

Oil prices down on receding supply shortage fears, weaker demand outlook

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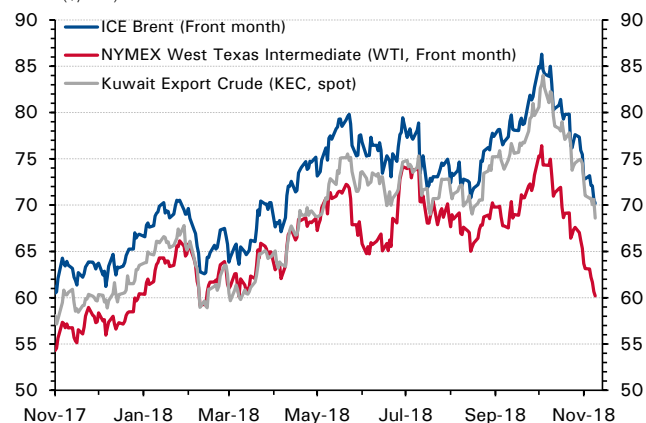
Highlights

- Oil prices head lower, to \$70/bbl (Brent), as oil demand outlook weakens and worries over a supply shortage recede.
- US extends temporary sanctions waivers to 8 importers of Iranian crude, including China, India and Japan.
- Iranian exports decline by 37% (0.92 mb/d) since April to 1.6 mb/d in October; OPEC output reaches 32.7 mb/d in September, a rise of 0.63 mb/d since May, to offset Iranian and Venezuelan supply losses.
- US crude oil output sets new record of 11.6 mb/d.
- Oil demand growth in 2019 revised down by the IEA to 1.4 mb/d on higher oil prices and emerging market weakness.
- Balance of oil price risks in 2019 skewed to the downside.

From bulls to bears in a month

Since peaking at near four-year highs in early October, oil prices have dropped by more than 18%, to around \$70/bbl (Brent) and \$60/bbl (WTI), as bullish market sentiments shift perceptibly more bearish on receding fears of a supply shortage caused by US sanctions on Iran, record high US crude production and on a weaker global economic and oil demand outlook. (Chart 1.) The Trump administration's decision to temporarily extend waivers to eight of Iran's largest customers, including China, India, Japan and South Korea was a significant contributor to the bearish narrative. Oil prices have also been caught up in the broader equity market sell-off.

▶ **Chart 1: Crude oil prices**
(\$/bbl)

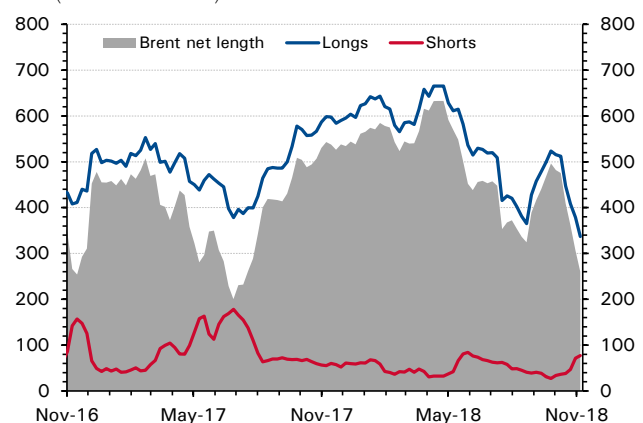


In the futures markets, hedge funds have reduced their 'net long' positions on Brent crude, the difference between bets on higher prices ('longs') and lower prices ('shorts'), for the sixth

consecutive week, to 260,048 futures and options contracts, according to ICE data. This is the lowest level since July 2017, indicating that investors are turning increasingly more negative about the oil price outlook. (Chart 2.)

The precipitous fall in prices, in the case of WTI, by more than 19% to its lowest level since March, appears to have prompted OPEC to consider the option of cutting production in 2019, a complete reversal of their current trajectory.

