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Economic Update

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Oil Markets

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Oil prices soften in February as central bank monetary tightening dominates sentiment

Summary

Range-bound oil futures fell slightly in February on further central bank policy tightening and continued crude stock builds in the US. Nevertheless, oil demand growth estimates in 2023 were revised up on improving Chinese economic activity, which together with Russia's unilateral output cut of 500 kb/d from March and OPEC+'s reiteration of continued supply restraint, should see the market tighten and prices firm from 2Q23 onwards.

- Oil prices were range-bound in February but ended lower, with fears of further monetary tightening by central banks dominating sentiment and outweighing the potentially positive impact on global oil demand of China's reopening. International benchmark Brent crude finished the month at $83.9/bbl (-0.7% m/m; -2.4% ytd), down for the second month in a row. Local marker Kuwait Export Crude (KEC), which is marketed mainly towards Asia, closed the month up at $83.0/bbl (+0.6% m/m; +1.2% ytd). (Chart 1.)

- Prices through February were caught between competing bearish and bullish impulses. In the former, markets grew concerned about a potentially higher and longer rate tightening cycle after bullish US economic data, while continued US crude stock builds seemed to suggest softer than expected oil demand. But on the positive side were China's improving economic metrics post-Covid reopening and Russia's announcement of a 'voluntary' production cut of 500 kb/d effective March. OPEC+ also reiterated its intention to keep production levels unchanged amid continuing oil demand uncertainty.

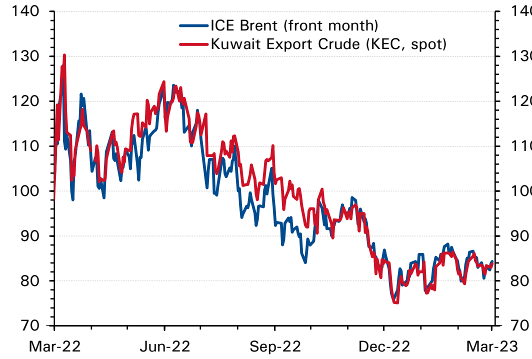
- Global oil demand itself looks to be on the verge of accelerating amid the lifting of Covid lockdowns in China and firm economic readings in the US. Both the International Energy Agency (IEA) and OPEC recently lifted their oil demand growth forecasts for 2023, by 200 kb/d to 2.0 mb/d and by 100 kb/d to 2.3 mb/d, respectively. (Chart 2.) The IEA expects China to account for almost half of its forecast gain, propelling world oil demand to a new high of 101.9 mb/d in 2023. Mobility indicators from China have improved, with congestion levels picking up in February as transportation activity normalizes—a positive for oil and refined products demand. (Chart 3.)

- On the supply side, Russian production continues to confound expectations of sizeable output losses. The IEA was forced to revise up its estimates of Russian production in 1Q23 and in 2023 by 460 kb/d to 10.84 mb/d and by 290 kb/d to an average of 10.0 mb/d, respectively. The IEA puts 2023's decline at 1.3 mb/d on average. OPEC, interestingly, sees Russia's output falling from 10.28 mb/d in 1Q23 to a low of 10.0 mb/d in 2Q23, but then rising in 2H23 to 10.15 mb/d by 4Q23. OPEC estimates the decline to be 0.85 mb/d. (Chart 4.)

- Nevertheless, the consensus is quite clear that the market will grow increasingly tight as the year progresses on the back of Russian supply shut-ins and continued OPEC+ supply management. The IEA warned as much in its most recent oil market report, saying that the current market surplus "could quickly shift to deficit as demand recovers and some Russian output is shut in". Russia's intentional crude output cut (to around 9.35 mb/d) from March comes in the wake of the EU embargo and EU/G7 price cap on Russia's refined products. While many see this as being a consequence of the embargoes, it is probably equally, if not more likely, a retaliatory move on the part of the Kremlin to firm up prices by tightening the market. As for OPEC+, as well as

