Economic Update

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Oil Markets

Oil prices recover after falling on oil demand concerns caused by rising Delta infections

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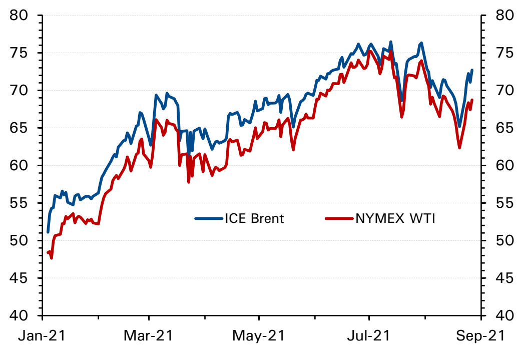
Summary

Oil prices have recouped their losses from mid-August, boosted by China's quick re-emergence from lockdown and, recently, by the arrival of Hurricane Ida. Broader oil demand concerns remain, however, with the Delta variant spreading in the Far East and the US. The IEA has downgraded its projections for 2H21, and markets will be looking to OPEC+ to adapt to any demand shortfalls by slowing the pace of its supply increases.

- International crude oil benchmark Brent closed last week at $72.7/bbl, posting its biggest one-week gain (+11.5% w/w) in more than a year on renewed oil demand optimism following China's swift emergence from lockdown. (Chart 1.) The arrival of Hurricane Ida in the US Gulf of Mexico and comments by the US Fed Chairman Powell on monetary tightening helped boost prices on Friday—as did a drop in US crude and gasoline inventories, which was met with relief after the previous week's gasoline build. US marker West Texas Intermediate (WTI) closed at $68.74/bbl on Friday. Oil is up more than 40% year-to-date.
- Brent's prompt spread (M1-M2) was back in a firmer backwardation structure (the price of near-dated, or spot, contracts being higher than the price of later-dated contracts), indicating somewhat tighter market conditions. (Chart 2.) The spread had recovered to close to $1, from a low of 38 cents earlier in the month, when demand conditions were looking weaker on the back of Delta variant concerns.
- The previous week saw prices pummeled by the spread of the virus in the Far East, Australasia and the US. Markets were also weighed down by the US Federal Reserve signaling that it could move closer to tightening monetary policy to head off rising consumer inflation—the US dollar index was up 1.1% w/w by the close of trading on 20 August on the news. Brent incurred seven consecutive days of losses—the longest run of daily declines in more than three years—before settling at a three-month low of $65.18/bbl on Friday 20 August. The bearish turn was also compounded by a surprise weekly increase in US gasoline stocks (+696 kb/d), which markets interpreted as a sign that US oil demand was faltering during the peak oil consumption season. The spread between Brent and WTI has indeed widened since July, and was as much as $3.5/bbl this week from $0.6/bbl in early July, a likely sign of a looser US market. (Chart 3.)
- The US Department of Energy has indicated that it will release up to 20 mb of sour crude from its Strategic Petroleum Reserve (SPR) in 4Q21 to fund federal projects, in the largest sale since 2014. This impact of this has already been felt on the price of heavier, sour US crude prices.
- During the pandemic, the markets had been keeping a watchful eye on oil consumption in China, the world's second largest oil consumer, for clues to the robustness of global oil demand growth. It was little surprise then that markets were alarmed when the Chinese authorities announced earlier in the month the re-imposition of mobility restrictions across several cities to combat a resurgence of Delta variant-inspired infections. Refinery run rates in July had dropped by 0.89 mb/d month-on-month to 13.9 mb/d, the lowest level in more than a year, which, following, several months of sharply lower crude imports (-0.56 mb/d y/y on avg. over Jan-July period), had many speculators

Chart 1: Benchmark futures prices

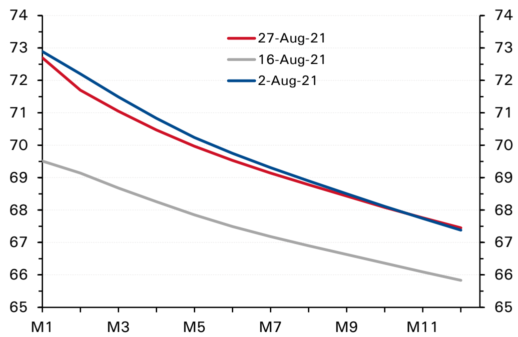
($/bbl)



Source: Refinitiv

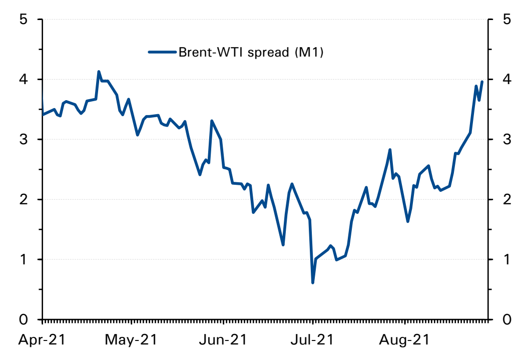
Chart 2: ICE Brent 12-month forward curve

($/bbl)



Source: Refinitiv

Chart 3: Brent-WTI spread



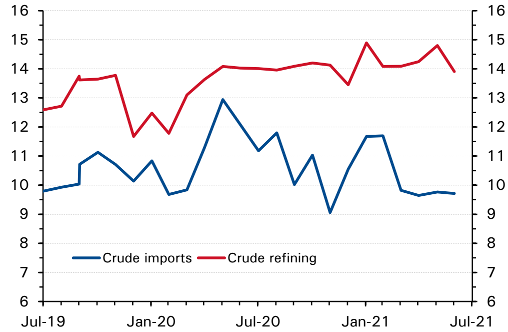
Source: Refinitiv

questioning the tightness of the global market. (Chart 4.) But this weakness likely reflects recent moves by the authorities to regulate the proliferation and practices of China's independent 'teapot' refiners, such as the trading of import quotas. The government has curtailed the amount of crude import licenses it issues to these refiners.