▶ **Chart 2: Money manager net length**
(thousand contracts)



This is a far cry from the state of the market in the run up to oil's peak at \$86 in early October. That rise capped a two-month price rally that was driven primarily by concerns of a global supply shortage caused mainly by the US sanctions on Iran and falling output from Venezuela.

There were also doubts about Saudi Arabia and OPEC's ability to tap into spare production capacity to offset these losses, as

shown by the slower-than-expected ramp up in output from OPEC and its allies after they had indicated in late June that they would pump an additional 1 mb/d over the coming months to keep the market well-supplied. The slow pace of supply additions while the price of Brent increased towards its eventual peak even drew the ire of President Trump, who accused OPEC of intentionally “ripping off the rest of the world”.

Iran sanctions kick in, with exemptions

On 5 November, US sanctions on Iran went into full effect. In all, about seven hundred Iranian entities, including individuals, banks and businesses, across the country’s energy, shipping and financial sectors were targeted.

Henceforth, foreign countries and entities purchasing Iranian crude without special US dispensation or transacting with the Islamic Republic’s central bank will be effectively barred from doing business using the US financial system—a penalty that has forced Iran’s largest crude customers to pare back purchases and firms such as France’s Total to pull out of a planned \$4.8 billion natural gas development project in the country. The international payments enabler, SWIFT, also announced that several Iranian banks will have their access to the platform suspended.

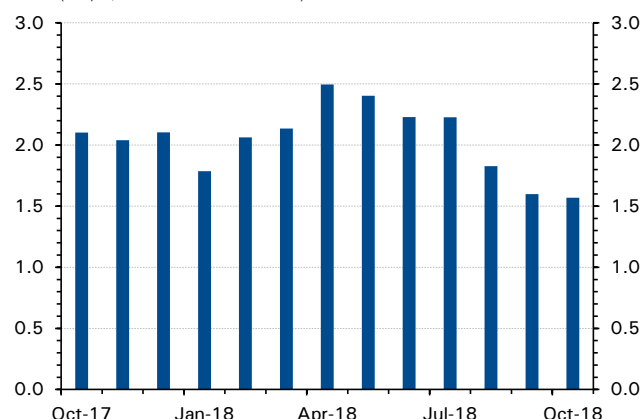
However, in a surprise move on the eve of the sanctions ‘snap-back’, the Trump administration, announced that eight of Iran’s largest crude oil customers, including China, India, South Korea and Japan—but not the EU as a single entity—would be offered temporary waivers to allow them sufficient time to cut their imports down to zero, the administration’s stated objective. The EU, for its part, continues to hold out hope that its plans for a special payments vehicle to help Iran bypass the US financial system and continue exporting to Europe and Asia will materialize.

Implicit in the US’s softer Iran stance is the Trump administration’s anxiety over spiking oil prices and the effect on the US consumer both ahead of and after the US midterm elections. But the markets also took the move as a signal that the projected loss of Iranian crude may not be so severe as to leave the markets short of barrels.

To be sure, Iranian crude exports continue to fall. The most recent figures show the crude exports at 1.6 mb/d in October, a decline of 926,000 b/d, or 37%, from the country’s peak export volume of 2.4 mb/d in April, the month before the US announced its intention to re-impose sanctions. (Chart 3.) Though the rate of decline has eased somewhat over the last two months—and may continue to do so now that the waivers have been issued—the expectation is that the regime’s crude exports will probably fall back over the next few months to the previous sanctions-era levels of around 1-1.2 mb/d.

Chart 3: Iran crude oil exports

(mb/d, excludes condensates)



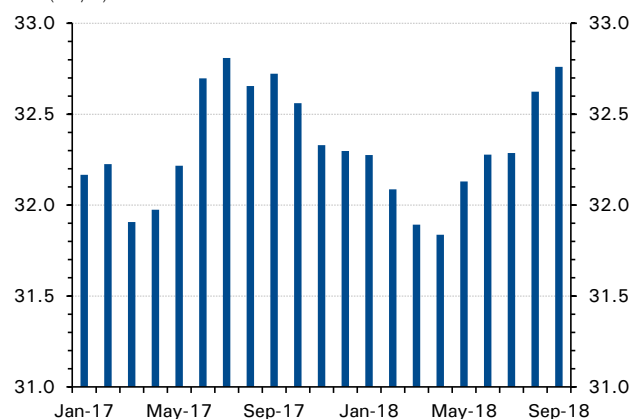
Source: Bloomberg, based on tanker tracking data

