Economic Update
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Oil Markets

Oil prices range-bound as demand concerns resurface

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Summary

Oil prices have fallen slightly from recent 11-month highs amid renewed oil demand concerns following the spread of more virulent coronavirus strains. The demand for oil could accelerate in the second half of 2021 as suggested by the IEA, and in line with the IMF's 2021 growth forecasts. For now, Saudi Arabia's production cut has helped tighten supplies and put a floor on prices. Supply restraint may have to continue for longer.

- Oil prices closed the month up nearly 8%, with international benchmark Brent ending January at $55.88/bbl (+7.9% m/m) and US marker West Texas Intermediate (WTI) finishing at $52.2/bbl (+7.6% m/m). (Chart 1.)

- Brent futures also ended the month further in backwardation (i.e. where the price premium of near over longer-dated futures has widened), a signal that the market expects near term supply to be tighter. (Chart 2.) Saudi Arabia's decision to unilaterally cut production in February and March by 1 mb/d is probably the major factor in this development.

- Last week saw Brent trading in a very narrow $55-$56 range, with bullish impulses largely held in check by near-term concerns over a faltering oil demand recovery amid the emergence of more virulent coronavirus strains. Positive for oil was EIA data showing the steepest fall in US commercial crude inventories since last July and reports that Russian oil companies could redirect more oil for domestic use (rather than export it). News that the latest Covid vaccine candidate, the one-shot jab from Johnson and Johnson, appeared to offer protection from some of the new coronavirus variants, was enthusiastically welcomed, but failed to push Brent out of its range and top its recent eleven month high of $56.58.

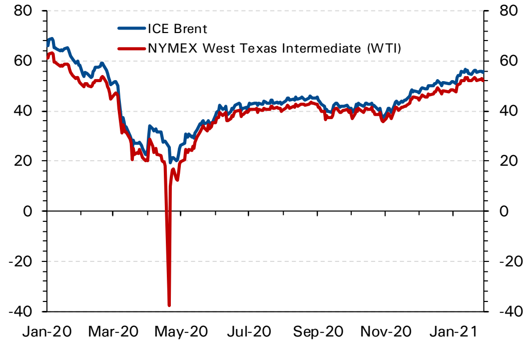
- The vaccine-inspired optimism that was a feature of markets at the start of January has been tempered by the increase in cases and hospitalizations linked to the new variants. Many economies have had to re-impose or tighten mobility restrictions. Even China has had to reinstate measures following a flare up of infections in Hebei Province. The authorities have also had to urge citizens not to travel over the Lunar New Year, the largest annual human migration in the world and a key driver of transportation fuel consumption. Air and road data show a marked reduction in activity already, which will negatively affect oil demand this quarter.

- The potential for weaker Chinese oil consumption at the start of 1Q21 stands in stark contrast to oil activity at the end of 2020. Refiners, with one eye on the Lunar New Year travel season, processed record amounts of crude in November and December, 14.2 mb/d and 14.13 mb/d, respectively, according to the National Bureau of Statistics. China's imports of crude, however, fell to a 27-month low of 9.06 mb/d (-18% m/m) in December. (Chart 3.) This was at least partly due to independent refiners exhausting their import quotas for the year, though.

- The International Energy Agency (IEA) cited the return of Covid-lockdowns over the winter in cutting its oil demand growth estimate for 1Q21 and the year as a whole. 1Q21 oil demand growth was revised down by a massive 580 kb/d, with the year-avg. then coming in at 5.45 mb/d. (Chart 4.) This is still a significant improvement on 2020's unprecedented contraction of 8.85

Chart 1: International crude oil prices

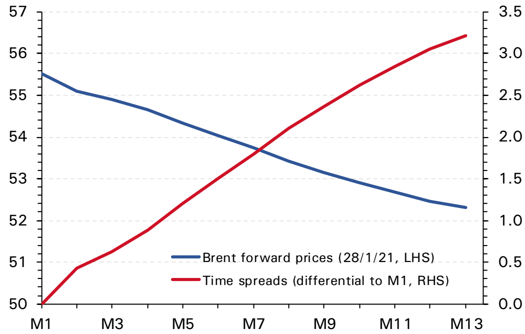
($/bbl)



Source: Refinitiv Datastream

Chart 2: ICE Brent forward curve

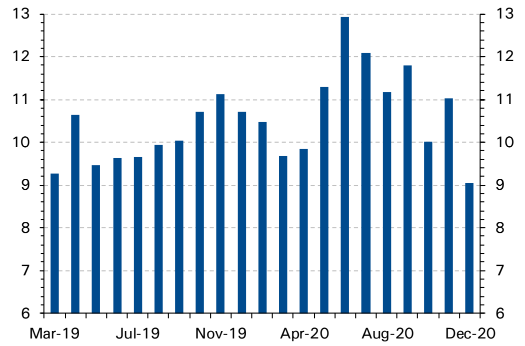
($/bbl))



Source: Intercontinental Exchange (ICE)

Chart 3: China crude imports

(mb/d)



Source: China General Administration of Customs mb/d, and oil demand is expected to accelerate in 2H21 and end 4Q21 at a high of 99.05 mb/d.

- The acceleration of oil demand in the second half of 2021 is attributed to higher global growth, which is projected by the International Monetary Fund (IMF) to reach 5.5%, an upward revision (+0.3%) from October's forecast. The IMF reasons that the recovery will accelerate in 2H21 due a combination of vaccine gains and additional policy support.