- Projections for global oil demand growth appear less certain than even a month ago, thanks to the Delta variant. The International Energy Agency (IEA) expressed its concern in its August oil market report that the spreading virus could derail the economic recovery. It downgraded its estimate for oil demand growth in the second half of the year by 0.5 mb/d on the back of the re-imposition of Covid-19 restrictions across Asian oil consumers especially. The IEA noted that global refinery activity was weaker than expected in July and that refining margins remained under pressure. There is only a small window for meaningful increases in activity in August and September before seasonal maintenance sharply reduces refinery runs in the autumn. For 2021 as whole, growth is still expected to come in at 5.3 mb/d on average, with 2022 seeing a further gain of 3.2 mb/d. (Chart 5.)
- OECD commercial oil stocks continue to fall, albeit slowly, according to OPEC's estimates of closing levels at end-June. Stocks on land were down slightly to 2.92 billion barrels by the end of 2Q21 (-4 mb q/q; -289 mb y/y). (Chart 6.) In terms of forward oil demand cover, this level equates to 64 days, an improvement from 66 in 1Q21 and 76 a year earlier.
- On the supply side, the onus will once again be on OPEC+ to manage the ever-changing dynamics in the market. The group is pursuing an agenda of incremental, 400 kb/d, monthly output increases to April 2022, rising to 432 kb/d from May to September 2022, in order to fully phase out the remaining 5.76 mb/d of oil withheld from the market. The baseline for cuts will also be adjusted upwards for the five largest OPEC+ producers from May 2022, following the UAE's objection to its original 2019 baseline, agreed at the 18 July meeting.
- For demand-supply balances in 2021, the new output schedule should see 2 mb of additional supply brought on in 2H21 and the market remaining tight with stock draws of 0.8 mb/d on average. However, this is contingent on two important dynamics: oil demand growth not weakening and oil supply not witnessing additional increases from the likes of Iran and Libya (from July levels) within OPEC and from the US outside of OPEC.
- US crude production has responded in 2021, reaching 11.4 mb/d (based on weekly data) in recent weeks, but at 400 kb/d year-to-date, the gains have been modest. Output remains 1.7 mb/d (-13%) below the pre-pandemic peak of 13.1 mb/d. (Chart 7.) US shale operators have largely stuck to their post-pandemic mantra of production restraint, prioritizing cash flow and shareholder returns over breakneck production growth and the likely lower prices that would ensue. However, output looks poised for further gains over the next few months, judging by the increasing number of oil rigs that drillers are putting into service—20 alone in August to a total of 405. This is almost at pre-pandemic levels.
- The impact on prices of additional OPEC+ and non-OPEC supplies in the months ahead would ordinarily be bearish. However, the tighter oil market narrative of 2H21, based on resurgent oil demand, still predominates, even if recent data has caused some jitters. We would not be surprised, though, if OPEC+ opts to slow or pause the monthly supply increases to keep prices within range should demand underwhelm in the coming months.

Chart 4: China crude imports and refining rates

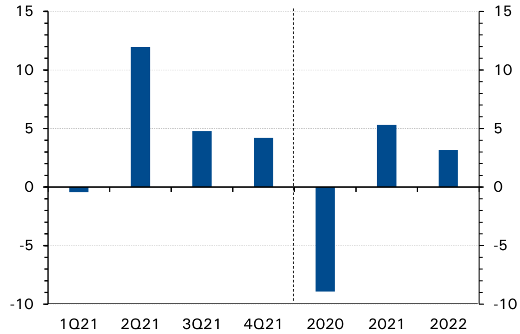
(mb/d)



Source: GACC, NBS; note: Jan/Feb data is estimated

Chart 5: Oil demand growth

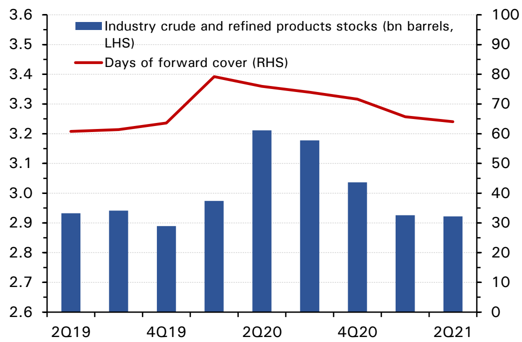
(mb/d)



Source: IEA

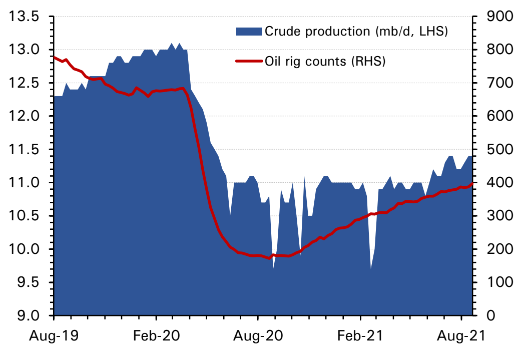
Chart 6: OECD oil stocks on land

(mb)



Source: OPEC based on IEA, EIA, Argus, METI, Euroilstock and OPEC

Chart 7: US oil production and rig counts



Source: US Energy Information Administration (EIA), Baker Hughes

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