Oil markets

Oil prices hold on to recent gains but markets uneasy ahead of OPEC meeting

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Highlights

- Brent continues to hold above $60 and looks on course to notch up a third consecutive month of gains; prices boosted last week by closure of Keystone pipeline in the US after an oil leak.
- Market sentiment had turned more negative recently as US crude output surged to a shale-era high (9.66 mb/d) and uncertainty surrounded Russia's commitment to extend the OPEC/non-OPEC production cut agreement.
- OPEC to meet on 30 November to discuss agreement extension after crude production fell in October to 32.59 mb/d (103% compliance).
- The US will become the largest crude and petroleum liquids supplier by 2025, the IEA estimates in its World Energy Outlook 2017.
- Markets are likely to be over-supplied in 2018, leading to an increase in OECD stocks.

Brent holds above $60 in anticipation of OPEC/non-OPEC meeting

With major oil markers, Brent crude and West Texas Intermediate (WTI), currently ranging around the $63 and $58 levels, respectively, oil prices look on course to notch up a third consecutive month of gains. (Chart 1.) Last week, prices were given an unexpected boost by the closure, after an oil leak, of the Keystone pipeline in the US which transports Canadian crude to refineries on the US Gulf Coast.

Since their 2017-low in June, Brent and WTI are up by at least 38%, a four-and-a-half month bull run that has been driven by a combination of better-than-expected global demand growth, tighter crude supplies and heightened geopolitical risk.

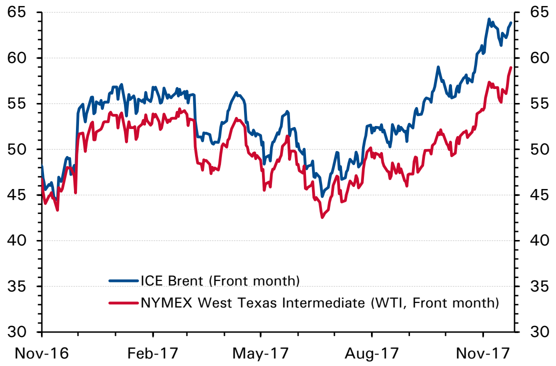
OPEC, for its part, has commendably stuck to its task of cutting crude output, averaging 97% compliance over the ten months of the agreement so far. OPEC has also achieved some success in its other key performance yardstick: drawing down OECD commercial crude and petroleum product stocks to the five-year average. The most recent data from the International Energy Agency (IEA) shows inventories falling in September to below 3 billion barrels for the first time in two years. (Chart 2.) Admittedly, Hurricane Harvey was a factor in this, with its negative impact on US petroleum product stocks, but the trend has been generally downward for most of the year.

And markets have, by and large, been receptive to the data supporting OPEC's efforts. They have also been reassured by OPEC and its non-OPEC partners' willingness to do "whatever it takes" to drain the supply glut and rebalance the market.

But lately, having priced in the likelihood that the oil producers would

Chart 1: Crude oil prices

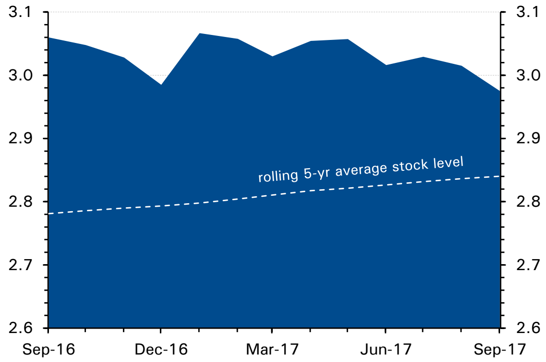
($/bbl)



Source: Thomson Reuters Datastream

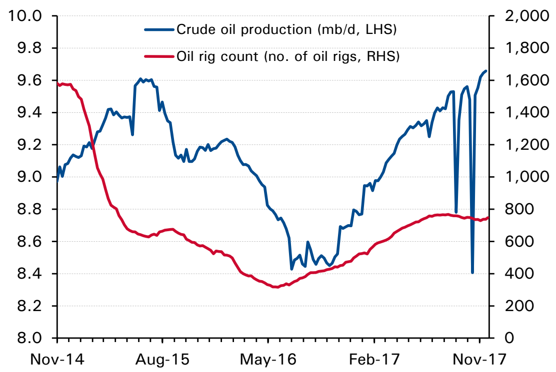
Chart 2: OECD commercial crude & product stocks

