Economic Update

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Oil

Oil prices look for traction amid persistent coronavirus-weakened economic activity

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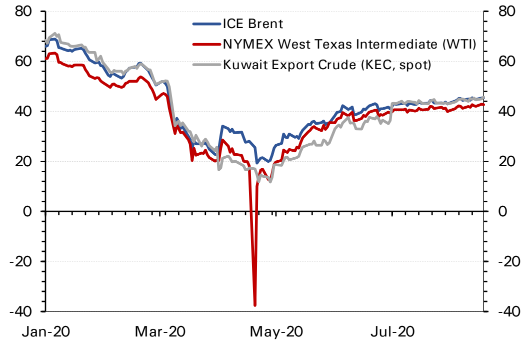
Summary

Oil prices look to break out of their tight trading ranges but remain constrained by worries over spiking global Covid-19 infections. The base case outlook is that prices will firm while OPEC+ keeps its discipline to end-2020 and that oil demand continues to improve slowly and at a faster rate than OPEC/non-OPEC supply growth. This should lead to tighter markets and stock drawdowns. But the economic recovery is looking less and less V-shaped as mobility and activity remains fitful and uncertain.

- Oil prices tested the upper limits of their near two-month trading ranges recently, with Brent and WTI futures touching five-month highs of \$45.46/bbl and \$42.9/bbl last week, respectively. Since hitting a low of \$19.3/bbl on 21 April, the international benchmark Brent has more than doubled in price (+135%), though it remains down over 31% so far in 2020. (Chart 1.)
- Oil's recent movements were catalyzed by a combination of better-than-expected US jobs data and a third consecutive week of US inventory drawdowns. The US Dept of Labor's employment release showed weekly initial unemployment claims falling from 1.19 million to 963,000 in the week ending (w/e) 8 August, the first time that they have been below 1 million since mid-March. In the same week, US commercial crude stocks declined by 4.5 mb to 514 mb (-5% from their record high of 540 mb in the w/e 19 June).
- Stocks are still around 49 mb (10%) above the seasonal average but they are declining. They now provide around 35 days' worth of supply cover compared to a historic high of 42 days in early May. Gasoline and distillate stocks also fell. But crude refining activity continues to be sluggish amid resurgent coronavirus infections; while refinery crude demand has increased recently, at 14.7 mb/d, it is still down 15% y/y.
- Spiking and persistent global Covid-19 infections continue to worry the markets, dampening economic activity and stoking oil demand fears. Prices may remain rangebound until major demand-side announcements are made. These could be additional fiscal stimulus, sizeable drawdowns in crude and petroleum stocks, accelerating economic activity in large, oil consuming economies such as China, or a vaccine break-through.
- Markets had been hopeful that US congressional lawmakers would sign off on a trillion dollar plus coronavirus stimulus package, but partisan wrangling has delayed it. Lawmakers return from recess in September.
- China's purchases of crude in recent months have helped tighten the oil markets. Imports in June reached a record 12.9 mb/d, according to the General Administration of Customs (GAC), breaking the previous month's record of 11.3 mb/d as China took advantage of the Saudi-Russian oil price war to load up on cheap crude. Refinery processing rates also set a record in July, jumping 12% y/y to 14.0 mb/d, the National Bureau of Statistics (NBS) reported.

Chart 1: Crude oil prices

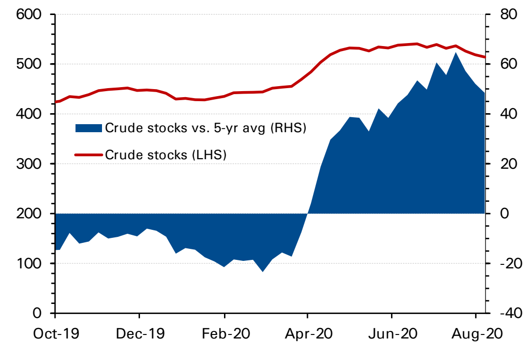
(\$/bbl)



Source: ICE, Bloomberg, KPC

Chart 2: US commercial crude inventories

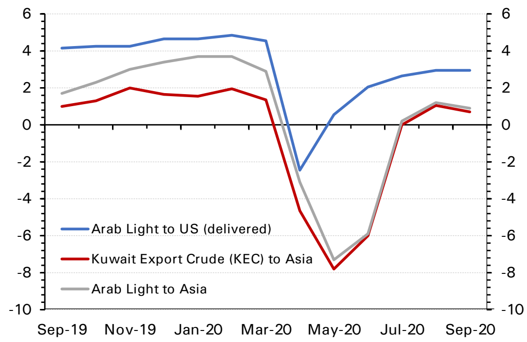
(million barrels, mb)



Source: US Energy Information Administration (EIA)

Chart 3: Saudi and Kuwait medium sour crude OSPs

(\$/bbl, as a differential to Oman/Dubai or ASCI benchmark)

