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Economic Update

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Oil Markets

Oil prices fall in August on global economic recession fears, possible Iran supply boost

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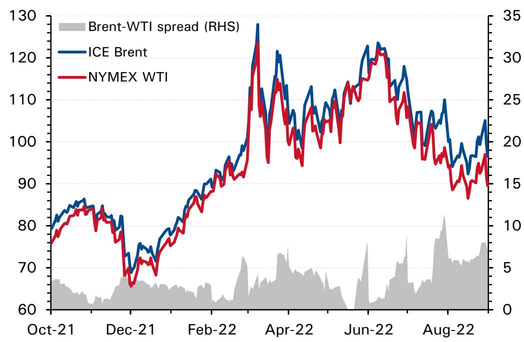
Summary

Global economy and stagflation worries and their negative impact on oil demand weighed heavily on oil markets in August, pushing prices down for a third month in a row. News that Iran nuclear talks were resuming was also a factor. Despite increasing global oil supplies, physical markets remained relatively tight as OPEC+ supply continued to undershoot its target and US output gains remained modest. Saudi Prince Abdulaziz suggested OPEC+ output cuts could be on the table again in order correct the physical/paper market disconnect and amid thinning OPEC+ spare capacity.

- Oil prices closed lower in August for the third consecutive month, on heightened global economic recession fears amid aggressive US Fed policy tightening and an unfolding European energy crisis triggered by the Russia-Ukraine conflict. A stronger US dollar could also have weighed on oil prices. Brent futures fell 12.3% in August to settle at $96.5/bbl, the worst monthly performance since November 2021, while prompt time spreads (M1-M2) have narrowed to $1.2 from over $2 at the start of the month, signaling less supply tightness. (Charts 1 & 2.) Brent's year-to-date gains have been pared back to 24%, from a high of 65% in early March ($128) after Russia's invasion of Ukraine. US marker West Texas Intermediate (WTI) shed 9% to end at $89.6/bbl. Local grade Kuwait Export Crude (KEC) fell 7.2% to $104.2/bbl.
- The widely traded Brent-WTI spread, which reflects the relative sensitivity of the two key crude benchmarks to global (Brent) and regional (US) demand/supply dynamics, was again trending up in the last half of the month at over $7/bbl. (See Chart 1.) Though still short of its 8-year wide figure of $13 in late July, Brent's premium over WTI nevertheless reflects the difficulties Europe is facing sourcing substitutes for Russian oil and, as the global benchmark, its higher sensitivity to global geopolitical risk:—supply fears in Libya and Iraq in August as well as from the Russia-Ukraine conflict more broadly. The widening spread has also encouraged US oil producers to ramp up exports to Europe and beyond: US crude exports broke all records in August averaging in one week exports of 5 mb/d.
- Market sentiment has been dominated by worries about the global economy and the pace and extent of US Fed interest rate hikes required to tame multi-decade high inflation. The release of weak Chinese industrial, consumer and oil import/consumption data soured the outlook. Coupled with news that Iran nuclear negotiations were back on after months of no progress, Brent sold off, dropping to pre-Ukraine invasion levels of around $92. Money manager net length, a measure of bullish market sentiment towards oil, fell in August to its lowest since November 2020. Open interest, a measure of market activity, declined to a 7-year low amid low liquidity and high hedging costs.
- This shrinking of market liquidity and trading activity was brought up by Saudi energy minister Prince Abdulaziz in mid-August when he lamented the volatility and disconnect between the futures and physical oil markets. He suggested that it could require OPEC+ to cut production after its September meeting. Oil prices traded positively off his comments for the rest of August.
- The marked volatility is also a symptom of a highly uncertain global oil demand backdrop. Oil demand growth has been decelerating since peaking in 1Q22 as the global economy grapples with multiple headwinds including spiking inflation and energy costs, tighter monetary policy, a stronger US dollar and negative spillovers from both the Russia-Ukraine conflict and

