Oil markets

OPEC extends output cuts for 9 months but oil prices remain in the doldrums

Highlights

- Oil prices back below $50/bbl as markets remain unfazed by 9-month OPEC output cut extension, and reiteration of Saudi-Russian oil supply management in 2018.
- Sentiment remains bearish and focused on US shale gains, despite signs that global and US crude stocks are declining, albeit slowly.
- US crude production reached 9.3 mb/d at the end of May, up 6.5% in 2017.
- Market is currently in supply deficit territory, according to the IEA.

Oil prices on the back foot despite OPEC output cut extension

Surveying the oil markets at the start of May, when prices were under pressure and ranging between $49-$51 per barrel (bbl), OPEC ministers could be forgiven for believing that a decision to extend their 6-month production cut agreement for an additional 9 months, to March 2018, would be just the prescription to boost the oil price. After all, the agreement achieved a surprisingly high level of compliance, removing almost 1.8 mb/d of crude from the oil market as it nudged it towards a new balance. By the end of the month, however, it was clear that the markets were following a different script, oil prices were on the back foot and OPEC was looking vexed.

Brent dipped below the symbolic $50 floor to $49.75/bbl on 2 June, while WTI dropped to $47.7/bbl. Both price markers have just posted 2 consecutive weeks of losses and were down by around 12% year-to-date. (Chart 1.)

Oil’s reversal prompted the Saudi and Russian ministers recently to reaffirm their pledge to bring global crude stocks down to 5-year average levels and to reiterate their commitment to further manage the oil supply after the expiration of their current output cut agreement, in March 2018. But the markets appear immune to the bullish rhetoric, even while supplies are tightening and global and US crude inventories, whose stubbornly high levels were the source of much of the markets’ anxieties, are indeed finally beginning to fall. OECD commercial crude and petroleum products stocks declined for the second consecutive month in March, by 32.9 million barrels to 3.03 billion barrels, the International Energy Agency (IEA) estimated in its May report. (Chart 2.)

While over in the US, commercial crude inventories recorded their steepest decline since December 2016 last week in late May, falling by 6.4 million barrels amid record refinery runs and lower US imports. (Chart 3.) Indeed, crude stocks in the US have been declining for 8 consecutive weeks, but markets are paying little attention.

Instead, they appear to be primarily focused on the US shale story and the reality that whatever OPEC removes from the markets, shale
producers are slowly putting back. The head of Russia’s largest oil producer, Rosneft, conceded as much last week when he raised the prospect of US oil companies adding as much as 1.5 mb/d to global supplies within the next year. If realized, this increase would offset more than two thirds of the crude that OPEC and non-OPEC producers are clearing from the market—a sobering thought.

Such is the resurgence of US crude output—production reached 9.3 mb/d by the end of May, 11% higher than the low recorded last July—that both OPEC and the IEA have had to repeatedly revise their own estimates of US growth upwards for this year. (Chart 4.) The IEA’s latest forecast has US crude supply increasing by an average of 790,000 b/d in 2017, up 100,000 b/d from its previous report, while OPEC projects US crude rising by 600,000 b/d by the end of the year.

OPEC achieves a commendable compliance rate as production cuts are extended for an additional 9 months

OPEC, for its part, has tried its best to reassure the markets, promising to do “whatever it takes” to accelerate the drawdown of excess global crude stocks and bring the market to a swift balance. OPEC production in April, according to secondary sources, fell below its target level of 31.75 mb/d to 31.73 mb/d for the first time, achieving a compliance rate of 107%. (Charts 5 & 6.) While the UAE finally met its output cut pledge in April, and Iraq inched closer to its quota, declines in Libya and modest supply gains in Nigeria, two countries exempt from the output cut accords, have undoubtedly helped the group attain its aggregate production target. Things may be more complicated over the coming months, with both those countries expected to raise production.

This, along with the above mentioned US shale gains, is part of the reason why the markets were underwhelmed by the 9-month extension; deeper cuts would have had, in hindsight, a more profound effect on market sentiment.

Market rebalancing firmly underway

Nevertheless, market rebalancing is underway, with the IEA reporting that the demand/supply balance is expected to end 2Q17 firmly in supply deficit territory. (Chart 7.) Crude demand is expected to peak in 3Q17, which should see surplus crude stocks drawn down at a faster rate.

For 2017 as a whole, the IEA sees demand growing by 1.3 mb/d to 97.9 mb/d, which is a slower rate of growth than 2016’s increase of 1.7 mb/d.

In the end, while the market’s attention has been focused almost exclusively on the supply side of the equation, demand will need to remain robust for oil prices to firm up.