Oil markets

Markets optimistic of higher prices in 2017 on OPEC/non-OPEC supply cuts

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Highlights

- **2016 ended with oil prices in the mid-to-high $50's, up by more than 52% in the case of Brent.**
- **Markets are optimistic that in 2017, announced OPEC/non-OPEC production cuts will ease the supply glut of the past two years.**
- **Global demand growth in 2017 was revised up by the IEA to 1.3 mb/d on better-than-expected US demand figures.**
- **Assuming full OPEC/non-OPEC compliance and better crude demand then the market could move into a deficit of around 0.6 mb/d in 1H17.**
- **All eyes will be on US shale's response to higher prices in 2017 as production is already up by 4% (0.3 mb/d) from its 2016 low.**

2016 closes with oil prices up more than 45% thanks to OPEC's decision to return to supply management

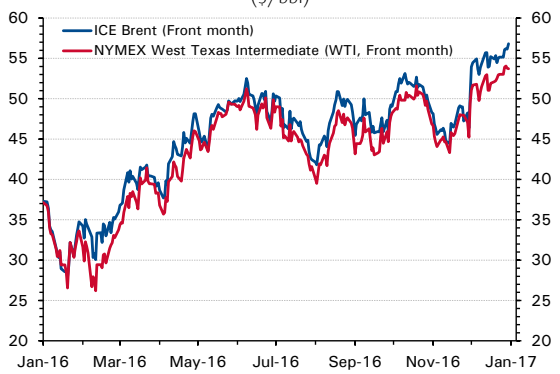
2016 closed with oil prices in the high 50's and markets optimistic that agreed upon OPEC/non-OPEC crude production cuts will lead to firmer prices in 2017. Brent crude, the international benchmark, was up at close to $57 per barrel (bbl) by year's end, a rise of 52.4% in 2016; West Texas Intermediate, the US crude marker, ended the year at $53.7/bbl, up 45% on the start of the year. (Chart 1.)

Looking at the forward price curve out to 2020 for Brent, price gains would appear to be front loaded, however, with the curve moving from a traditional contango structure (i.e. the price for Brent delivery is higher in the future than it is now) in the first half of 2017 into backwardation and then contango again towards the tail end of the curve. (Chart 2.) This would seem to reflect the dynamics of the current market, where physical supplies are expected to be tight in 1H17 as supply is reined in and the market moves from a surplus to a projected deficit. Further out, things are more uncertain, but in all likelihood, higher oil prices will spur higher production from US shale producers, many of whom are already locking in hedges, resulting in more downward pressure on prices.

Nevertheless, the contrast with the situation at the beginning of 2016 is striking indeed, especially considering that prices were, at one point last January, flirting with $26/bbl when historically high global crude inventories and persistent oversupply weighed heavily on sentiment. Then, OPEC, including a newly sanctions-free Iran, and Russia were turning on the taps in an effort to maximize market share. It was as if producers were engaged in a rhetorical race to the bottom. But twelve months is a long time in the oil markets, and while markets are still awash in crude, sentiment has turned perceptibly bullish. For that, the markets have OPEC to thank. The 13-member group's decision on 30 November to cut production, after an 8-year hiatus, in a last ditch attempt to reduce global crude stocks and unwind the 2-year supply glut was a

Chart 1: Crude oil prices

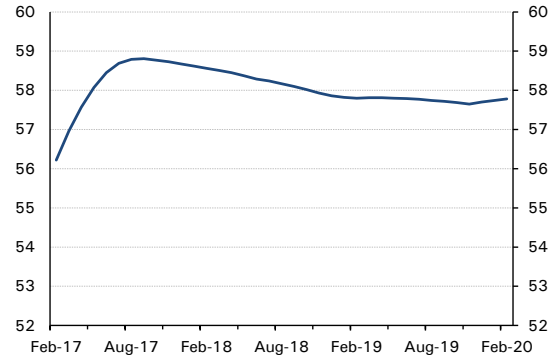
($/bbl)



