Oil prices surge on improved demand outlook and supply tightness

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Oil price gains underpinned by tighter demand-supply fundamentals

- Oil prices are currently on a tear, with international benchmark Brent topping $80/bbl on Tuesday 28th in intraday trading for the first time in almost 3 years, before settling lower at $79.1/bbl (+8.4% mtd; +52.7% ytd.) US marker West Texas Intermediate (WTI) is up almost 13% mtd at $75.3/bbl. (Chart 1.)

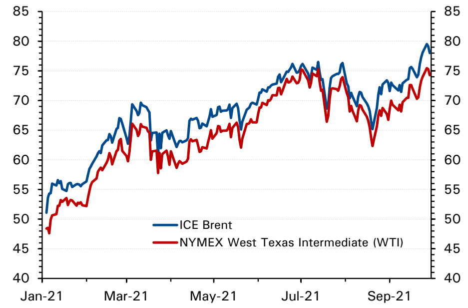
- A month is a long time in the oil markets. Sentiment has turned bullish in recent weeks, with August's narrative of delta-variant-linked oil demand weakness amid potential oversupply giving way to increasing optimism about a global economic and oil demand recovery. Demand growth is now seen outpacing oil supply growth, partly due to OPEC+ market management and partly due to supply outages, the largest of which was caused by Hurricane Ida in late August. This knocked out more than 13% (1.5 mb/d) of US crude output initially.

- The drawdown in global oil stockpiles has provided the most visible evidence of the recovery in oil consumption. OECD total commercial oil stocks have trended down below their pre-pandemic five-year averages, a key OPEC and International Energy Agency (IEA) metric. OPEC estimates end-July industry stocks at 2.9 billion barrels (57 mb below the 5-year average and providing 63.7 days of oil demand forward cover), while the IEA puts them at 2.85 billion barrels (120 mb below the 5-year average). (Chart 2.) In the US, meanwhile, commercial and Strategic Petroleum Reserve (SPR) crude levels have declined to 3 and 18-year lows, respectively. The extra SPR barrels, released by the US Department of Energy on several occasions this year to finance federal spending, are helping to offset crude shortages. In a first, China also tapped its strategic reserves to supply local refineries and temper rising prices. Imports of crude also increased, to a 5-month high (10.5 mb) in August—a bullish sign.

- Global balances have tightened considerably. September's IEA report predicts for 3Q21 a third consecutive quarterly stock draw (-0.8 mb/d), on the back of rising oil demand and underperforming OPEC and non-OPEC supply. (Chart 3.) While OPEC+ commenced tapering its supply cuts in August (at a rate of 400 kb/d per month), several producers, such as Angola and Nigeria, have been unable to bring on the required volumes due to outages. Coupled with Ida-related supply losses in the US, the market is short of barrels. While demand and supply could equilibrate in Q4, the evolving natural gas crunch that has seen gas prices treble may boost winter oil demand (by encouraging gas to oil liquids switching). The IEA (and others) will in its next release likely raise its Q4 and 2021 oil demand growth estimates above 4 mb/d and 3.26 mb/d.

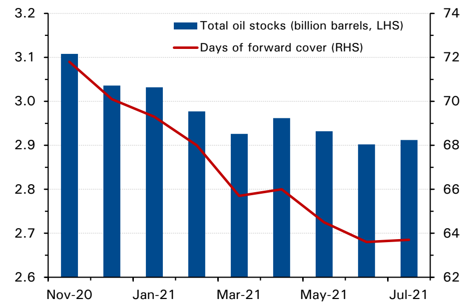
- The picture for next year looks markedly different. In contrast to this year's story of lagging supply and stock draws, 2022 could be one of oversupply and stock builds. The IEA's current oil demand and non-OPEC supply projections imply a stock gain of 3.4 mb/d, assuming robust US output gains materialize and OPEC+ sticks to its roadmap of supply increases to the full. (Chart 4.) In this scenario, OPEC+ would be producing above the "call" on its crude, and more so if Iran's oil is unshackled by sanctions under a new JCPOA agreement. The implications for oil prices are therefore negative. For a supply glut to be averted, either oil demand will need to be stronger than the IEA and others anticipate or OPEC+ will need to pause its tapering schedule.

Chart 1: Benchmark crude oil futures prices
($/bbl)



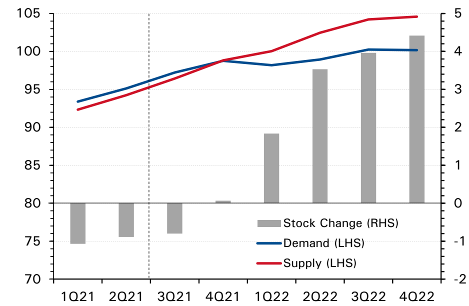
Source: Refinitiv

Chart 2: OECD industry oil stocks



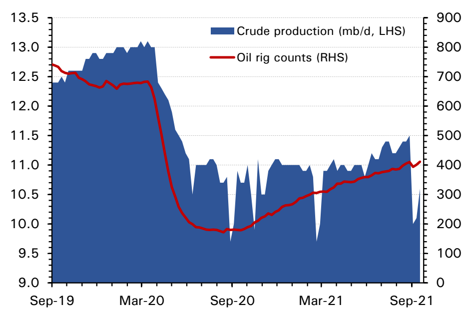
Source: OPEC, Argus, EIA, Euroilstock, IEA, JODI, METI

Chart 3: Oil demand and supply balance
(mb/d)



Source: IEA

Chart 4: US crude production and rig counts



Source: EIA, Baker Hughes

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