PUBLIC

Economic Update

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Oil Markets

Oil prices retreat again in September as global economic recession fears intensify

> Omar Al-Nakib
Senior Economist
+965 2259 5360
omarnakib@nbk.com

Summary

Oil prices were on the back foot again in September, closing down for the fourth month in a row as global recession fears intensified amid aggressive central bank rate hikes, increased cost of living pressures and a European energy crunch. OPEC+ is due to reverse its recent 100 kb/d output increase this month and could sign off on further production cuts at its 5 October meeting to support prices. US crude output gains in 2022 remain modest.

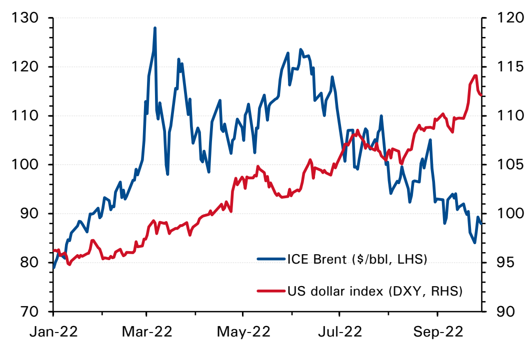
- Oil prices were overwhelmed in September by fears about a global economic recession amid aggressive US Fed monetary tightening, spiraling living costs in advanced economies and persistent demand weakness in China. Brent crude dropped 8.8% in September—a fourth consecutive monthly decline—to close at $87.9/bbl (+13.1% ytd), its lowest level since January. (Chart 1.) West Texas Intermediate (WTI) fell to $79.5/bbl (-11.2% m/m). A strengthening US dollar has also contributed to oil's decline (pushing up prices in foreign currency terms), rising 3% in September and almost 17% in 2022.

- Reflecting the bearish sentiment in recent months, Brent futures net length—a measure of speculative pressure—had retreated to about 158k contracts by end-September, from a high of 255k in the week after Russia's invasion of Ukraine. (Chart 2.) Futures market activity, as measured by 'open interest' (the number of outstanding Brent futures and options contracts), plummeted to a 7-year low of 1.78 million contracts in early September. The decline in open interest and trading volumes to well below historical norms has exacerbated volatility in a market already on edge from the Ukraine conflict, Europe's ongoing energy crunch and a faltering global economy as central banks ratchet up interest rates. Saudi Prince Abdulaziz remarked in August about the increasing disconnect between the paper and physical markets and that OPEC+ might need to counter through production cuts—something which they subsequently approved at their September meeting. However, physical and paper market asymmetries do appear to be unwinding, as evidenced in the narrowing spread between physical North Sea dated Brent and its futures market equivalent. (Chart 3.)

- It is also interesting to note how Kuwait Export Crude (KEC) has held up slightly better than expected for a medium sour crude that tends to sell at a discount to light sweet Brent. KEC closed September at $96.1/bbl (-7.8% m/m; +21.5% ytd) and has on many occasions this year sold at a premium to not only the regional medium sour benchmark, Dubai, but also light sweet North Sea Dated Brent. This probably reflects several factors: a tighter medium sour market after Russian oil supplies were curtailed and for which Middle East grades such as KEC are a good substitute; increased demand for middle distillates such as diesel from East Asian refineries amid limited Chinese diesel export quotas; and an easing of North Atlantic supply tightness amid higher US light sweet crude exports.

