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Economic Update

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Oil Markets

Tentative start for oil prices in 2023, but sentiment slowly turning more bullish

> Omar Al-Nakib
Senior Economist
+965 2229 5360
omarnakib@nbk.com

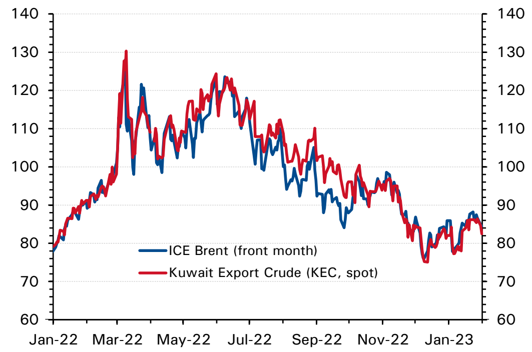
Summary

Oil prices traded sideways for most of January before retreating on global economic uncertainty. Nevertheless, sentiment appears to be turning more bullish on hopes of a solid Chinese economic rebound and on the expectation of Russian supply losses in the wake of punishing EU embargoes. Oil balances are expected to materially tighten. Consensus estimates see oil prices ranging higher to average $91 in 2023.

- Oil prices closed lower in January amid continued uncertainty about the global economic outlook. International benchmark Brent crude dropped 1.7% m/m to end the month at $84.5/bbl, its first monthly decline since November. Local marker Kuwait Export Crude (KEC), in contrast, finished up slightly at $82.5/bbl (+0.6%), a first monthly gain in eight months. (Chart 1.)
- Brent futures were range-bound for most of the month, despite several bullish signals in recent weeks, from signs that Chinese economic activity and oil demand growth is accelerating to indications that the US economy is holding up better than expected and that the pace of Fed monetary tightening is moderating. The IMF has also upgraded its assessment of global economic growth this year.
- A further price-supporting impulse has come more recently from the supply side, with the OPEC+ monitoring committee, which met on February 1st. It recommended holding crude output steady at 40.1 mb/d, rather than deviate from last October's agreement, which called for a reduction in OPEC+ aggregate production by 2 mb/d (from August 2022 reference levels) for the entirety of 2023. OPEC, like the markets more broadly, is adopting a 'wait and see' approach regarding the trajectory of both global oil demand and global oil supply following China's lifting of Covid restrictions and the EU's embargo on Russian crude oil imports to the bloc, respectively. The EU will shortly institute an embargo on imports of Russian refined products.
- Sentiment has improved across various metrics. The volume of bullish positions in the Brent futures market has increased to its highest in eleven months, with almost nine times as many 'long' positions as 'short' positions taken out (net length rose to 252k contracts by 24 Jan, its highest since Russia's invasion of Ukraine). Meanwhile, open interest surged during January to levels last seen in March, and Brent's near-term time spreads (e.g. M1-M2) flipped back into a premium (near-term contracts priced higher than contracts for later delivery)—a sign of near-term tightness (Charts 2 and 3.)
- Nevertheless, the oil demand picture appears to be improving. The IMF, in its January WEO update, revised up its estimate of global growth for 2023 by 0.2% points to 2.9%, the first upward revision in a year, citing China's reopening and resilient US demand. Chinese economic growth could reach 5.2% this year, up from 3.0% in 2022, helping drive a rebound in oil demand after a decline in 2022. Early signs from China are encouraging: Covid-19 critical cases and deaths are down more than 70% from their peak, gasoline sales are up more than 20% y/y over the Lunar holiday week, and the authorities have greatly increased the volume of crude that independent refiners are permitted to import.
- The IEA estimates that China's oil consumption is set to account for half of the 1.9 mb/d of global oil demand growth the agency forecasts this year, with

Chart 1: Oil prices

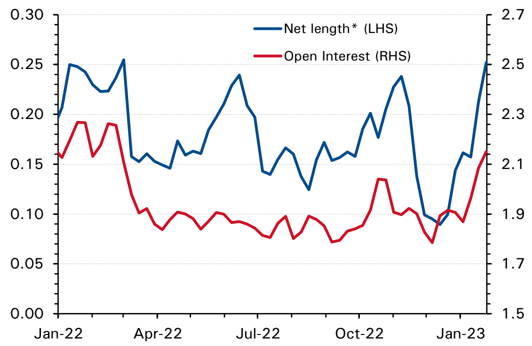
($/bbl)



Source: Refinitiv, Bloomberg

Chart 2: Money manager net length

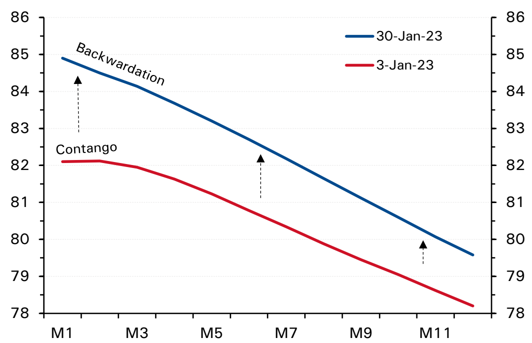
(million contracts*)



Source: Bloomberg, Refinitiv; *futures and options

Chart 3: Brent forward curve

($/bbl)



