Economic Update

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Oil Markets

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Oil prices rally on signs of recovering oil demand and OPEC+ supply reductions

Highlights

- **Oil prices have rallied in May as economies emerge from lockdown and as OPEC+ supply cuts come into effect.**
- **Brent is up more than 46% mtd at $35.75/bbl while WTI has notched up monthly gains of almost 78% to $33.5/bbl.**
- **Covid-19 caused global oil consumption to decline by unprecedented 25% y/y in April, the IEA estimates.**
- **OPEC+, with the backing of the G-20, agreed to the largest oil production cuts in history (9.7 mb/d) in April.**
- **Oil price risks in 2020 are tilted slightly to the upside, with stock draws and resurgent demand likely in 2H20.**

Oil markets rebound from 'Black' April

Oil prices are currently enjoying something of a minor rally, buoyed by signs that oil demand is slowly recovering as economies emerge tentatively from lockdown and by evidence that global oil producers have accelerated their curtailment of oil supplies.

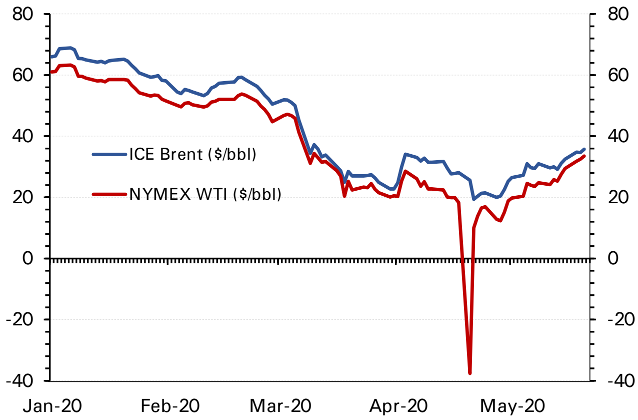
The major international benchmark, Brent crude, was last trading at $35.8/bbl, up 46% in May, while the key US benchmark, West Texas Intermediate (WTI)'s most recent close was at $33.5/bbl, a whopping 78% increase since the start of the month. For WTI, which is also at its highest level in two months, the market rebound and relief has been signficant, coming in the wake of the marker's eye-watering 306% one-day decline in mid-April to $-37.63/bbl.

The events of 'Black' April, as the International Energy Agency (IEA) dubbed the month, were unprecedented: a combination of the largest oil demand collapse in history caused by the corona pandemic and an immense oil supply glut sparked by the dissolution a month earlier of the OPEC+ agreement, which resulted in producers ramping up production to the maximum in a fight for market share and markets fearing that global storage limits would be completely overwhelmed. That fear was enough to unite Saudi-led OPEC, Russia-led non-OPEC and several members of the G20 group of economies, including the US and Canada, to agree to the largest coordinated production cuts in history in early April.

But it was not enough to prevent WTI's plunge into negative territory, however. WTI experienced the sharp end of the market's fear of rapidly depleting storage.

Chart 1: Benchmark crude oil futures

($/bbl)



Source: ICE, Bloomberg

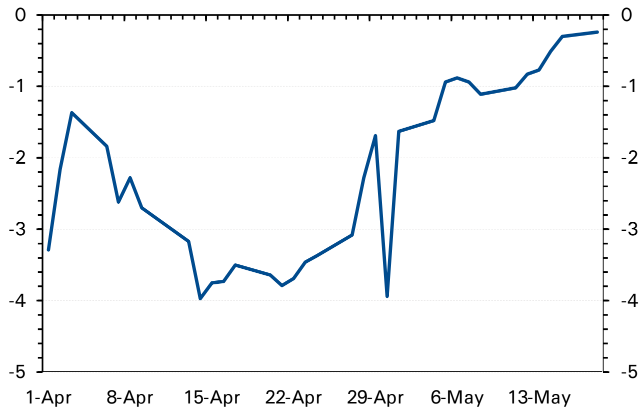
Holders of the May futures contract, faced with declining and increasingly expensive storage in the key crude delivery point at Cushing, Oklahoma and no time to sell it with the contract expiry day upon them, had to essentially pay market participants to take crude off their hands. The $3.8bn US Oil Fund ETF, which held 25% of all outstanding NYMEX WTI futures contracts at the time, was nearly a victim of the price crash, scrambling to roll over its contracts to the next month ahead of their expiry.