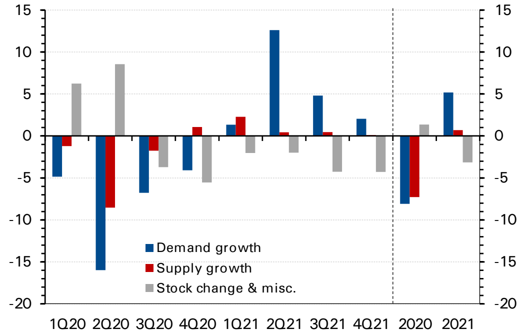


Source: MEES; crude to Asia vs Oman/Dubai; to US vs. ASCI

- Globally, refining margins (crack spreads i.e. the difference between crude feedstock prices and refined product prices) are under pressure due to crude demand growth overshooting refined products demand growth. While crude prices have gained over the last few months as supplies are curtailed and in anticipation of stronger economic activity, products prices—gasoline, diesel (gasoil) and especially jet fuel—more closely reflect consumption. The crack spread for gasoil in Singapore was still down at around $6/bbl last week, having been as high as $16.15/bbl last January, according to Platts.
- Weak refining margins in Asia partly motivated the reduction in crude official selling prices (OSPs) for September by regional oil producers. Saudi Aramco and Kuwait's KPC cut the price of their Arab Light and Kuwait Export Crude prices (KEC) (reduced the premium over the Oman/Dubai benchmark) by $0.30-0.35/bbl.
- The International Energy Agency (IEA), in its August oil market report, revised down its estimate of oil demand growth this year, by 140 kb/d to -8.1 mb/d, due to Covid-impaired mobility. (Chart 4.) This is the steepest annual contraction in oil demand in history, with overall global oil demand like to fall to 91.9 mb/d on avg. in 2020. Weak demand for jet fuel is especially concerning; the number of air kilometers travelled in July was still 67% down y/y. 2021 should see oil demand rebound by 5.2 mb/d to 97.14 mb/d—still almost 3 mb/d below the pre-pandemic level.
- On the supply side, the ending of the first phase of the OPEC+ agreement on 1 August would have seen the producers' group begin to taper their cuts to 7.7 mb/d for the next five months from 9.7 mb/d. In practice, OPEC supplies already started rising in July due to the ending of the additional voluntary cuts undertaken by Saudi Arabia, Kuwait, the UAE and Oman. OPEC-13 production increased by 978 kb/d (+4.4% m/m) to 23.17 mb/d in July, with OPEC-10 compliance falling to 96.7% from 112.8% in the previous month, according to OPEC. (Chart 5.)
- Saudi Arabia increased output by 866 kb/d to 8.41 mb/d (103% compliance), Kuwait upped its production by 73 kb/d to 2.16 mb/d (102%) and the UAE raised its supplies by 98 kb/d to 2.43 mb/d (102%). Serial non-compliers Iraq and Nigeria again failed to honor their OPEC+ pledges to cut more than was required to compensate for three months of overproduction; Iraq pumped 3.75 mb/d in July (85% compliance), but now needs to make 850 kb/d worth of compensatory cuts. It earlier promised 400 kb/d of cuts this month and next. A Joint Ministerial Monitoring Committee (JMMC) meeting is currently taking place. No change in policy is expected, though.
- With demand still weak, the prospect of increased OPEC+ supplies reaching still-saturated markets is bearish for oil prices. Perhaps partly mitigating this will be the fact that volumes will not reach the 2 mb/d due to compensatory cuts by Iraq and others. Saudi Arabia also explained that most of its 588 kb/d of extra August supply will be consumed domestically (for summer electricity needs) rather than exported.
- US crude production, at 10.7 mb/d in the w/e 7 August, is still struggling to recover. Output remains down 2.4 mb/d (18.3%) from its all-time high of 13.1 mb/d in February. The industry is suffering from low oil prices, a dearth of capital, reduced investor risk appetite and balance sheet repair by the oil firms. US oil rig counts have plummeted to 172, the lowest level since pre-shale boom 2005, Baker Hughes reported. (Chart 6.)

Chart 4: Global oil supply & demand growth

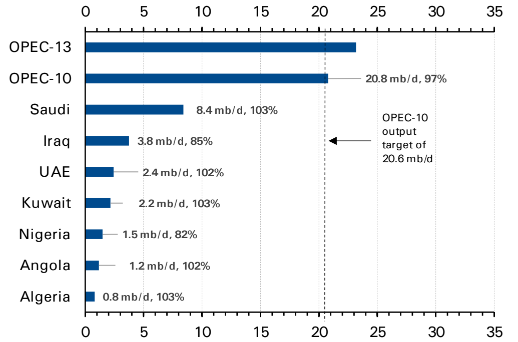
(mb/d))



Source: IEA, OPEC, NBK est.—assumes full OPEC+ compliance

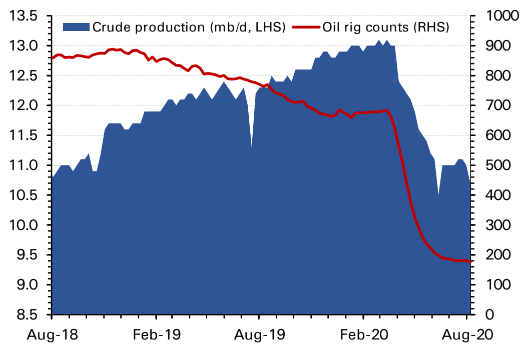
Chart 5: OPEC production and compliance in July

(mb/d; compliance denoted as a %)



Source: OPEC secondary sources, IEA, S&P Global Platts

Chart 6: US oil production and rig counts



Source: EIA, Baker Hughes

- Recent noise about US shale producers bringing back idled oil wells has not yet shown up in the weekly figures at the aggregate level. Shale operators surveyed by Rystad Energy showed that most intended to restore almost all-shut in production by the end of September, but this is very much dependent on oil price recovery. Canadian and Brazil oil production, however, appears to have picked up, the IEA noted.
- Expectations are that the oil market will tighten in 2H20, with demand growth outpacing supply growth. This should result in a drawdown in global inventories that should peak in 4Q20. (See Chart 4.) Prices should therefore firm. This forecast comes with the important caveat that oil demand does not deteriorate due to worsening coronavirus infection rates. Moreover, OPEC+ discipline will need to be maintained. Libyan, Iranian and Venezuelan production remain wildcards with bearish price potential, given how far output has fallen below potential in these countries.

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