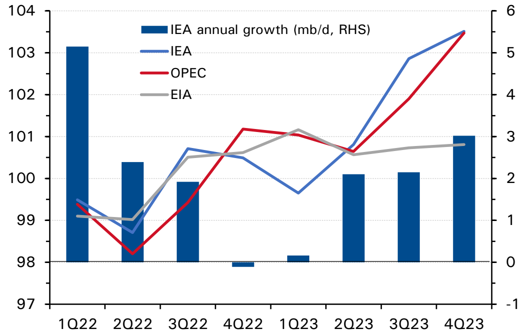
Source: Bloomberg, Refinitiv

demand for jet fuel (travel) and diesel (industry) greatly improved. It expects world oil demand to reach a record high of 101.7 mb/d in 2023. This comprises a drop in oil demand of 0.8 mb/d q/q in 1Q23 amid a contraction in industrial activity in Europe, followed by a rise through the remainder of the year to reach 103.5 mb/d by 4Q23. (Chart 4.)

- On the supply side, the oil market is expected to tighten going forward, with the impact on oil market balances of the EU's crude and refined products embargos on Russian oil supply greatest in the second half of the year. The tightness in the diesel market could be especially acute. However, there is considerable variation among energy houses on the extent of Russian crude output curtailments in 2023, especially with the G-7 crude price cap seemingly achieving (so far) its intended purpose of reducing Russian oil export revenues without disrupting Russian supplies too much. The IEA puts the decline at 1.3 mb/d on average from 2022's level. (Chart 5.)
- Meanwhile, December's supply data showed OPEC-10 production rising slightly by 55 kb/d to 24.6 mb/d as higher output in Nigeria and Angola offset declines from Gulf region producers Kuwait, the UAE, and Iraq, according to OPEC secondary sources. Total OPEC-10 production was still some 854 kb/d below quota, however. Kuwait and Saudi are among six OPEC-10 members producing at or below their quotas. Total OPEC+ output (excluding Libya, Iran, Venezuela and Mexico) increased by 85 kb/d in December to 38.3 mb/d, with the quota shortfall easing to 1.8 mb/d. (Chart 6.) Russian crude output, at 9.86 mb/d, was down only 10 kb/d m/m.
- Outside of OPEC+, US crude production was flat over the last three weekly readings at 12.2 mb/d (+100 kb/d mtd) according to EIA data. US oil rig count increases, meanwhile, look to be in reverse, with the number of active rigs drilling for oil falling to 609 (-1.9% mtd) by January 27th. Last year saw US oil supply average 11.68 mb/d, a gain of 616 kb/d (+5.5%), though still down on 2019's record of 12.3 mb/d, a high that the EIA does expect to be broken this year, with its forecast of a 547 kb/d increase to 12.4 mb/d.
- The oil market is in a state of extreme flux, with uncertainty high and volatility elevated. The threat of a global recession hangs over the outlook in 2023. Nevertheless, international energy and research houses have in recent weeks nudged up their global economic, oil demand and oil price forecasts (to $91/bbl) for the year. We believe the balance of risks is to the upside, with prices expected to move higher on the back of rebounding Chinese demand, projected Russian supply losses, OPEC+ supply restraint and underwhelming non-OPEC output increases. The market should get materially tighter in the second half of the year.

Chart 4: World oil demand

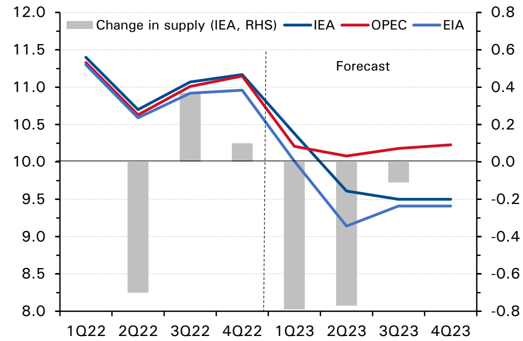
(mb/d)



Source: IEA, OPEC and EIA

Chart 5: Estimates of Russian supply losses

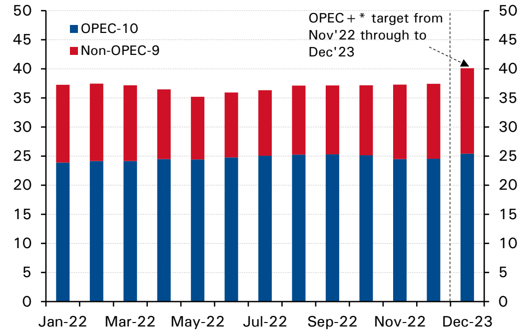
(mb/d)



Source: OPEC, EIA, mees

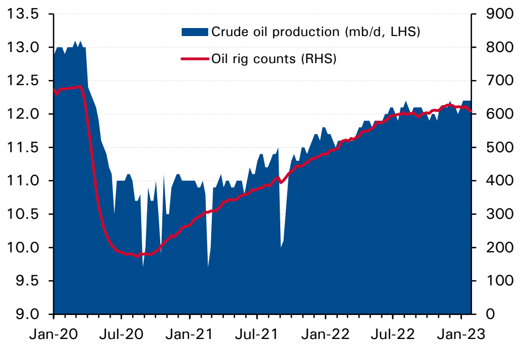
Chart 6: OPEC+ crude production

(mb/d)



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

Chart 7: US crude oil production and rig counts



Source: EIA, Baker Hughes

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2222 2011
Fax: +965 2229 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353