(billion barrels)



Source: International Energy Agency (IEA)

Chart 3: US crude oil production and rig counts



Source: US Energy Information Administration (EIA), Baker Hughes announce a nine-month extension of their production cut agreement when they meet on the 30 November, markets became a little less certain that such an outcome will materialize. In fact, hedge funds appear to have pulled back on the record net long positions (the difference between bets on a price increase and bets on a price fall) that they had been building over the last couple of months.

The trigger has been Russia, whose oil producers appear to be wavering in their appetite to roll over their output cuts until the end of 2018, so soon before the agreement expires in March 2018. Indeed, echoing Saudi Arabia's official stance when Ali Al-Naimi was at the helm of the oil ministry, Russia's oil men are unwilling to pull back on production only to cede further market share to competitors such as the US, whose crude exports are indeed making inroads in Russia's largest export market: China. (40-year old restrictions on US crude exports were lifted by the Obama Administration in December 2015.)

OPEC's prospects face difficult headwinds from US shale's resurgence

To be sure, Brent is holding above $60. While this is a level that is being viewed in some quarters, perhaps optimistically, as oil's new price 'floor', markets are, nevertheless, anxious. This unease has been further fuelled by the resurgence of US shale; just last week US crude output posted another shale-era high, reaching 9.66 mb/d (of which shale comprises 64%) and shows every sign of continuing to increase. (Chart. 3)

For every barrel of crude taken off the market by OPEC/non-OPEC in 2017, the US has managed to resupply almost half a barrel. So OPEC is left to grapple with an especially challenging conundrum: the more successful the group is in reducing global oil balances as a means to raise the price of oil—their ultimate objective—the more likely US crude producers ramp up output. US shale is highly price-responsive and, with a large backlog of drilled but uncompleted wells (DUCs), production could respond very quickly.

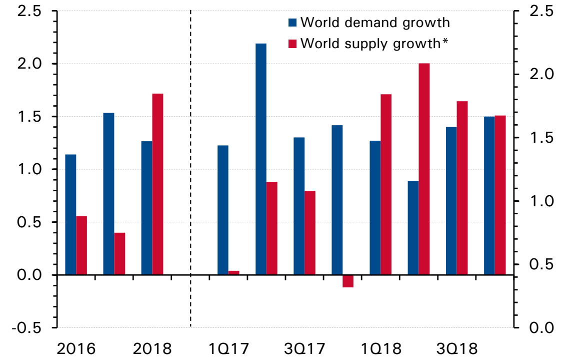
The IEA's recently released World Energy Outlook 2017 weighs in on the potential for US shale growth in the medium to long-term. And it does not make for comfortable reading for the established oil producers. According to the IEA, not only have the technically recoverable reserves of US shale been revised upwards, by 30%, but shale oil production itself is expected to more than double by 2025 (from the current 6.0 mb/d to 13.0 mb/d). More than 80% of the 4.9 mb/d of non-OPEC oil production that is expected on stream by 2025 will be sourced from the US. Thus the US will become, in the words of IEA Executive Director Fatih Birol, the "undisputed leader of global oil and gas markets for decades to come".

Therefore, as a result of shale's gains, the IEA predicts that OPEC's share of the global oil market will most likely fall, from 43% in 2016 to 41% in 2025. The good news for OPEC, however, is that the IEA also expects US growth to plateau by the end of the next decade and then reverse in the 2030s, with a concomitant rise in OPEC's market share to 46% by 2040.

Sobering as this may sound, prices could still reach $85/bbl in 2025, the IEA noted in its base case, New Policies Scenario. The reason: the dearth of investment in conventional oil projects since oil prices collapsed in 2014. This could amount to a loss of 2.5 mb/d (2.6% of global supplies) from global oil balances every year—a volume that even burgeoning US oil will not be able to entirely offset.