- Global oil demand growth is losing momentum, the International Energy Agency (IEA) stated in its closely watched oil market report for September. The agency cited weaker OECD and Chinese economic activity, weighed down in the former by intensifying cost of living pressures and a debilitating energy crunch and in the latter by recurring Covid lockdowns and an ongoing real estate crisis. While gas-to-oil switching is expected to support oil demand (+700 kb/d) over the next two quarters, it will not be enough to prevent oil

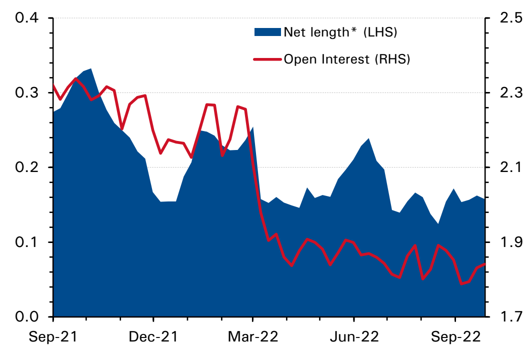
Chart 1: Oil prices and the US dollar



Source: Refinitiv, Bloomberg

Chart 2: Brent net length and open interest

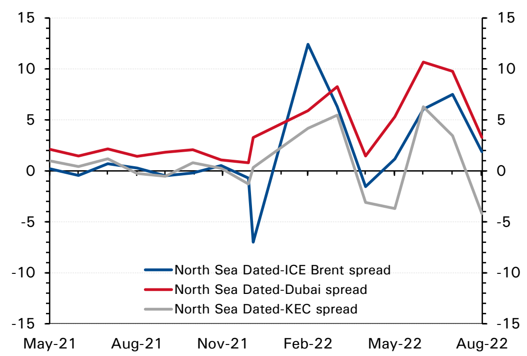
(million contracts)



Source: Refinitiv, Bloomberg

Chart 3: Light sweet-medium sour spreads

($/bbl)

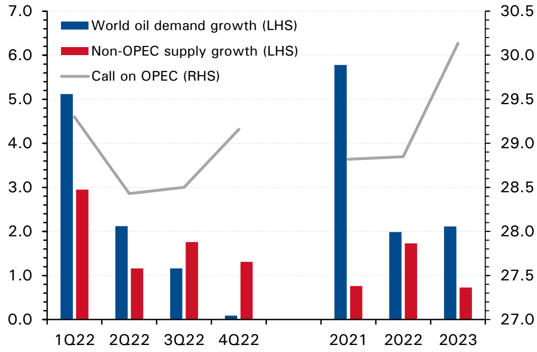


Source: OPEC, Argus

demand growth from slowing significantly from an estimated 1.1 mb/d in 3Q22 to effectively flat in 4Q22. (Chart 4.) For 2022 as a whole, demand growth should come in at 2.0 mb/d, increasing slightly to 2.1 mb/d in 2023.