The unprecedented event sent shockwaves through the industry, with many fearing that the international benchmark, Brent crude, which dropped 9% to $25.6/bbl on the same day, would suffer a similar fate. (That was not likely to come to pass, however, as Brent futures, unlike WTI futures, do not result in physical delivery of crude after expiry; they are cash-settled.)

Brent did not escape altogether, though. The marker touched a 22-year low of $19.99 in late April, and was increasingly out of whack with the price of its physical equivalent, Dated Brent. This is the benchmark that is used to price more than half the world's physical cargoes, and which, at one point, was trading nearly $10 below the front month Brent futures contract. This indicated that physical market participants, such as crude importers, storers, refiners etc, were signalling an oversatured crude market at more alarming levels than the financial futures market was appreciating. But the supply glut and storage constraints were being reflected in the upwardly sloping futures curve (contango), with time spreads (the difference between the price of Brent for near term delivery, M1, and the price for delivery in two months, M2) widening by nearly $-4 on two occasions in April. (Chart 2.)

Chart 2: ICE Brent futures time spreads (M1-M2)

($/bbl)

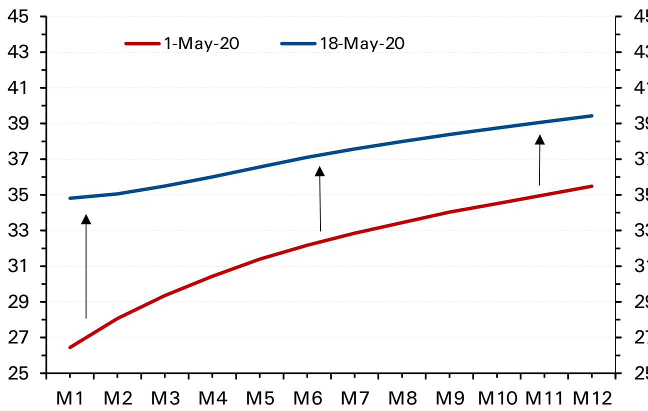


Source: ICE, NBK

The steepening contango reflected a buyers market awash in crude, in which crude buyers or crude storers, faced with diminishing storage capacity and higher storage costs, were forcing sellers to substantially discount their crude to make the purchase cost-effective for them. However, in May markets have been more upbeat about improving demand-supply dynamics and prices have risen. This has led to a shifting up and flattening of the forward curve. (Chart 3.)

Chart 3: ICE Brent forward curve

($/bbl)



Source: ICE, NBK

Unprecedented supply cuts for unprecedented times

On the weekend of 10-13 April, the oil markets were treated to a spectacle unimaginable only a few weeks earlier: OPEC and non-OPEC oil producers, led by Russia, signing off on the largest coordinated oil production cuts in history. Collective cuts will begin 1 May, totalling almost 10% of global supply (9.7 mb/d), with all producers required to cut output by almost 23% relative to a reference baseline initially, before tapering off to around 14% in the period January 2021 to April 2022. (Chart 4.)

The agreement was explicitly backed by the G-20 group, which through the US, Brazil, Canada and others will contribute another 5 mb/d worth of 'involuntary', organic cuts. Since these G-20 cuts are market-led, taking place as drilllers idle wells that are uneconomical at low oil prices, there is no pre-planned schedule. It is also probable that over the duration of the OPEC+ cuts, prices will rise to a level that will see many of these wells brought back on line.

Chart 4: OPEC+ production cut schedule

(kb/d)

Country	Baseline	May-June 2020	Jul-Dec 2020	Jan 2021-April 2022
Algeria	1,057	816	864	912
Angola	1,527	1,179	1,249	1,318
Congo	325	251	266	281
Eq. Guinea	127	98	104	110
Gabon	187	144	153	161
Iraq	4,653	3,592	3,804	4,016
Kuwait	2,809	2,168	2,296	2,424
Nigeria	1,829	1,412	1,495	1,579
Saudi Arabia	11,000	8,492	8,994	9,495
UAE	3,168	2,446	2,590	2,735
OPEC-10*	**26,682**	**20,598**	**21,815**	**23,031**
Azerbaijan	718	554	587	620
Bahrain	205	158	167	177
Brunei	102	79	84	88
Kazakhstan	1,709	1,319	1,397	1,475
Malaysia	595	459	486	513
Mexico**	1,753	1,353	1,433	1,513
Oman	883	682	722	762
Russia	11,000	8,492	8,994	9,495
Sudan	75	58	61	65
South Sudan	130	100	106	112
Non-OPEC-10	**17,170**	**13,254**	**14,037**	**14,820**
OPEC+	**43,852**	**33,852**	**35,852**	**37,851**
Total cuts	*-*	*-10,000*	*-8,000*	*-6,001*

