Oil markets

Oil prices gain in September on signs the physical market is tightening

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Highlights

- **Brent up near 1-year high of $57/bbl, while WTI breaks through $50/bbl, as oil prices enjoy second consecutive month of gains.**
- **Sentiment improves on signs that the physical market is tightening, but market rebalance is unlikely before 2019, the IEA notes.**
- **The IEA has revised its demand growth estimates for 2017 upwards by 100,000 b/d to 1.6 mb/d.**
- **OECD stocks continued to draw down in July, but still remain above OPEC's target 5-year average stock level.**
- **US crude production/refining ramps up after Hurricane Harvey.**
- **OPEC output fell by 80,000 b/d to 32.76 mb/d in August on supply outages in Libya; OPEC compliance improves to 98%.**
- **Speculation intensifies that OPEC is mulling extending its production cuts beyond March 2018 and/or deepening them by an additional 1%.**

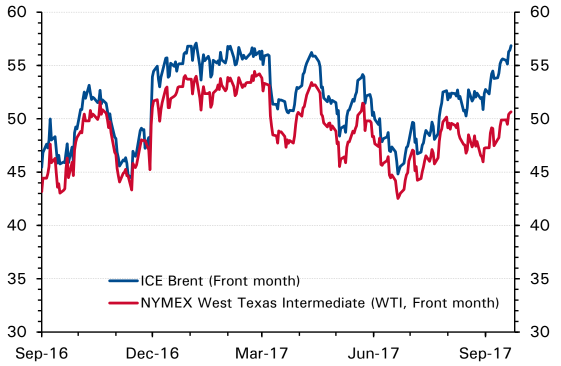
Oil prices enjoy post-Harvey boost amid signs that the physical markets are tightening

By the standards of 2017, September has so far been a good month for oil prices. Both Brent and West Texas Intermediate (WTI) are up by 8% or more to the $56 and $50 per barrel (bbl) levels, respectively, amid signs that the physical markets are tightening. (Chart 1.) For Brent, the recovery has seen the marker recoup almost all its losses this year, as it trades near its January 2017-high of $57/bbl. Encouraging demand/supply fundamentals are driving the improvement in sentiment: global demand for crude posted one of its best quarters of growth for a long time in 2Q17; OPEC production trended downwards in August, along with an improvement in members' compliance; and OECD crude and petroleum product stocks drew down in July for the fifth time in seven months.

Moreover, reflecting the tightening in fundamentals, the Brent forward curve has flipped into a structure known as backwardation, where contract prices for future delivery are below contract prices for immediate/spot delivery. (Chart 2.) This suggests that traders are beginning to view the near-term more bullishly than the medium-to-long term. This is the first instance of backwardation since oil prices were above $100/bbl in 2014.

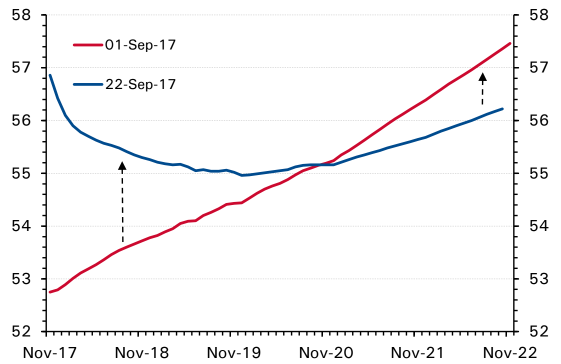
Over in the US, the Texas/Gulf Coast energy industry looks to be finally re-emerging from the disruption caused by Hurricane Harvey in late August. Most of the state's 30 or so refineries are back on line, proceeding to claw back 21% of the volume they had been processing before the hurricane hit. Crude production also appears to be ramping up again, climbing to 9.5 mb/d in the week-ending 15 September, after having fallen by as much as 8% (749,000 b/d) in the week immediately

Chart 1: Crude oil prices
($/bbl)



Source: Thomson Reuters Datastream

Chart 2: Brent forward curve
($/bbl)



Source: Bloomberg

Chart 3: Brent/WTI front month spread
($/bbl)

Source: Thomson Reuters Datastream

after the hurricane made landfall. (See Chart 4.) Crude and product stocks, however, moved in opposite directions in the aftermath of the hurricane, with crude inventories building and refined products, such as gasoline and middle distillates (e.g. diesel), falling.

