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Oil Markets

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Oil prices fall on emergency stock releases but Russia/OPEC supply shortfalls mounting

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Summary

Oil prices have fallen from their highs on news that the US and the IEA would tap emergency stockpiles to cool spiraling fuel costs. While downside risks to global oil demand growth appear to be stacking up—from the Ukraine conflict to China's Covid-19 outbreak and tighter US monetary policy—low global stocks and persistent OPEC+ supply shortfalls, including Russian losses, should keep the oil market fairly tight this year.

- Russia's invasion of Ukraine on 24 February has upended oil markets, inserting a degree of volatility and tumult not seen since the onset of the Covid-19 pandemic. Oil prices have whipsawed between fears of profound oil and gas shortages due to a combination of punishing financial sanctions and self-embargoing by Western energy companies and worries about oil demand destruction caused by higher prices. Global monetary policy has tightened in response to surging inflation and in China, the worst flare up in Covid-19 infections has seen several cities and industrial zones placed under partial or complete lockdown, raising concerns about the impact on economic activity.
- From late March, however, oil prices were on the back foot after the International Energy Agency (IEA) followed the US in approving an emergency release of strategic oil reserves to help offset shortages from Russia and bring down fuel prices. International benchmark Brent crude closed on Friday 1st April down 13% in a single week at $104.4/bbl, having a week earlier been bolstered by the Houthi attacks on Saudi oil facilities and US/EU discussions on reducing Russian imports. (Chart 1.)

Speculators head for the doors amid extreme volatility

- Market volatility has been extreme, to say the least, with Brent oscillating by more than $20 in some trading sessions—the largest swings on record—and by $5 or more in 23 of the last 24 sessions. On 8th March Brent surged to its highest intra-day level since 2008, touching almost $140/bbl, before paring back gains. The CBOE oil price volatility index has spiked to its highest level since Spring 2020 when the pandemic pummeled oil futures and the price of US oil marker WTI fell into negative territory. (Chart 2.)
- The volatility has been exacerbated by falling market liquidity, with market participants closing out positions, often motivated by profit-taking as well as a desire to minimize risks. Open interest, a measure of the total number of outstanding futures and options contracts, has declined to its lowest level since 2015. (Chart 3.) The risk-off sentiment was also not helped by increased trading costs, as major futures exchanges hiked up margin requirements. Money manager net length (a measure of managers' confidence that prices will rise) declined substantially in March as investors grew more bearish about the price outlook. (Chart 4.) Brent front month time-spreads (M1-M2) halved on 1 April to mid-February levels, though even at $1.6/bbl in backwardation, they continue to signify a relatively tight market. (Chart 5.)

OPEC+ maintains course despite US pressure and supply shortfalls

- OPEC's role in global oil supply was once again in focus at the OPEC+ ministerial meeting of late March. The group, seemingly impervious to pressure from the US and other customers grappling with high prices to ramp up production further, ratified the current OPEC+ production schedule. From

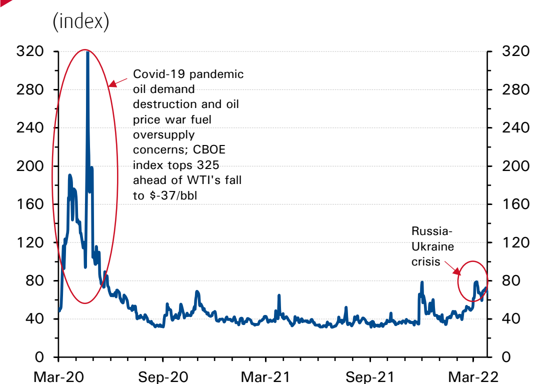
Chart 1: ICE Brent futures (M1)

($/bbl)

Source: Refinitiv

Chart 2: Oil price volatility (CBOE)

(index)



Source: Refinitiv, CBOE

Chart 3: ICE Brent futures Open Interest (OI)

(million futures contracts)

Source: Bloomberg, ICE

May to September, OPEC+ will pump an additional 432 kb/d per month (up from 400 kb/d), with the five largest OPEC+ members (Saudi Arabia, Kuwait, the UAE, Iraq and Russia) also working towards a higher baseline. OPEC+ has consistently maintained that oil's increase in recent months is largely due to a higher geopolitical risk premium related to the Russia-Ukraine crisis and not a reflection of a structural supply deficit in the oil market. The OPEC press release spoke of an outlook that was consistent with a 'well balanced' market. The group maintains that there will be a stock-build in 2022.