OPEC finally opens the taps to offset Iranian supply losses

OPEC has finally increased its output to compensate for Iranian and Venezuelan losses. The group’s crude production reached 32.7 mb/d in September, an increase of 630,000 b/d over May’s levels. (Charts 4 & 5.) Adding in Russia’s output gain of 390,000 b/d over the same period, then OPEC and its allies are not far off the 1 mb/d they had promised in late June. Saudi Arabia, for its part, ramped up production in September by 500,000 b/d to 10.5 mb/d, close to its all-time high of 10.67 mb/d from November 2016.

Chart 4: OPEC crude oil production

(mb/d)

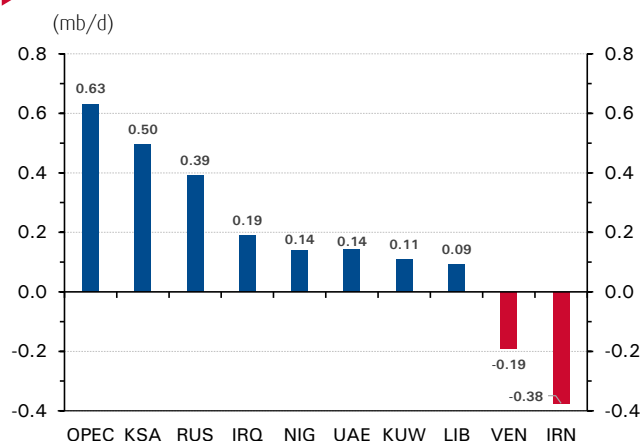


Source: OPEC secondary sources

Kuwait and the UAE produced around 2.8 and 3.0 mb/d in September, respectively, according to OPEC secondary sources, which brings their respective incremental increases from May to 110,000 b/d and 140,000 b/d. The Saudi energy minister, Khaled Al-Falih, remarked recently that OPEC is in “produce as much as you can mode”, with Saudi Arabia looking at possibly 11 mb/d or higher over the coming months. All the indications are that those oil producers with the spare production

capacity—Saudi Arabia, Iraq, Kuwait, the UAE and non-OPEC Russia—intend to increase supplies in the short term.

Chart 5: OPEC and Russia output changes since May 2018



Source: OPEC secondary sources, International Energy Agency (IEA)

While a thinning Saudi and OPEC spare oil production capacity buffer—estimated at around 2% of global demand, which is low by historical standards—would ordinarily sound the alarm bells as far as the markets are concerned, the focus appears to have shifted to the risk that the market could tip into oversupply.

Oversupply concerns on the rise as US crude production breaks records and crude stockpiles increase

These concerns were recently aired by both the Saudi energy minister and the Saudi OPEC governor. Both alluded to surging shale-led production in the US and rising US crude stockpiles amid weakening slowing global demand growth.

In the US, crude output set another all-time high record in recently, reaching 11.6 mb/d in the week-ending 2 November, according to weekly data from the US Energy Information Administration (EIA). (Chart 6.) US crude production has now surpassed both Russia and Saudi Arabia as the largest in the world, surging by an incredible 1.8 mb/d, or 19%, in 2018 so far. US crude stocks also notched up a seventh consecutive week of increases, to reach 431.8 million barrels.