Chart 4: World supply and demand growth

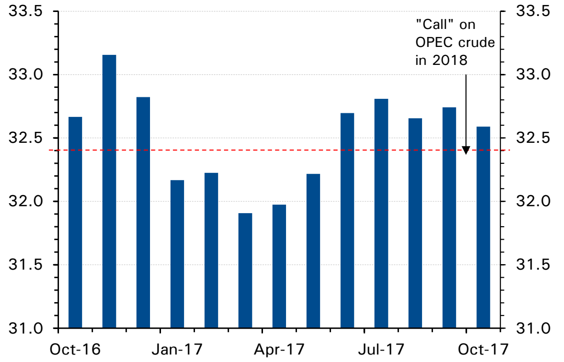
(mb/d)



Source: IEA, NBK estimates; *assumes OPEC output stays at current level

Chart 5: OPEC crude oil production

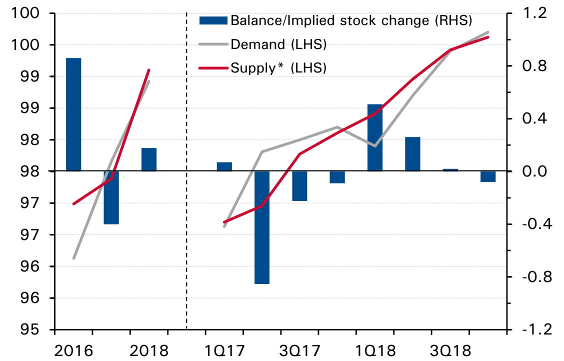
(mb/d)



Source: OPEC (secondary sources)

Chart 6: Balance of supply and demand

(mb/d)



Source: IEA, NBK estimate; *assumes OPEC output stays at current level

Oil demand growth to slow in the medium-to-long term due to improved fuel efficiency and increased use of electric vehicles

Global oil demand growth is expected to slow markedly from 1.5 mb/d this year to an average of 0.9 mb/d over the next five years. As we move into the next decade, increased fuel efficiency and energy pricing policies as well as substitution by alternative fuels will begin to significantly impact oil consumption. Casting a shadow over the outlook for oil in the transportation sector, which is by far the largest consumer of oil, will be the electric car. The IEA reckons that by 2040, the global electric car fleet could expand to 280 million from 2 million today. Moves to phase out conventional gas and diesel vehicles have already started, as evidenced by France and Britain's plans to ban their sale by 2040.

Back to you OPEC to manage global supply

Despite the recent elevation of the US to swing producer status, it will still be left to OPEC, which supplies more than 30% of the crude oil market, to manage global crude balances. With demand growth expected to slow in 2018 to 1.3 mb/d—a downward revision of 0.1 mb/d that the IEA states is due to relatively mild early winter temperatures—and non-OPEC supply expected to increase by 1.4 mb/d next year thanks to US shale, OPEC's first order of business is to confirm the production cut extension. (Chart 4.) Anything less than nine months, however, could spark a market sell-off.

Second, OPEC may need to tie down wayward producers, Iraq and the UAE, who have yet to fulfil their obligations eleven months into the agreement. Nigeria and Libya, whose production is not subject to quotas, will also need to be co-opted. These two combined have supplied an additional 620,000 b/d of oil this year, which has negated around half of the 1.2 mb/d of production withdrawn by the twelve other OPEC members.

Therefore, as well as extending the production cuts, OPEC may also need to deepen them. The IEA puts the "call" on OPEC's crude in 2018 at 32.4 mb/d, which is almost 200,000 b/d below current OPEC output of 32.6 mb/d, according to OPEC secondary source figures. (Chart 5.) Clearly, despite compliance of 103% among the twelve OPEC agreement signatories in October, production is above what the IEA expects the market to be able to absorb next year. In consequence, OECD inventory levels are expected to increase rather than decrease, in at least two quarters in 2018. (Chart 6.)

At the end of the day, OPEC and its partners may need to come to terms with the fact that, thanks to US shale and advances in unconventional crude production, the structure of the oil market appears to have irreversibly shifted. However, with the lowest costs in the business, OPEC and especially the GCC oil producers can still put up the stiffest fight. The game is most certainly on.

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