Oil prices surge after Saudi production cut decision

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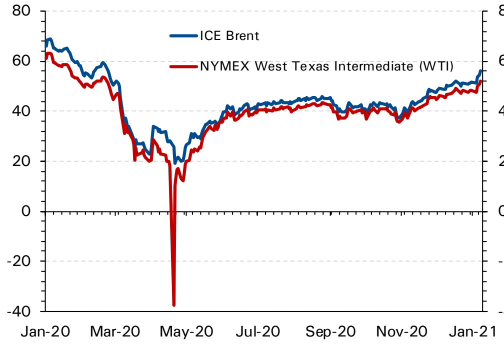
Summary

Oil prices surged last week to 11-month highs following the OPEC+ announcement that Saudi Arabia would cut its production to preemptively head off any oil demand weakness this quarter. Positive developments in the US, including President-elect Biden's stimulus plans and further crude inventory drawdowns helped boost oil prices further. Despite the start of mass Covid-19 vaccination programs, many economies have entered lockdown again, bringing with it the prospect that oil demand weakness may persist for longer than expected and through this quarter.

- Oil prices surged to 11-month highs last week, with the international crude oil benchmark, ICE Brent, rallying to $55.99/bbl by Friday's close and West Texas Intermediate (WTI) reaching $52.24/bbl. The rally's major catalyst was the OPEC+ announcement on Tuesday that Saudi Arabia would unilaterally cut its production by 1 mb/d in February and March, but the mood improved further on Friday after US President-elect Joe Biden promised a stimulus package that would run into the trillions and a faster rollout of the Covid-19 vaccine. (Chart 1.)
- A larger than expected decline in US crude inventories on Wednesday and a weakening US dollar had also helped stoke bullish sentiment. In truth, markets have been more willing to be hopeful since mid-December after the coronavirus vaccinations began to roll out. Brent posted gains of 8.8% in December and reduced its 2020 loss to -21.5% by year-end. Oil prices have also now recouped all their Covid-19 pandemic-related losses.
- The Saudi decision to curb its own crude supplies by 1 mb/d, about 10%, in February and March took the markets completely by surprise. Brent rose almost 5% on the news, pushing the forward curve into steeper backwardation (near term prices being higher than longer-dated prices). By last Friday, the front month contract had widened to a premium of $0.72/bbl over the contract for delivery three months later. (Charts 2 & 3.). This reflects the expectation of tighter near-term supplies.
- The production cut was framed by Saudi energy minister Prince Abdulaziz as a preemptive move to head off any oil demand weakness in light of the recent return to mobility restrictions in major advanced and emerging economies amid the new, more highly transmissible Covid-19 variant. It is also contingent on other OPEC+ members, with the exception of Russia and Kazakhstan, rolling over January output into February and March. Russia will be allowed to increase its production by 65 kb/d and Kazakhstan by 10 kb/d in each of the next two months. In aggregate, OPEC+ output will therefore fall by 925 kb/d in February before the cuts ease to 850 kb/d in March. For Kuwait and the UAE, production will remain at 2.33 mb/d and 2.63 mb/d, respectively, having already increased supply by 1.4% in January as per the decision of the 12th OPEC/non-OPEC ministerial meeting in December, which sanctioned a collective OPEC+ supply increase of 500 kb/d from January. (Chart 4.)
- Last week's OPEC announcement is all the more surprising given that it followed several days of disagreement and even a suspension of talks between the Saudi camp, which preferred to either keep output steady or even reduce it (the preferred option for Saudi), and Russia, which favored

Chart 1: International crude oil prices

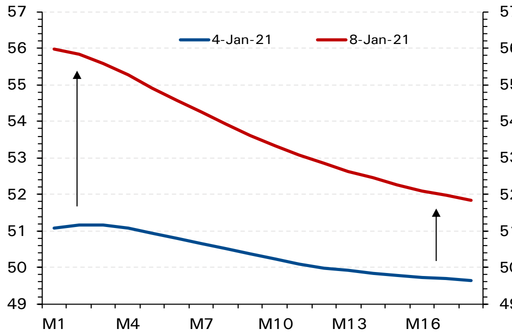
($/bbl)



Source: Refinitiv

Chart 2: ICE Brent forward curve

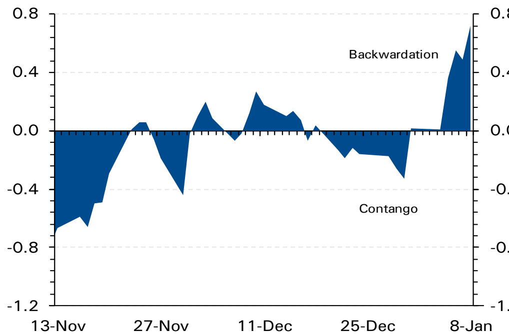
($/bbl))



Source: Intercontinental Exchange (ICE)

Chart 3: ICE Brent 3-month time-spreads

($/bbl)



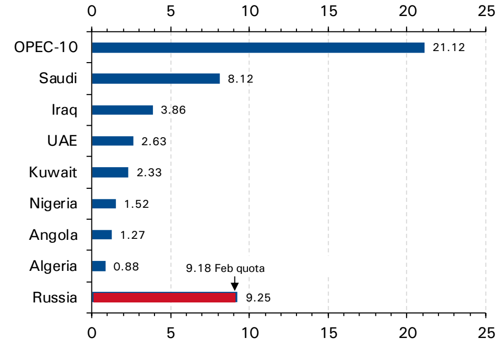
Source: ICE

increasing output by another 500 kb/d. The outcome was hailed by Russia's Novak as a "great New Year's present for the whole industry" and by Saudi Prince Abdulaziz as a "win-win...if things go south, then we have taken pre-emptive action...if it doesn't, then we expedited the recovery".