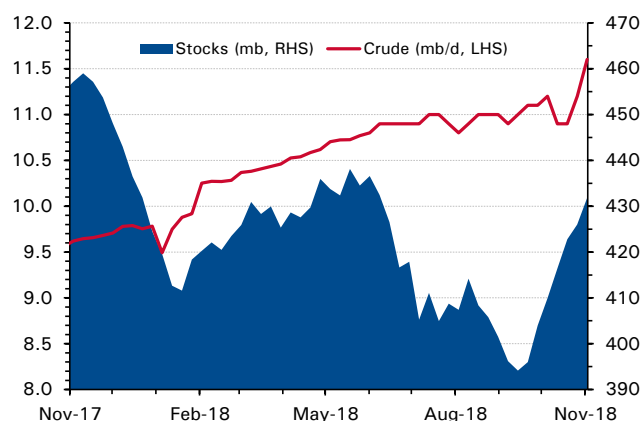
Oil market already in surplus, with weaker oil demand growth ahead as global economy slows

In fact, according to the IEA, oil supply has exceeded oil demand in every quarter of this year, with more noticeable stock builds occurring over the second and third quarters of the year. (Chart 7.) Saudi oversupply concerns, therefore, appear to have some substance.

Moreover, on the current supply trajectory, the situation is not likely to improve in 2019. Not only were oil demand growth projections brought down this year, by 130,000 b/d to 1.3

mb/d, but the IEA has also cut its forecast for 2019, by 200,000 b/d to 1.4 mb/d.

Chart 6: US crude production and crude stocks

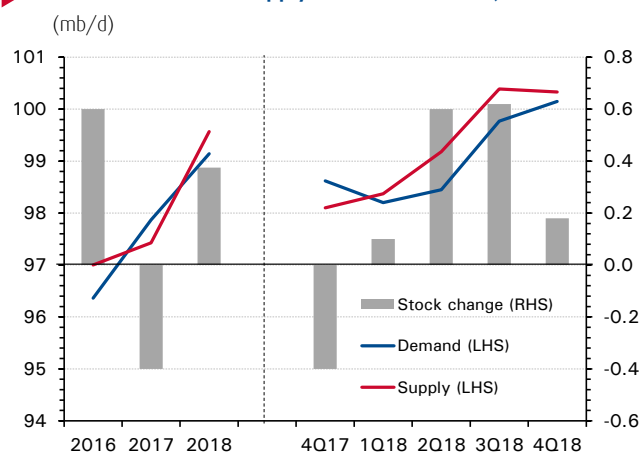


Source: US Energy Information Administration (EIA)

The agency cited a combination of higher oil prices, downward adjustments to Chinese data and weaker global economic growth, as projected by the OECD and the International Monetary Fund (IMF).

Higher oil prices combined with significant currency depreciation in emerging markets stemming from rising US interest rates and some capital ‘flight to quality’—risks the IMF identified in their October WEO—have raised the domestic cost of oil products in several emerging markets. In India, for example, which has seen its currency decline by almost 15% this year against the dollar, the authorities had to reduce domestic gasoline and diesel prices in early October to mitigate the impact on households.

Chart 7: Balance of supply and demand to 4Q18



Source: IEA, assumes OPEC output is maintained at September’s levels

Even in the US, higher pump prices for the consumer are beginning to affect demand for gasoline. Gasoline’s share of total US oil demand is significant at 44%, but according to

weekly August and September figures, gasoline demand has been contracting.

Weighing on the outlook for next year in addition to tighter US monetary policy is the possibility of heightened trade friction between the US and China. Oil demand would naturally be impacted were an escalation in trade tariffs to occur and result in slower global economic growth. The IMF lowered its global growth estimate for 2018 and 2019 by 0.2 percentage points to 3.7%, in part to reflect these downside risks.

Where now for oil prices?

The balance of risks appear skewed to the downside as far as oil prices are concerned. The markets seem to be attaching greater weight to surging OPEC and US crude production, rising stockpiles and weaker economic growth ahead than they are to the possibility that Iranian sanctions and declining Venezuelan production will lead to a shortage of oil. Prices for future Brent oil deliveries are lower than for immediate, or spot, deliveries. Known as backwardation, this state suggests that traders expect the market to have a surfeit of supply.

Of course, if OPEC and its partners were to reverse course in 2019 and cut production rather than increase it, then the landscape could change dramatically. All in all, the only thing certain in this market may be more volatility.

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