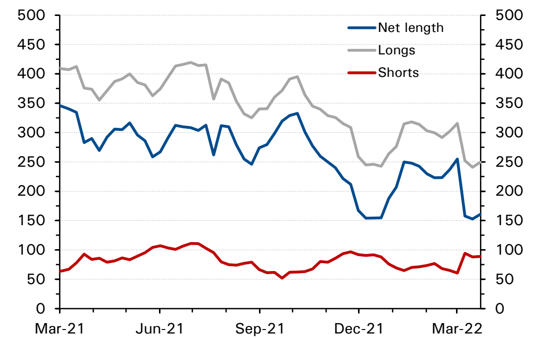
- But OPEC+ has consistently under-produced in relation to its own quotas, and appears to be falling even further behind. Only 90 kb/d of the 250 kb/d of incremental OPEC-13 supply that was expected in March actually materialized, according to Bloomberg's preliminary survey of output. In February, the last month for which there is OPEC data available, the 19-member OPEC+ group subject to quotas pumped 38.2 mb/d, falling short of its target by 930 kb/d. (Chart 6.) By April, the group's output needs to be at 39.9 mb/d, implying 1.7 mb/d of additional supply including catch-up barrels. This would then leave the group with 2.2 mb/d of pandemic-era cuts to unwind by September.
- For some larger OPEC producers, output could be ramped up to the new higher reference baseline once the original 2020 pandemic cuts are reversed. This could see an additional 1.63 mb/d of supply brought to the market from September onwards, but it is unclear at what monthly rate—if at all—this additional output would materialize. Moreover, with the exception of Saudi Arabia and the UAE, it is not certain that the sustainable production capacity even exists to attain these higher baselines. The last time Kuwait pumped at 2.95 mb/d was in 2016 but capacity is known to have fallen since then. Official figures show that Iraq and Saudi Arabia only managed to hit their respective baselines of 4.8 mb/d and 11.5 mb/d for one month. Russia has never managed to pump at 11.5 mb/d, and is even less likely to do so now.
- Estimates of lost Russian production due to financial sanctions and self-imposed embargoes on Russian energy by Western oil majors are difficult to determine, but could be anywhere between 0.5 mb/d on the lower end to as much as 3 mb/d at the upper end, with 1 mb/d a reasonable estimate. It seems clear, though, that Russian output will remain depressed for an extended period of time, likely even beyond the end of hostilities in Ukraine.

US and IEA step in with emergency stockpile releases to cool prices

- The Biden administration announced its intention to release 1 mb/d of crude from US strategic petroleum reserves (SPR) every day for six months, in order to cool domestic fuel prices. This is an unprecedented volume of crude—180 mb—which would cut US SPR stocks, already at a 20-year low of 568 mb (as of 25 March), to 385 mb after the drawdown, a level last seen in 1984.
- The IEA, which already committed to release 62 mb of strategic crude stocks on 1 March, agreed to coordinate a second emergency stockpile release, the details of which should be forthcoming soon. The drawdowns are occurring amid depleting global inventories. The IEA reckons that OECD commercial oil stocks are at their lowest levels since 2014. OPEC estimates total crude and petroleum stocks to have fallen to 2,677 mb in January (-359 mb y/y) and 250 mb below the 2015-2019 annual average. (Chart 7.)
- The US administration called its SPR release a 'bridge' until domestic production picks up by the end of the year, by about 1 mb/d (and by 700 kb/d in 2023). However, that it would take until the end of the year for US crude production to ramp up significantly to materially compensate for supply losses in Russia and elsewhere was also an implicit acknowledgment of the current difficulties facing domestic crude production.