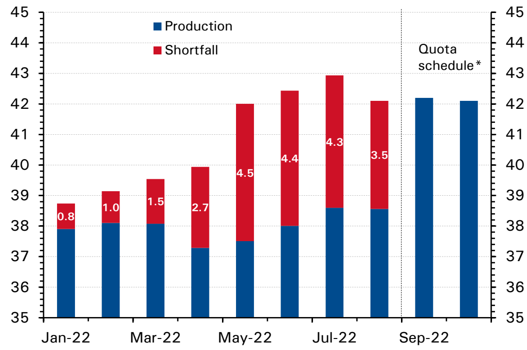
- The IEA pegs the 'call' on OPEC-13 in 4Q22 at 29.2 mb/d, which is almost 500 kb/d below the group's output in August. However, for 2023, the IEA says OPEC-13 would need to produce 30.1 mb/d to balance demand, a level the group last reached in 2019 and one that they are unlikely to match given the group's production capacity constraints and especially without both Iranian and Venezuelan supplies returning in sufficient quantities.
- According to the IEA, global oil stocks fell in July (-25.6 mb) on a drawdown in crude stocks in China and continued strategic petroleum reserve (SPR) releases by IEA member governments. Led by the US, these drawdowns at the rate of 1 mb/d have been key to bridging the supply deficit and balancing the oil market. Another 50 mb or more is due in October before the Biden Administration begins replenishing the SPR. At 423 mb as of 23 September, SPR levels are down by 25% since March. OPEC estimated that OECD commercial oil inventories rose in July but remained below the 5-yr avg.
- Meanwhile, OPEC+ supply (excl. Libya, Iran, Venezuela and Mexico) in August fell slightly to 38.6 mb/d (-37 kb/d) from July's post-pandemic high, according to OPEC data. (Chart 5.) Gains from Saudi Arabia, Kuwait and the UAE were offset by losses in Nigeria, Kazakhstan and Russia. Russia's output was 9.8 mb/d, according to S&P Global, once again proving resilient in the face of self-sanctioning. Output has only fallen by around 300 kb/d from pre-war levels, with India, Turkey and China emerging as the three largest importers of Russia's crude, albeit at heavily discounted prices.
- Almost all OPEC+ members produced below their quotas in August, leaving the group's collective output more than 3.5 mb/d below its target. The group's quota will be reduced by 100 kb/d in October amid a more uncertain oil demand outlook. OPEC+ will meet once again on 5 October, but the odds of further cuts have increased with prices below $90 and Russia reportedly keen for OPEC+ to act preemptively to support prices ahead of the shutting-in of substantial volumes of its own production after the EU's oil embargo and G7/EU price cap proposal kick-in in December. It is not clear how effective the plan will be with Russia on the one hand threatening to cut off oil to any country taking part in the plan and its biggest customers, China and India, on the other showing no inclination to take part.
- US crude oil output continues to underperform expectations. The latest EIA weekly figures show production back down to 12 mb/d, barely 200 kb/d above the level at the start of the year. This is despite a 26% ytd increase in the number of oil rigs. (Chart 6.)
- The outlook for oil prices remains highly uncertain amid competing bearish and bullish risk factors. On the downside, the higher risk of a global recession and the negative impact of a stronger US dollar on emerging market oil demand looms large. On the upside, the EU embargo on Russian oil and product flows (gas could also be affected) and OPEC's own production capacity challenges could lead once again to a structurally tight market that is unable to satisfy any increase in oil demand, say from a resurgent China. Moreover, were OPEC+ to cut production from November onwards, as recent reports seem to indicate, then there is very real possibility that supply could undershoot demand causing the market to tighten once again—especially if Russian oil is also shut-in due to the embargo. The small oil inventory builds that the IEA estimated through to the end of 2Q23 could conceivably turn into stock draws. (Chart 7.)

Chart 4: Oil demand/non-OPEC supply growth
(mb/d)



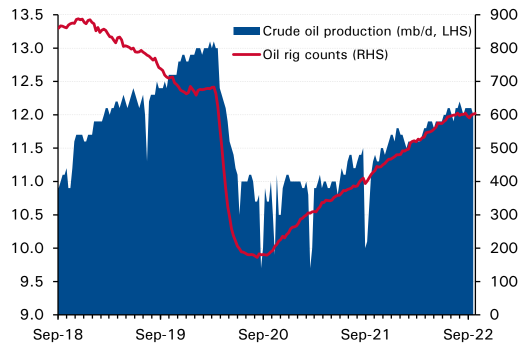
Source: IEA, OPEC

Chart 5: OPEC+ crude production
(mb/d, OPEC secondary sources data)



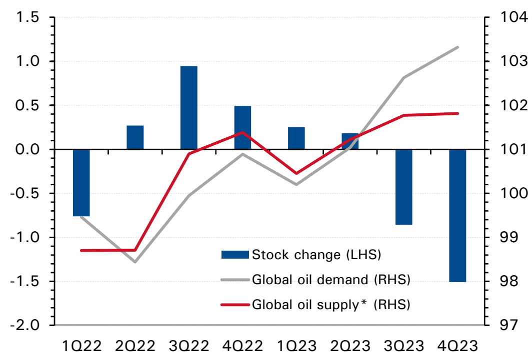
Source: OPEC, IEA, S&P; *excludes Iran, Libya, Venezuela & Mexico

Chart 6: US crude production and oil rig counts



Source: EIA, Baker Hughes

Chart 7: Global oil demand and supply*
(mb/d)



Source: IEA, NBK estimates, *based on August OPEC output levels

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353