Chart 1: Oil prices

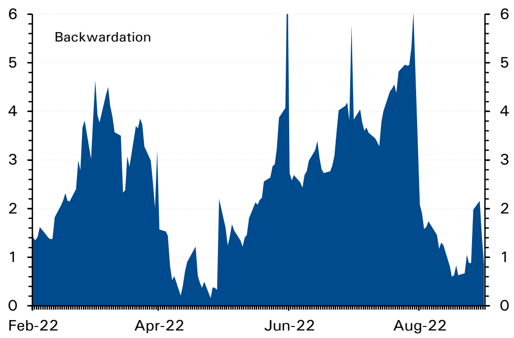
($/bbl)



Source: Refinitiv

Chart 2: Brent time spreads (M1-M2)

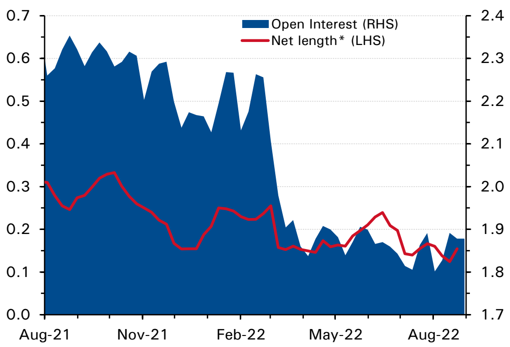
($/bbl)



Source: Refinitiv

Chart 3: Brent money manager net length

(million contracts)

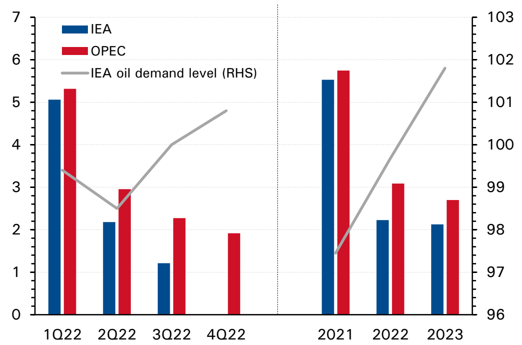


Source: Refinitiv, Bloomberg

China's protracted Covid-19 lockdowns. The economic repercussions of the Russia-Ukraine conflict, which extend beyond soaring energy costs, are still playing out of course, with Europe at the sharp end and facing the prospect of weaker industrial activity and consumer belt-tightening this winter amid likely energy rationing and soaring consumer prices. In July, the IMF downgraded its global economic forecast for a third time and now pegs growth at 3.2% in 2022, down from 4.4% in January, and at 2.9% in 2023.

