes OPEC quotas adhered to

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