Source: OPEC, Bloomberg; *excludes Iran, Libya and Venezuela; ** Mexico did not agree to the above schedule and will cut by 100 kb/d not 400 kb/d, so total OPEC+ cuts will amount to 9,700 kb/d rather than 10,000 kb/d.

OPEC Secretary General Barkindo recently stated that the combined OPEC+ and G-20 cuts could be in the order of 17 mb/d, or 17% of global oil supply, by June. This also includes the additional cuts recently announced by Saudi Arabia (1 mb/d), Kuwait (80 kb/d) and the UAE (100 kb/d) over and above their OPEC+ allocations, which will go into effect in June but presumably only for one month before output snaps back to the OPEC+ schedule, though this has not been confirmed. OPEC's GCC producers appear determined to drain the supply glut, so they may agree to a slightly more aggressive schuedule.

The agreement brought to an end a devastating 5-week oil price war. But it was almost derailed when OPEC+ member Mexico refused to agree to cut its output by 23% (400 kb/d) as everyone was doing; it would only consider a cut of 100 kb/d. It was left to US President Trump to broker a solution when he stepped in with the offer to make up the 300 kb/d difference through US declines.

For President Trump, who could quite plausibly claim to be the instigator in chief and driving force behind the "big oil deal", it was a rare diplomatic victory that combined coercion, cajoling and some veiled threats, like entertaining the idea of imposing taxes on crude imports or pushing the anti-cartel NOPEC legislation through congress. He deftly manoevered the narrative to his advantage, putting the burden of responsibility on the Saudi-Russia axis to, in effect, protect hundreds of US energy jobs. And it was done without conceding to demands in some quarters of the US shale patch to introduce production quotas.

For the Saudis, deep production cuts were what they had originally called for in early March before being rejected by the Russians, so by way of a 5-week fiscally costly detour, it is back to square one. But they have been vindicated, and, as well as having demonstrated to serial OPEC+ non-compliers and the watching world what the largest spare production capacity in the world could do, they will probably also be quietly pleased to see US shale production slip into reverse. Russia would no doubt count that as a resounding success.

Oil demand recovering slowly post-lockdown

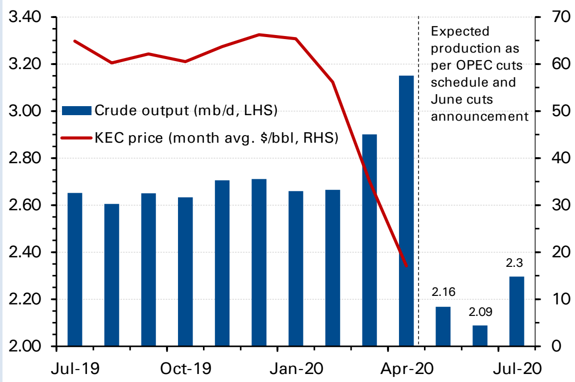
The IEA, in its recently released oil market report, struck an encouraging note with its upward revision to global oil demand growth projections this quarter and for the year as a whole. Citing an improvement in transportation fuel demand especially as countries, led by China, begin to relax Covid-19 lockdown measures and improve mobility, 2Q20 oil demand growth was revised up by 3.2 mb/d (bringing total demand to 79.29 mb/d) and 2020 growth was raised by 700 kb/d, leaving total demand averaging 91.2 mb/d. But this is still a contraction of 8.63 mb/d, compared to 2019, and 2Q20's drop of almost 20 mb/d y/y (-25.2 mb/d y/y in April) is still the worst on record.