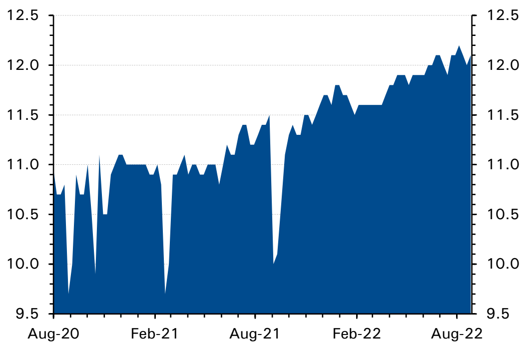
- The oil demand outlook for the remainder of 2022 is one of further moderation, with year-on-year growth seen below 100 kb/d in 4Q22 and averaging 2.1 mb/d for the year as a whole. (Chart 4.) The IEA reckons that world oil demand will still top pre-pandemic levels, at 100.8 mb/d, boosted by increased use of oil for power generation (gas-to-oil switching). For 2023, the consensus is still positive, at 2.3 mb/d, according to the three main energy reporting agencies the IEA, OPEC and EIA. This is heavily predicated on a resurgence in Chinese economic and oil demand activity, though.
- Global oil supplies rose to a pandemic-high in July, supported by OPEC+ output gains, including resilient Russian production, and the winding down of maintenance in Canada and the North Sea. US year-to-date production gains have been modest, rising by only 300 kb/d to 12.1 mb/d by end-August, according to EIA weekly petroleum data. (Chart 5.) OPEC+ production (quota-bound members) reached 38.5 mb/d (+548 kb/d) in July, the best monthly gain in a year, with Saudi, Kuwait and the UAE all ramping up production to hit their expanded quotas. OPEC+ still fell short of its 648 kb/d group output increase target for the month. As a result, the supply shortfall increased to 2.9 mb/d in July and will likely extend further in August and then in September when the group's quota increases by 100 kb/d, respectively. (Chart 6.)
- The latter was agreed at the August OPEC+ meeting but has largely been seen as a token gesture to pacify international calls for OPEC+ to combat high oil prices. Since then, market expectations have shifted considerably. With oil demand under pressure and Iran's potential return, there appears little likelihood that OPEC+ will sanction further increases from October onwards. The issue of eroding OPEC+ spare capacity will dominate OPEC+ deliberations. By October, spare capacity could be down to 2.3 mb/d (excluding Iran and Russia), held almost entirely in Saudi Arabia and the UAE.
- Prince Abdulaziz's suggestion that supply cuts could be back on the table at OPEC's September meeting, likely had OPEC+ spare capacity constraints in mind as well as the potential return of Iranian oil (at least 100 mb in floating storage and up to 1 mb/d within 12 months). OPEC+ would need to accommodate this (and would have the political cover to do so) as Iran would continue to seek an exemption from output cuts. In contrast, the potential loss of around 1.3 mb/d of Russian crude once the EU oil embargo kicks in at the end of the year has not figured publicly in the group's calculations.
- The loss of Russian of oil in 2023 (assuming buyers cannot be found for its heavily discounted grades), gas-to-oil switching and an expanding Chinese economy are the three most bullish impulses for oil prices in the months ahead. Combined, the IEA estimates they could by mid-2023 help shift the market from one of expected stock builds to one of stock draws. (Chart 7.) For the time being, however, volatility looks set to stay as market participants attempt to discern a likely path for oil prices amid often conflicting economic and physical market oil data. What is likely, however, is that OPEC will do whatever it takes to manage supply appropriately and provide support for prices close to $100/bbl.

Chart 4: Global oil demand/growth forecast
(mb/d, y/y)



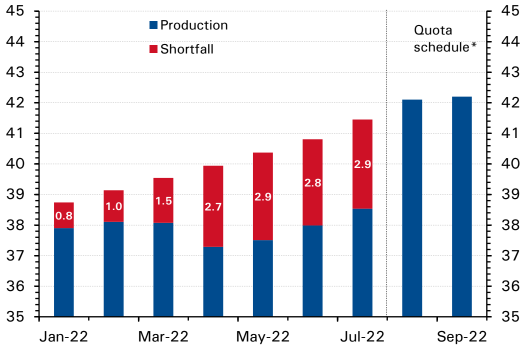
Source: IEA, OPEC

Chart 5: US crude production
(mb/d)



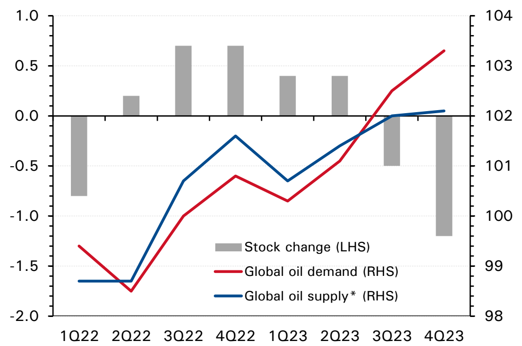
Source: US Energy Information Administration (EIA)

Chart 6: OPEC+ crude production
(mb/d)



Source: OPEC, IEA, S&P; *excludes Iran, Libya, Venezuela & Mexico

Chart 7: Balance of supply and demand
(mb/d)



Source: IEA, Mees *assumes Iran sanctions continue

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