Chart 4: Money manager net length (Brent)

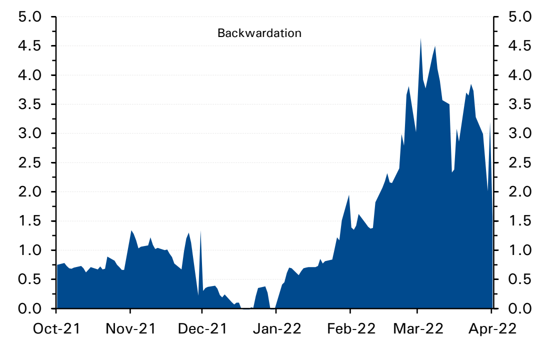
(thousand contracts, combined futures and options)



Source: Bloomberg

Chart 5: Brent time spreads (M1-M2)

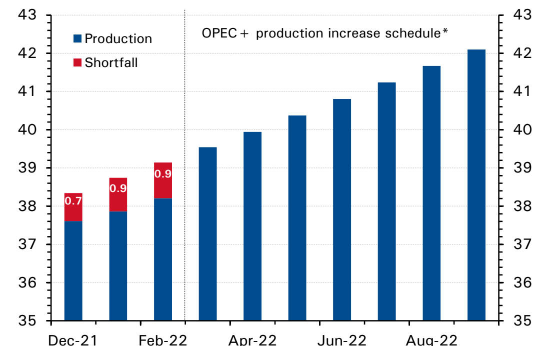
($/bbl)



Source: ICE, Refinitiv

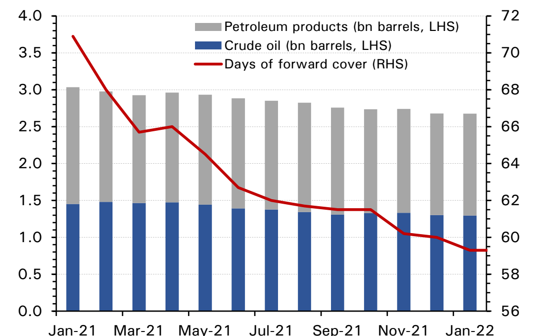
Chart 6: OPEC+ crude oil production

(mb/d)



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

Chart 7: OECD commercial crude inventories



Source: OPEC, IEA, EIA, Argus, METI, Euroilstock

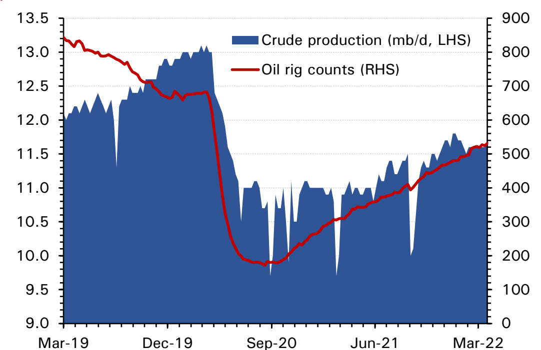
US shale industry still exercising supply restraint

- While output did rise by 100 kb/d to 11.7 mb/d in the US Energy Information Administration's (EIA) most recent weekly petroleum data release, production has largely been stuck at 11.6 mb/d this year, having expanded by only 483 kb/d in 2021. (Chart. 8) Expectations were high that the sharp rebound in oil prices since 2020 would see a rise in crude production, given the short-cycle, price-responsive nature of US shale. But producers have been cautious, preferring capital discipline and shareholder returns to the pre-pandemic years when the focus was on supply growth.
- That is not to say that supply has not risen; about 60%, of the 3.1 mb/d of crude taken off the market (at its trough) has been brought back and the industry has trebled the number of oil rigs since August 2020. But at 533 oil rigs (as of w/e 1 April), drilling activity remains 20% below pre-Covid levels.
- However, a good portion of output gains have come from the drawdown of inventories, so-called 'drilled but uncompleted wells', rather than new wells, and the number of these wells has declined by more than 50% to 4,372 according to the EIA. This means that the shale patch will need to accelerate drilling of new wells just to keep oil output steady, as decline rates in the shale patch are in the 200-400 kb/d range. Current elevated market prices support the rationale for increased capex spending, notwithstanding spiking costs of drilling equipment and labor. The EIA sees US crude output increasing in 2022 by 7% (855 kb/d) to over 12 mb/d and then next year by a further 8% to a new high of 12.9 mb/d.