Kuwait oil developments

- Kuwait last week followed Saudi Arabia in raising the official selling price (OSP) of its June-loaded crude oil—for the first time in three months for Asian customers. Prices were raised for all of destinations.
- For Kuwait's main crude, Kuwait Export Crude (KEC), the differential to the Oman/Dubai benchmark was lowered by $1.8 to -$6.00/bbl. This is still a weighty discount, however, and reflects the intense competition in Asian markets. The last time the KEC OSP was set as a premium to Oman/Dubai was in February (+1.95, for March loadings). (Chart 2)
- The discount for Kuwait's new super light crude (KSLC) was set at -$6.50 to Oman/Dubai, a reflection of weaker Asian demand for light crudes and the relative legacy shortage of heavier grades in the market due to OPEC+ production cuts and Iran/Venezuelan sanctions.

The OSP for the medium sour Khafji crude, which was exported in April for the first time in more than 5 years, was also set at a discount of -$6.00, despite being heavier and more sour than KEC. However, it was reported this week that Khafji production would temporarily cease from 1 June due to a lack of buyers in an over-saturated market.

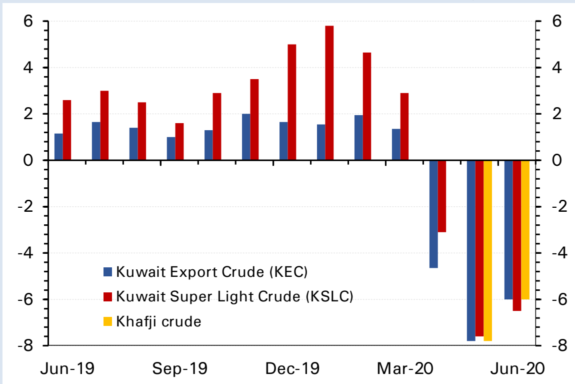
Chart 1: Kuwait crude oil production and price



Source: JODI, KPC and OPEC

Chart 2: Kuwait crude official selling prices (OSPs) to Asia

($/bbl, set as a differential to Oman/Dubai avg. assessed price)



Source: MEES, S&P Global Platts

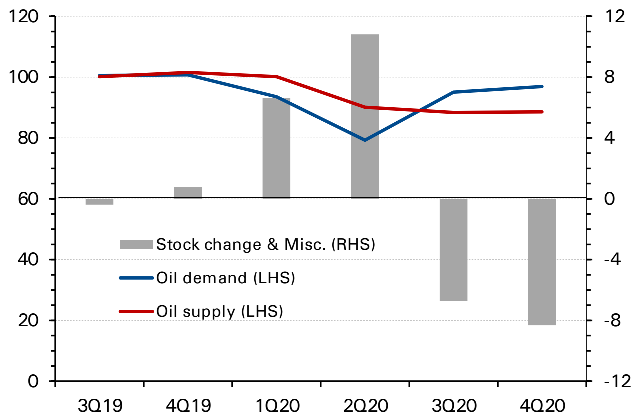
At the oil product level, demand for aviation fuel, gasoline and diesel in particular has cratered due to the imposition of often strict lockdown and travel restrictions. Depressed end user demand negatively fed back to refineries, leading to storage bottlenecks—the worst of which occurred this month, the IAE noted—and eventually decreased refining actity and even some closures. The IEA estimates that the decline in global refining throughputs peaked in May, with 2Q20 average runs falling by 13.4 mb/d y/y.

With oil demand declining right the way through the supply chain, crude and products were routed into storage tanks. OECD commercial stock levels reached 2,961 mb in March, climbing 68.2 mb (2.2 mb/d) month-on-month to 46.7 mb/d above the 5-year average. Stocks provide an incredible 90 days of forward demand cover. These are the most recent figures available, and they will surely have risen considerably in April and May to probably historic highs.

Our estimate of the global stock change resulting from the demand-supply balance shows crude stocks blowing out at around 10.8 mb/d in 2Q20. In 2H20, with oil demand improving and global supplies significantly pared back by OPEC+ and the G-20, the market is projected to shift into a supply deficit and stock draw of almost -8.3 mb/d in the fourth quarter. (Chart 4.) Obviously, there are a number of assumptions inherent in this projection, the most important being that global oil demand growth accelerates as per the IEA's projections and doesn't relapse with another Covid-19 wave in the autumn and that OPEC+ cuts proceed as planned and with 100% compliance.