Chart 1: Oil prices

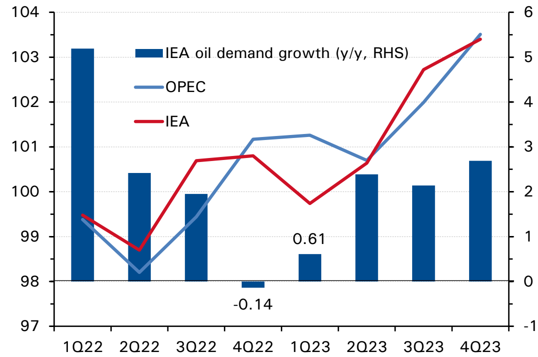
($/bbl)



Source: Refinitiv, Bloomberg

Chart 2: World Oil demand

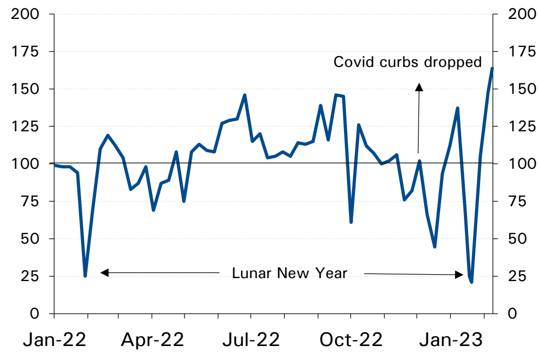
(mb/d)



Source: IEA, OPEC

Chart 3: China congestion index in 15 major cities

(7-day moving average, January 2021 = 100)



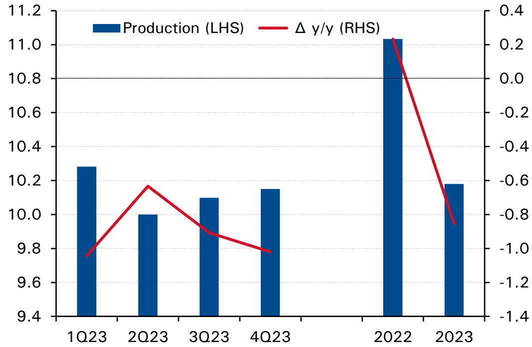
Source: Bloomberg, Baidu Inc.

dismissing speculation outright that the Saudi-led group would step in to offset lost Russian supplies, Saudi Prince Abdulaziz reiterated that OPEC+ intends to see the year out without any supply increases.