- The IEA estimates that global stocks could fall by 1.1 mb/d (or 100 mb) during this quarter, following an observed decline of 2.58 mb/d in 4Q20, largely on the back of Saudi Arabia's production cut. The Saudi decision to cut supply appears appropriate in light of the IEA's oil demand estimate of essentially flat-to slightly negative oil demand growth in 1Q21. Steeper stock declines are projected once vaccination efforts advance and activity returns in 2H21.

- OPEC+ supply increased in December to 34.4 mb/d, according to OPEC and Platts data, with compliance exceeding 100%. OPEC-10 members pumped 21.7 mb/d in December, with Congo (95%), Equatorial Guinea (0%), Gabon (21%) and Iraq (95%) failing to abide by their December allocations. Non-OPEC produced around 12.7 mb/d. From January, all OPEC+ members were permitted to increase supply by about 1.4% (500 kb/d in aggregate) to bring total OPEC+ output up to 34.86 mb/d. Mexico returned to the OPEC+ fold in January (its quota is 1.75 mb/d), bringing OPEC+ aggregate output upto 36.65 mb/d. This will decline to 35.8 mb/d by end-1Q21, adjusting for Saudi cuts/Russia and Kazakhstan increases, which means that there is still around 8 mb/d of OPEC+ oil being withheld from the market. (Chart 5.)

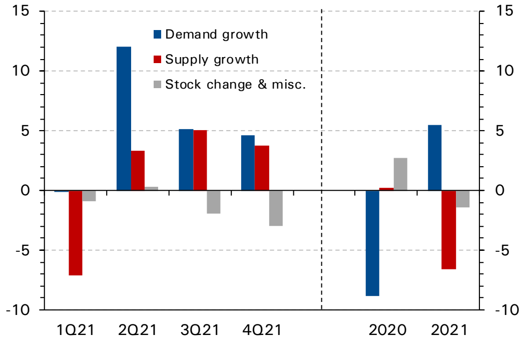
- The above supply figures do not include production from Libya, Iran and Venezuela nor the contribution of cumulative compensatory cuts that non-compliant producers are expected to make. Iran's production has been inching up of late, and could potentially increase if sanctions under the Biden administration are lifted. Libya's output, at 1.2 mb/d in December, is also at its highest since 2013. As for compensatory cuts, Iraq said recently that it intends to bring its output down in January and February by about 257 kb/d from December's level to 3.60 mb/d—so long as the Kurdish Regional Government (KRG) agrees to reduce flows from its fields. January tanker tracking data shows exports already starting to pare back.

- In the US, recent crude stock draws of 9.9 mb leave stock levels at 476.7 mb in the w/e 22 January, which provides 32.6 days of forward cover—the least since last April. (Chart 6.). Crude production fell to 10.9 mb/d even as oil rig counts continue to rise, to 295 by January's close (Chart 7.)

- Looking ahead, while the oil futures curve is signaling near-term supply tightness, the oil demand outlook for this quarter is murky, and perhaps only helped by winter heating fuels demand. Prices largely reflect future vaccine gains and Saudi Arabia's promise to restrain its supplies. The risk is that the pandemic will persist for longer than expected and beyond even the kingdom's willingness to singlehandedly shoulder output cuts. It appears that output restraint may need to stay for longer, but this many not be easy to maintain within OPEC+.

Chart 4: Oil demand, supply and stock changes

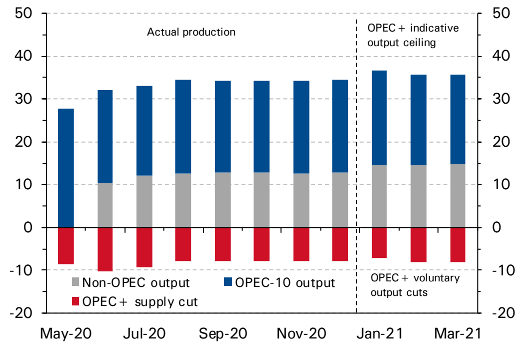
(mb/d)



Source: IEA, NBK; 2021 estimates assume full OPEC+ compliance

Chart 5: OPEC+ crude production

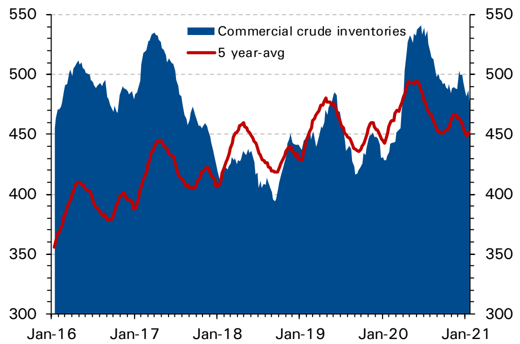
(mb/d)



Source: OPEC, Platts; *OPEC+ includes Mexico from Jan-21

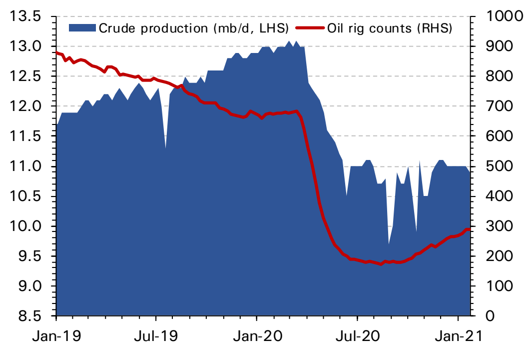
Chart 6: US commercial crude inventories

(mb)



Source: EIA

Chart 7: US crude oil production and rig counts



Source: EIA, Baker Hughes

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