- As a preemptive move to protect against potentially deteriorating oil demand, the Saudi assessment appears correctly judged. While oil demand appears to have beaten expectations in December, the current quarter is looking weaker than expected, with many advanced and emerging economies facing a second or even a third round of lockdowns. Moreover, with Spring not far off and refinery maintenance season kicking in—a traditionally soft period for oil demand—markets should be wary of putting too much hope on a resurgence in oil demand in the weeks ahead.
- The global crude and petroleum products inventory overhang also remains ample, especially in refined petroleum products like distillates (diesel, jet fuel etc.), whose consumption was severely affected by the coronavirus-downturn. The International Energy Agency (IEA) estimated that OECD industry stocks were, at 3,129 mb in October, still about 183 mb above the 5-year average, with a stock surplus likely at the start of 2021.
- In the US, the Energy Information Administration (EIA) reported a US crude stock draw of 8 million barrels for the week-ending 1 January, which was the largest since late August and leaves stock levels at 485.5 mb, about 7.7% above the 5-year seasonal average, down from 8.4% the previous week. (Chart 5.) In terms of supply cover, crude stocks provide 34.2 days, the lowest since last August's reading of 34.5 days. US crude production, meanwhile, remained flat at 11 mb/d for the sixth consecutive week. (Chart 6.) The number of oil rigs brought back on line increased by 8 to 275 last week, making it a 7^{th} week in a row of increases. Since dropping to 172 wells in August, the lowest level in more than a decade, the US oil rig count has recovered by 60%, or 103 additional rigs.
- The IEA's 2021 estimate for oil demand growth in 1Q21, currently at 0.6 mb/d, may also be revised down in line with weaker consumption on the back of a combination of mobility restrictions and, so far, a mild northern hemisphere winter. The softer outlook may be mitigated somewhat by potential Chinese oil consumption, which was behind much of oil demand's gains in the second half of 2020. The IEA estimate of oil demand growth this year is 5.7 mb, a clear improvement on 2020's estimated decline of 8.8 mb/d. (Chart 7.)
- While there has been a significant turnaround in market sentiment and increased optimism following the Saudi production cut announcement and the broader rollout of the coronavirus vaccines, oil demand softness will persist through the quarter. With many economies currently back imposing mobility restrictions and quarantines, consumption will remain subdued. Once again, aviation fuel demand in the oil mix will be the most affected and probably the last to recover. The global economy pins its hopes on a speedier vaccination rollout.

Chart 4: OPEC-10 & Russia output quotas Feb-March

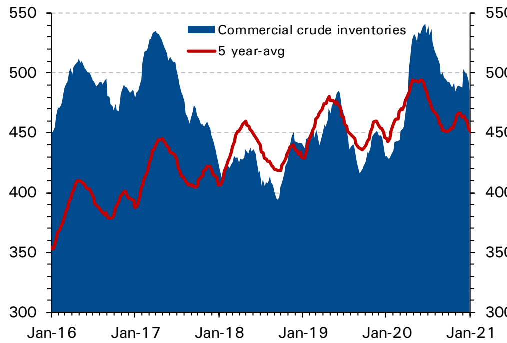
(mb/d, major OPEC-10 producers)



Source: OPEC, S&P Platts Global

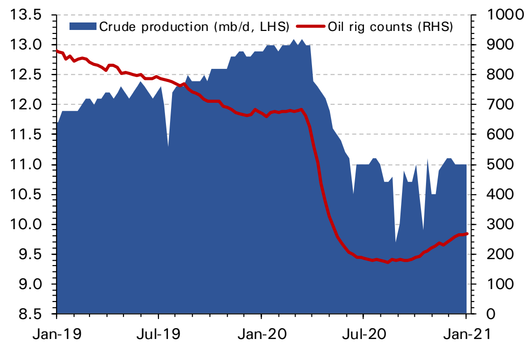
Chart 5: US commercial crude stocks

(million barrels)



Source: US Energy Information Administration (EIA)

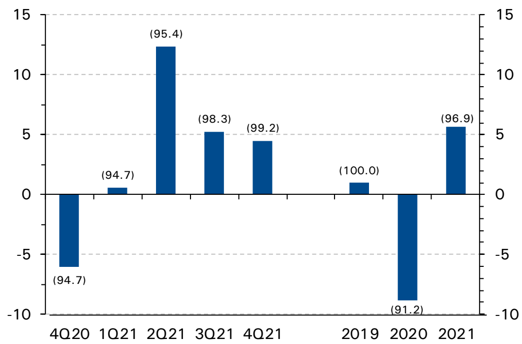
Chart 6: US crude oil production and rig counts



Source: EIA, Baker Hughes

Chart 7: Global oil demand growth

(mb/d; figures in brackets denote global oil demand level)



Source: International Energy Agency (IEA)

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