Downside risks to oil demand growth stacking up

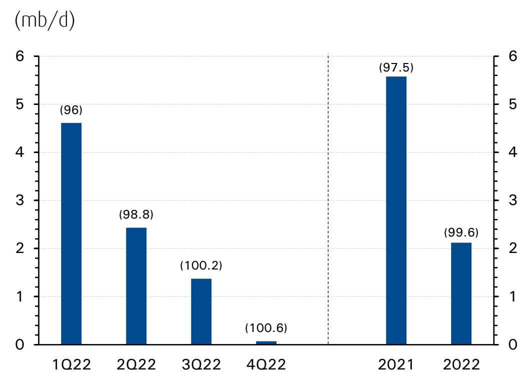
- Oil demand remains subject to uncertainty, but downside risks to the outlook appear to be slowly stacking up. The spike in energy and commodity prices especially after the Russia-Ukraine conflict amid already high global inflation has left many households in the West facing a cost of living crisis, which could weaken economic growth. Moreover, oil demand destruction is expected the higher oil prices go and the longer they stay elevated.
- In its March oil report, the IEA, citing surging energy and commodity prices but also the war in Ukraine and international sanctions, reduced its estimate of average global oil demand growth in 2Q22-4Q22 by a sizeable 1.3 mb/d. This would cut average annual growth by 950 kb/d to 2.1 mb/d, leaving demand at 99.7 mb/d. (Chart 9.) This means that oil demand will not surpass pre-pandemic levels this year as had been hoped. Russia, Ukraine and Europe, with its proximity to spillovers from the conflict, could see industrial activity pared back.
- Moreover, estimates of China's economic growth are also being cut amid rising Covid-19 infections and widespread mobility restrictions. Activity in key economic hubs such as Shanghai and Shenzen is expected to be negatively affected. Refining activity has already taken a hit, with processing rates in Shandong province, home to about half of China's independent refiners, cut by about 50% to a five-year low, Bloomberg reported. Crude inventories have risen rather than fallen—as in other parts of the country—and there are reports of refiners reselling unused crude cargoes.
- The estimated impact on European, Chinese and global GDP of the above developments are expected to feature in the forthcoming IMF World Economic Outlook. The IEA will likely have a clearer idea of the expected hit to oil demand in its April report, probably lowering its estimate even further.

Chart 8: US crude oil production and oil rig counts



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

Chart 9: Global oil demand growth



Source: IEA; numbers in brackets refer to total global oil demand

Market tightness to linger into 2H22, leaving prices elevated

- Nevertheless, even with the downward revisions to oil demand growth, tight market fundamentals are expected to persist until at least the end of 3Q22. This should keep oil prices elevated. The supply shortfall from Russia and OPEC+ will likely exceed any weakness in oil demand. Also supply gains from the US and non-OPEC producers more broadly will take time to materialize.
- Furthermore, Iran's return to the market, which could have brought back up to 1 mb/d of additional supply within six months, has been delayed after nuclear talks were paused amid haggling over sanctions. Russia, a key P5+1 member, also indicated that it would veto a new agreement unless its trade and investment with Iran was exempt from the West's punishing Ukraine-linked sanctions.
- Moreover, with commercial crude inventories at multi-year lows, it seems reasonable to expect a period of substantial restocking, especially ahead of the peak northern hemisphere oil demand season in the third quarter of the year. While the urgency to replenish crude stocks is not of the same magnitude as the requirement to refill natural gas stocks especially in Europe, purchases will need to take place. The likelihood of supply undershooting demand is probably still greater than the reverse at this juncture. But markets should brace for continued volatility in 2022.

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