Oil markets

Market optimism extends into 2018 as oil prices trade at three-year highs

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Highlights

- **Oil prices continue to trade at three-year highs, with Brent and WTI topping \$68 and \$62, respectively, last week; 2017 was Brent's best performing year since 2011, with a gain of 18%.**
- **Recent protests in Iran have helped oil sustain its positive momentum; the renewal of the OPEC agreement along with evidence of continued global stock draws have motivated increased investor bullishness.**
- **But scope for further stock declines in 2018 is limited, with global demand and supply expected to roughly balance, according to the IEA.**
- **US crude output tops the 1970 year avg. record, reaching 9.78 mb/d.**

Oil prices extend positive momentum into 2018

2018 has commenced with oil prices at their highest level in more than three years. Both Brent crude, the international benchmark, and West Texas Intermediate (WTI), the US marker, reached levels last Thursday not seen since December 2014—\$68 per barrel (bbl) and \$62/bbl, respectively. (Chart 1.) The two crude markers gained 18% (Brent) and 12.5% (WTI) in 2017, which, in Brent's case, was its best annual performance since 2011. WTI, meanwhile, continues to trade at a discount to Brent that is not far off the two-year high spread of \$7 that was recorded last September; the higher Brent-WTI price spread of 2017 has facilitated record US crude exports to international markets after the forty-year moratorium was lifted in late 2015. (Chart 2.)

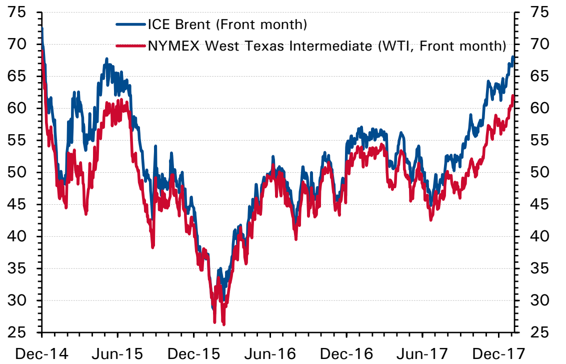
Oil prices have been helped in recent weeks by the protests in Iran, the Islamic Republic's most serious since 2009, which has once again re-emphasized the geopolitical risk premium that oil market participants have regularly commanded through the years, and the closure of the Forties pipeline in the North Sea, a key conduit for dated Brent crude. But it is the extension of the OPEC production cut agreement to the end of 2018 that has been the overriding stimulus for the market's bullishness.

2017 saw OPEC make a successful return to supply management

OPEC, for its part, is entitled to view 2017 with some satisfaction, perhaps even as a watershed year for the fourteen-member group in terms of proactive supply management. By inking a supply cut agreement in one of the most testing and volatile periods in recent times, not only did OPEC confound the critics and naysayers who had long reckoned that the organization's best days were in the past, but it managed to pull it off with a degree of internal unity, discipline and cooperation (especially with oil producers from outside the group) hitherto unheard of.

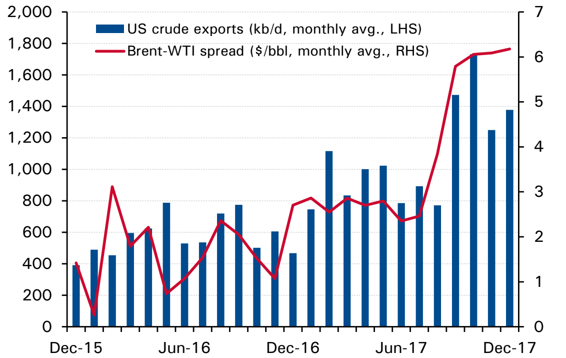
Compliance among the twelve OPEC members subject to production quotas averaged 97.4% over the eleven months of 2017 for which data is available, a very respectable achievement. Indeed, with OPEC aggregate output declining to 32.4 million barrels per day (mb/d) in November, a

Chart 1: Crude oil prices
(\$/bbl)



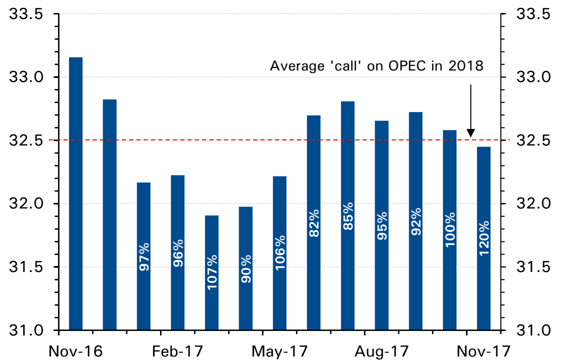
Source: Thomson Reuters Datastream

Chart 2: Brent-WTI spread and US crude oil exports



Source: Thomson Reuters Datastream, EIA, NBK

Chart 3: OPEC crude oil production
(mb/d)



Source: OPEC (secondary sources); Note: figures in charts denote % compliance drop of 130,000 b/d after Saudi Arabia, Angola and Venezuela recorded slightly lower production, compliance reached a record 120% in the month. (Chart 3.)

And the results speak for themselves: oil prices are currently ranging 50% above their 2017-low last June; physical markets have visibly tightened, with oil supply undershooting oil demand in every quarter of 2017, thanks to OPEC/non-OPEC's withdrawal of a combined 1.8 mb/d of crude from the markets (Chart 4); and OECD crude and petroleum product stocks have declined to within 100 million barrels of OPEC's five-year rolling average target, having been more than 337 million barrels above the target only fifteen months before. (Chart 5.)