The resumption of demand from the US has been generally positive for crude prices. Brent also benefitted from the disruption, with the spread to WTI, the US marker, widening to a two-year high of $6.3/bbl on 8 September after European and non-US refineries, which process Brent, ran at higher rates to compensate for the products shortfall in their markets created by the cessation of imports from the US. (Chart 3.) Of course, burgeoning US crude supply, thanks to rising shale production, has also been putting downward pressure on WTI relative to Brent.

Market rebalancing is taking time, and likely to extend into 2019

The long-sought after rebalancing of supply and demand is proceeding, albeit slowly, the International Energy Agency (IEA) noted in its recent oil market report. The process has been helped along by stronger global crude demand growth in 2Q17 (+2.3 mb//d; +2.4% y/y), especially in OECD Europe and the US. (Chart 5.) Indeed, this has prompted the IEA to revise upwards its demand growth estimates for this year by 100,000 b/d to 1.6 mb/d. Next year, the agency estimates that crude demand will rise by a still robust 1.38 mb/d.

Also helping matters was a decline in global crude supplies in August because of scheduled maintenance and unplanned supply outages. The latter includes the aforementioned Hurricane Harvey as well as, for example, the disruption to crude flows from Libya, after armed protestors conspired to shut down the country's largest oil field, Sharara.

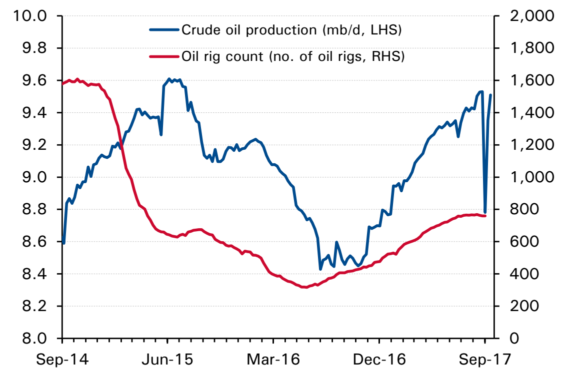
The IEA puts the global supply pullback in August at around 720,000 b/d, which is the first fall in four months. However, in our view, this won't be enough to prevent supply exceeding demand in 3Q17, by an estimated 100,000 b/d, and avert a build-up in global crude stocks after months of drawdowns.

Despite the negative impact of Hurricane Harvey on US crude production, non-OPEC supply growth is still expected to accelerate before year-end, possibly adding as much as 500,000 b/d in the fourth quarter. However, for 2017 on average, we expect there could be a supply shortfall of around 200,000 b/d. (Chart 6.) This would be the first year since 2013 that demand exceeds supply on an annual basis.

Though this will be comforting for OPEC as it works its way through its 15-month production cut agreement in a bid to accelerate the global stock drawdown, the group still has its work cut out. Nine months into the agreement period and OECD crude and petroleum product inventories, one of the key yardsticks by which OPEC measures its success, are still stubbornly high at 3.02 billion barrels (July). This is still more than 250 million barrels above OPEC's target 5-year average level of around 2.75 billion barrels—even if total crude and product stocks have fallen in five of the last seven months. (Chart 7.)

Worryingly for OPEC, 2018 could see stocks accumulate rather than draw down if, as the IEA reckons, non-OPEC supplies, led by a resurgent US, increase at double 2017's rate by an estimated 1.5 mb/d. This would almost certainly push back OPEC's coveted stock drawdown target into 2019.

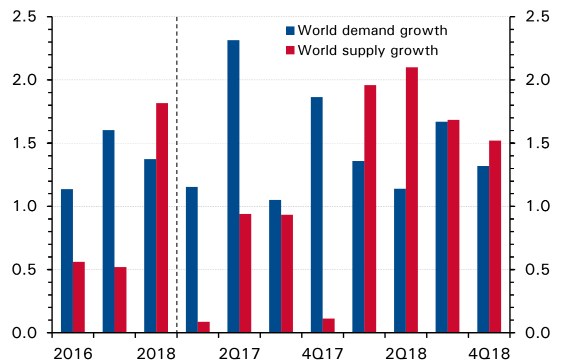
Chart 4: US crude production and oil rig counts