Source: Thomson Reuters Datastream

Chart 2: Brent forward curve

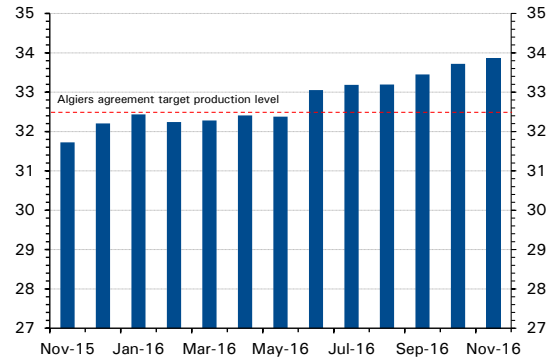
($/bbl)



Source: Thomson Reuters Datastream

Chart 3: OPEC crude oil production

(mb/d)



Source: OPEC secondary sources; Note: excludes Libya and Nigeria

timely and dramatic intervention. Led by Saudi Arabia, OPEC agreed to reduce its output by 1.2 million barrels per day (mb/d) to 32.5 mb/d for a period of 6 months, effective January 2017. (Chart 3.) According to the terms of the agreement, all members, with the exception of Iran, Nigeria, Libya and Indonesia, which has since left the group, are required to reduce output by 4.5% from October's reference production level. They will all be subject to a strict monitoring program by a committee chaired by Kuwait to ensure compliance. At the same time, 11 non-OPEC countries led by Russia and including Mexico, Kazakhstan and Oman have also agreed to pare back production, by 558,000 b/d, this year.

According to recent reports, Saudi Arabia, and its GCC allies have already instructed their respective refinery customers to expect fewer deliveries beginning this month. The Kuwaiti press reported last week that the country's production will be officially cut by 130,000 b/d to 2.75 mb/d in January. Russia has also instructed its oil companies to curb their output.

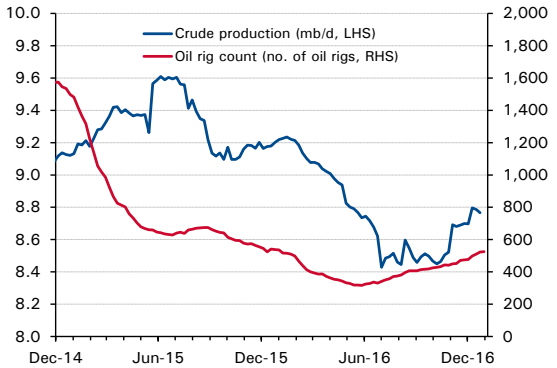
However, OPEC, for its part, may need to consider more severe cuts than its members initially signed up for, judging by the group's aggregate production figure of 33.87 mb/d in November. The latter is 150,000 b/d higher than the group's October reference baseline, thanks to returning Libyan and Nigerian crude supplies. (See chart 3.) Saudi Arabia and its GCC neighbors most likely will have to offset these gains with larger production cuts of their own if the group intends to keep to within its target range.

Moreover, data out of the US in December revealed that oil drillers were returning idled rigs back online at the fastest rate since March 2014, with 65 oil rigs added by the end of the month, bringing the total US oil rig count up to 525—the highest since last January. US crude production is back up to around 8.7 mb/d, despite 2 consecutive weeks of declines. US shale's gains prompted the International Energy Agency (IEA) last month to revise up its forecast for US production growth in 2017 by 70,000 b/d.

On the demand side, the IEA has just revised up its global oil demand forecast for 2016 and 2017. The agency now estimates that growth will come in 120,000 b/d higher at 1.4 mb/d in 2016 and 100,000 b/d higher at 1.3 mb/d this year thanks to better-than-expected US crude demand and revisions to Russian and Chinese crude data.

Taken together, still-relatively buoyant crude demand growth and curtailing OPEC/non-OPEC supply should see the balance of supply and demand swing into deficit during the first half of 2017. The IEA reckons it could be by as much as 0.6 mb/d. Should oil prices reflect this changed dynamic then, conceivably, by OPEC's next ministerial meeting in June, the group could be congratulating itself on a job well done. But of course, not only does this assume that both OPEC and non-OPEC producers do indeed stick to their individual production quotas, which would be no mean feat given their history of producing above their targets, but also that US shale doesn't reemerge even stronger than before. In any case, as with 2016, this year is likely to demonstrate once again that OPEC still has the power, both rhetorically and materially, to move markets.

Chart 4: US crude oil production and oil rig counts



Source: US Energy Information Administration (EIA)

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