Of course, in its efforts to rein in a three-and-a-half-year old supply glut, OPEC has been aided by stronger global crude demand growth (+1.5 mb/d in 2017), especially from emerging markets such as China, and a clutch of supply outages, especially among its own members. Libya and Nigeria, for example, have found their efforts to realize sizable output gains hampered by persistent terror attacks on their oil infrastructure, while Venezuela has had to grapple with structurally declining oil production because of cash-flow constraints and chronic underinvestment. Add in some Middle East geopolitical risk to the mix—most recently concerning Iran—and price pressures are firmly on the upside. Indeed, $60 appears to be the new price floor.

In futures markets, investor bullishness has been evident in the record net long positions being staked by hedge funds. The shape of the Brent crude forward curve is also instructive: 2017 was the first year since 2014 in which near-term prices were higher than longer-term prices, a structure known as backwardation. (Chart 6.) Buyers are placing a premium on contracts for immediate delivery rather than contracts for later delivery that would also involve them incurring additional storage costs.

But with global demand and supply expected to roughly balance in 2018, scope for further stock draws is limited

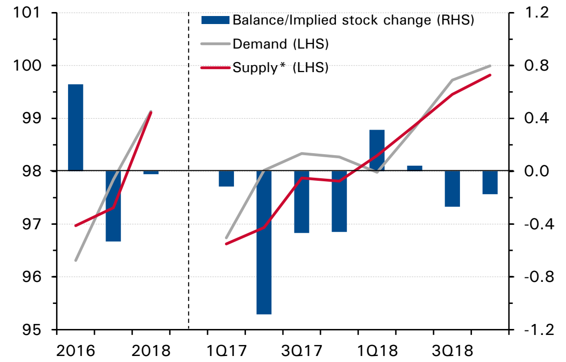
OPEC recognizes that there is little room for complacency this year, however. With demand growth set to decelerate to 1.3 mb/d from 1.5 mb/d in 2017 and non-OPEC supply growth, led by surging US shale production, expected to more than double to 1.6 mb/d this year from 0.6 mb/d in 2017, the scope for continued stock drawdowns appears limited. Indeed, the International Energy Agency (IEA) projects an average global stock increase of 0.2 mb/d in the first half of 2018 followed by a roughly equal decrease in the second half of the year. (See Chart 4.)

Emerging as a significant spoiler in the outlook for 2018 is, of course, US crude production. And here the IEA, not wanting to be caught flat-footed, has revised up its forecast for US output once again. The agency sees growth of 870,000 b/d in 2018, more than double 2017's estimate of 390,000 b/d. This would contribute more than 75% of total-non OPEC supply growth in 2018. US crude output reached 9.78 mb/d at end-2017 and has already surpassed its all-time record of 9.64 mb/d (year-average) set in 1970. (Chart 7.)

For OPEC, 2018 could shape up to be another important year. Again, much will depend on the group's ability to capitalize on the prevalent bullish sentiment through its own production-cutting efforts and manage the challenge posed by burgeoning US supply in particular.

Chart 4: Balance of oil supply and demand

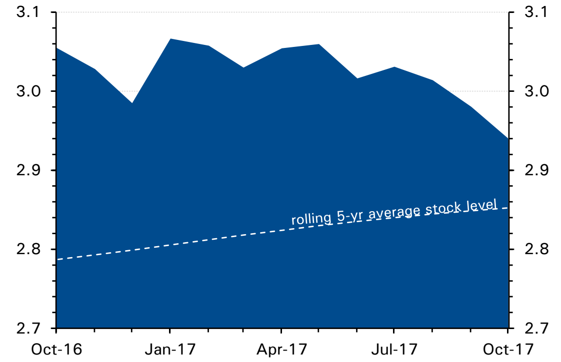
(mb/d)



Source: IEA, NBK; * forecast assumes OPEC output at 32.5 mb/d in 2018

Chart 5: OECD commercial crude & product stocks

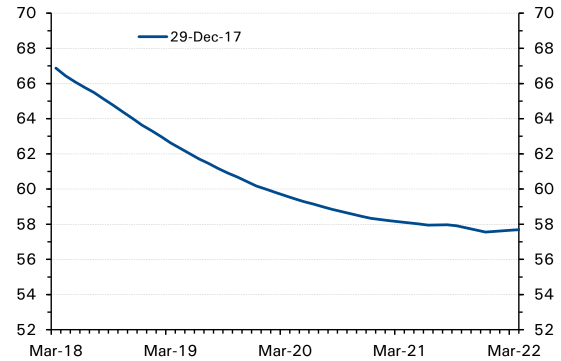
(billion barrels)



Source: IEA

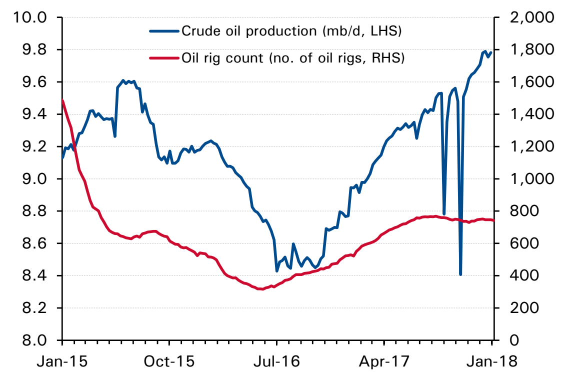
Chart 6: Brent forward curve

($/bbl)



Source: Bloomberg

Chart 7: US crude oil production and rig counts



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

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