Chart 4: Global oil demand, supply and stock change

(mb/d)

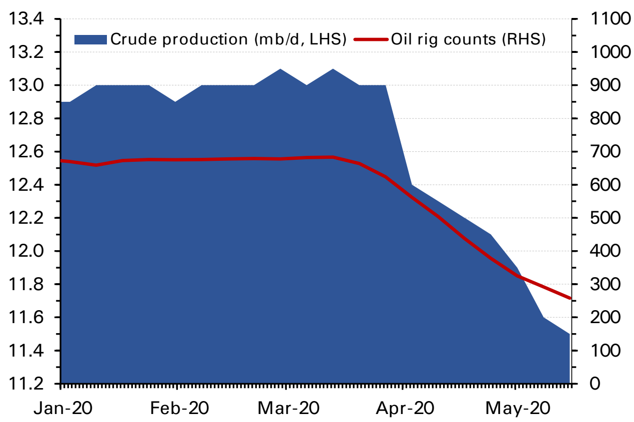


Source: IEA, OPEC, NBK estimates

US shale: what lies beneath

The US shale patch, with its relatively higher well decline rates and elastic supply response has been especially hard-hit by the oil price war. While US crude production growth was already moderating prior to the March decline, preliminary, weekly estimates by the Energy Information Administration (EIA) show that production went into a near-sustained reverse in March. By the week-ending 15 May, output had declined by 1.6 mb/d (-12.4%) to 11.5 mb/d from its peak of 13.1 mb/d at the end of February. (Chart 5.)

Chart 5: US crude production and oil rig counts



Source: EIA, Baker Hughes

The Saudi-Russian oil price war appears to have reversed a year and a half's worth of US output gains. And the peak-to-present decline is likely to be even greater, possibly by an additional 1 mb/d to -2.6 mb/d, if the EIA's own 'unaccounted for crude' adjustment factor is understood as an over-estimate of US production.

Low oil prices have made wellhead economics unsustainable for many shale operators. With far less access to capital financing as in the past, firms have had to operate within cash flows margins. And with crude stocks in US commercial storage facilities just a few million barrels short of historic highs, storing crude has become too costly. The result has been shuttered wells, evidenced by a 62% fall in oil rig counts so far this year. At 258, the number of oil rigs is at lowest level since 1979. It is likely that many of the higher cost shale firms will be among the casualties of the oil price downturn. But the permanent loss of production is difficult to predict. Nevertheless, drilling activity, led by the more efficient firms, is likely to rebound once prices rise, as happened in the 2016-2019 period. A large backlog of drilled but uncompleted wells (DUC)—3,464 in the Permian basin alone—should provide a good foundation.

Oil price outlook looking more positive but with caveats

The oil price outlook is undoubtedly better than it was a few weeks ago, now that OPEC+ supply cuts have gone into effect and producers such as Saudi Arabia, Kuwait and the UAE have been galvanized to remove the surplus supply overhang and begin the drawdown of crude stocks as quickly as possible. Crucially, oil demand appears to be slowly recovering as countries emerge tentatively from lockdown. Many energy and research houses, including ourselves, have, in response, adjusted their Brent oil price projections for 2020 (avg.) upwards to the $35-40/bbl range, while the Brent forward curve is pointing to a December 2020 price of around $37/bbl.

For prices to continue to rally, global economic growth—and with it oil demand growth—will need to accelerate signficantly from current levels. OPEC+ oil producers will need to observe better than average compliance with their production quotas, and will need to resist the urge to prematurally ease up on cuts at the first sign of tightening market fundamentals. Moreover, they will need a helping hand from North American producers, whose higher cost, unconventional oil fields will need to see continued and sizeable well shut-ins, some on a permanent basis.

Downside risks, however, are also very much present. These range from a delayed economic recovery, perhaps due to a second wave of Covid-19 infections either in the short term or in the autumn, to an oil recovery that is predominantly driven by stock-drawdowns rather than new oil purchases. Both are possible. As is a resurgent US shale sector, which could quickly come back to fill the OPEC+ supply void if prices move above operational expenditure levels. Moreover, it is not clear what shape global oil demand will take and whether some oil demand will be lost permanently as consumers shift their behaviour once the dust has settled. Employers and employees may see the cost and environmental benefits of working more from home, for example, which will lead to a decline in transportation fuel demand. Long haul aviation is already predicted to take at least a couple of years to return to pre-pandemic levels. Then there may be increased calls to accelerate the energy transition away from fossil fuels. With multiple unknowns, the outlook is, as ever, uncertain.

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