- OPEC secondary sources data showed OPEC-10 output in January falling by 36 kb/d to 24.5 mb/d as gains from Nigeria, Kuwait, and Angola were offset by Saudi and Iraqi declines. Total OPEC-10 production undershot its target by 931 kb/d (compliance of 173%) as Nigeria and Angola still struggled to recover supplies lost due to underinvestment, sabotage and civil strife. (Chart 5.) Meanwhile, total OPEC+ output, excluding quota-exempt countries (Libya, Iran, Venezuela, and Mexico), fell by 106 kb/d to 38.1 mb/d, according to S&P Global. Russia's crude output stood at 9.85 mb/d (-10 kb/d m/m), down only 230 kb/d (-2.3%) from pre-war levels. Overall, OPEC+ output was almost 2.0 mb/d below quota levels (compliance of 198%). This is significant because it means there is scope for several members' output to rise from current levels—as Nigeria and Angola showed—and still comply with quotas.
- In Kuwait, crude output increased slightly in January to 2.69 mb/d (+45 kb/d, m/m), a level marginally above the country's quota of 2.67 (87% compliance), according to OPEC secondary sources. (Chart 6.) Kuwait Petroleum Corporation's CEO, Sheikh Nawaf Al-Sabah, announced plans to invest $80 billion over the next five years, in line with the company's long-term capacity expansion plans. The country's heavy downstream investments—$30 billion in the Clean Fuels project and recently completed Al-Zour New Refinery project—appear to be paying dividends, with Kuwait ramping up exports of Euro-specification ultra-low sulphur diesel and fuel oil from its refineries to ease increasing tightness in distillate supplies in the Euro-area. Kuwait exported 123 kb/d of refined products to Europe in December (+81% y/y). Sheikh Nawaf reckons that cargoes of diesel to Europe will more than double to over 2 million tons (+41 kb/d) in 2023.
- Meanwhile, US crude production was steady at 12.3 mb/d in February and up only 200 kb/d in 2023 so far, according to EIA weekly data. (Chart 7.) In contrast, oil rig counts look to be ranging lower, falling 3.4% ytd by the w/e 24 February to 600. The EIA expects output to expand by 592 kb/d on average this year, slightly lower than 2022's growth of 652 kb/d and for US production to set a new yearly average record of 12.5 mb/d. The break-neck pace of previous years' growth is unlikely to be repeated anytime soon, however. Despite record profits in 2022, US energy majors are indicating that they will continue to focus on capital discipline amid high labor and equipment cost inflation and to prioritize shareholder returns.
- Uncertainty remains the key theme in oil markets as a potential recession in advanced economies looms over the 2023 outlook. Energy houses and firms did lower their price forecasts slightly during February to reflect the economic uncertainty. For some this was a moderation of hitherto overly optimistic estimates. Despite near-term softness, we see prices rising through the year, to an average of $90/bbl, with the balance of risks tilted to the upside on a pickup in Chinese demand, cuts in Russian supplies, OPEC+ supply restraint and lower-than-expected increases in non-OPEC output.

Chart 4: OPEC estimates of Russian supply losses

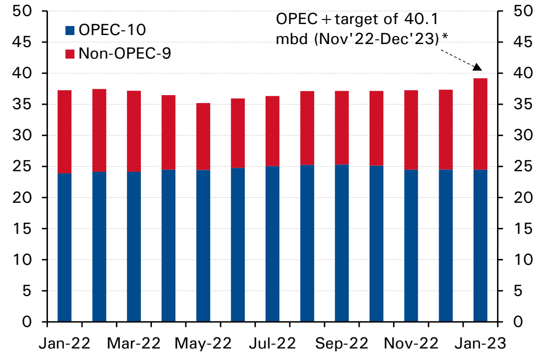
(mb/d)



Source: OPEC; Note: includes condensates

Chart 5: OPEC+ crude production

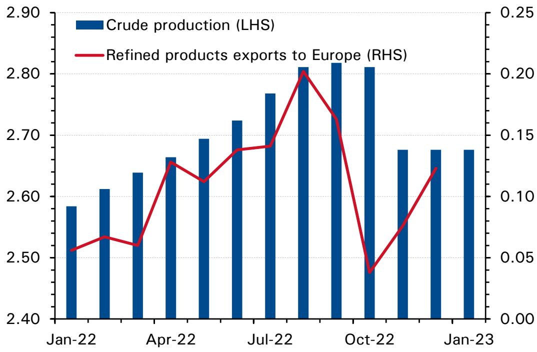
(mb/d)



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

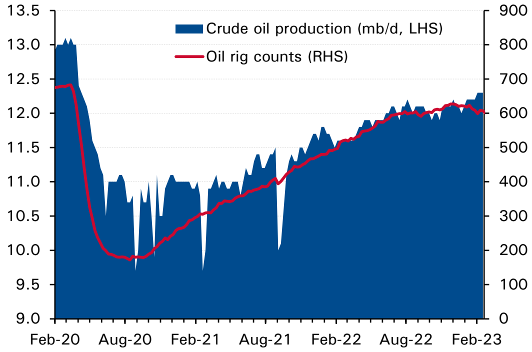
Chart 6: Kuwait crude prod. & Europe ref. exports

(mb/d)



Source: OPEC, mees, KPLER; Note: Jan 2023 export data pending.

Chart 7: US crude oil production and rig counts



Source: EIA, Baker Hughes

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