Source: US Energy Information Administration (EIA), Baker Hughes

Chart 5: World demand and supply growth

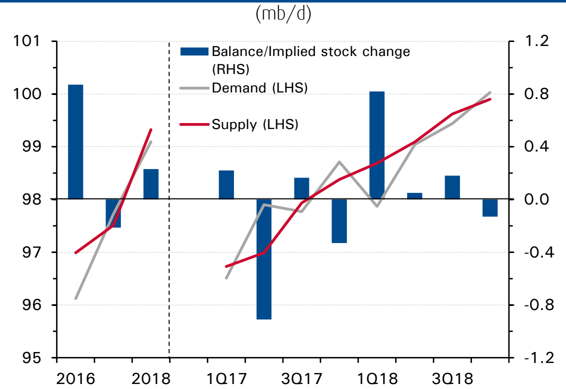
(mb/d)



Source: IEA, NBK; * forecast assumes OPEC output at August levels

Chart 6: Balance of supply and demand

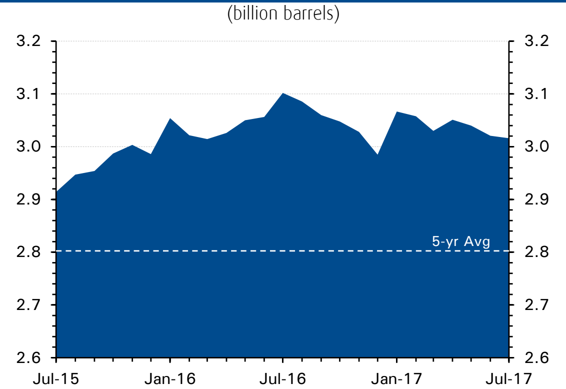
(mb/d)



Source: IEA, NBK; * forecast assumes OPEC output at August levels

Chart 7: OECD commercial crude and product stocks

(billion barrels)



Source: IEA

OPEC mulls extending production cut accord beyond March 2018 as compliance improves in August

It should come as no surprise then that there has been more chatter lately emanating from the OPEC camp about rolling over the production cut agreement beyond March 2018, possibly by more than three months. The group admitted in its recent oil report that it expects the demand for its crude (the "call") in the first and second quarters of 2018 to be below current production levels. This suggests that deeper cuts may have to be considered, with Iraq recently raising the possibility that oil producers may need to curtail output by an additional 1%. It is not clear that there is an appetite for this let alone an intention to comply among OPEC and the ten non-OPEC signatories to the current agreement; Iraq, for one, is among that select band of producers that has yet to fully meet its obligations even under the existing agreement.

Indeed, shoring up non-compliers and bringing on board Libya and Nigeria, who are exempt from the production cuts altogether, will need to be OPEC's first task. Compliance, using OPEC secondary source data, improved to 98% in August, up from 89% in July, as Saudi Arabia, Kuwait, Venezuela and several others pumped well below their quotas. Apart from Iraq, the UAE and Algeria remain the only OPEC members never to have achieved their targets.

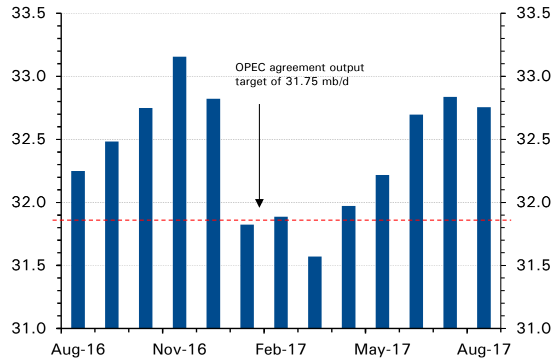
OPEC's aggregate output fell by 80,000 b/d to 32.76 mb/d in August from 32.84 mb/d in July. (Chart 8.) Supply is still more than 1 mb/d above the group's stated target of 31.75 mb/d, however. Libya's 110,000 b/d fall in crude production due to unrest played a big part in that. But August may only be a blip, and Libya's output could resume its upward trajectory and push beyond the 1 mb/d it pumped in July—almost double (480,000 b/d) the country's output last November, when the OPEC accords were inked.

As for the compliance rate among the Russian-led group of ten non-OPEC oil producers, this reached 100% for the very first time last month, the IEA stated.

Though the recent Joint Ministerial Monitoring Committee (JMMC) meeting in Vienna wrapped up over the weekend without any decision on extending or deepening the production cuts, markets will be especially sensitive to any announcements in favor of the latter. The next official OPEC meeting is scheduled for November, where it might be expected that some deliberations will take place. These may also include bringing Nigeria on board as a signatory; the country has been exempt from the production cut agreement, but recently indicated that it might accept restrictions once it achieves sustainable production of 1.8 mb/d. OPEC will be satisfied with that.

Chart 8: OPEC crude oil production

(mb/d)



Source: OPEC secondary sources

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