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Economic Update

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Oil Markets

Oil prices up at nine-week highs as attention switches to tight refined products market

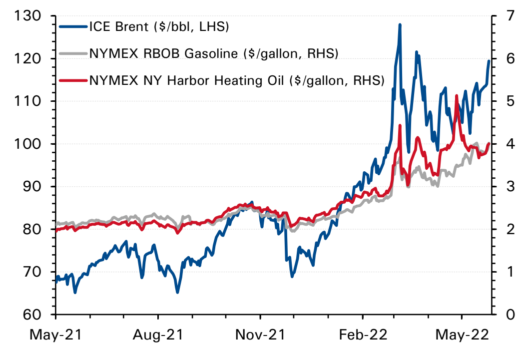
> Omar Al-Nakib
Senior Economist
+965 2259 5360
omarnakib@nbk.com

Summary

Amid heightened volatility, oil prices have moved upwards, as attention shifts from crude to the refined products market, where prices have set records and inventories have fallen to multi-year lows. With the peak summer oil demand season around the corner, oil prices could firm up despite increasing headwinds from a weaker global economic landscape. Market tightness may persist amid lagging OPEC+ and US shale supplies.

- Oil markets continue to endure quite pronounced volatility, linked to the Russia-Ukraine conflict and uncertainties over the near-term outlook for both oil supply and oil demand. ICE Brent crude closed at $119.4/bbl (+9.2% mtd; +53.5% ytd) on 27 May, gaining support from further crude stock declines and higher refining activity in the US. (Chart 1.) The tighter supply picture is also evident in the increase in the price premium for near-term Brent futures. ('backwardation'). (Chart 2.)
- Range-bound for several weeks, Brent finally broke free last week, rising to its highest level since late March at Friday's close. Markets had spent April and May largely alternating between concerns over the prospect of tighter supplies if the EU's planned embargo on Russian oil imports goes ahead amid only incremental OPEC+ output growth on the one hand and worries about faltering global economic growth amid high inflation and monetary policy tightening on the other.
- Attention has increasingly focused on the refined products market, especially in the US, where surging post-pandemic demand from industry and transportation has combined with limited oil supplies from Russia, due to self-sanctioning, and from China, due to reductions in export quotas, to send gasoline and middle distillate (e.g. diesel) futures prices to record highs. Indeed, product prices have outperformed crude prices this year, with US gasoline and heating oil futures up 72% and 66%, respectively. (See Chart 1.)
- Both gasoline and diesel distillate stock levels are at multi-year lows, the former at the lowest seasonal level in a decade (219 mb) and the latter at a fourteen year-low (107 mb), amid record high refining margins and reduced refining capacity. (Chart 3.) The latter has partly been a reflection of refinery closures during the Covid-19 pandemic. The US Energy Information Administration (EIA) estimates that refineries will be tapping 95% of their capacity during the forthcoming peak summer demand season.
- The focus on these dynamics is providing a bullish impulse to oil prices, helping to counteract the bearish pressure of potentially slower global economic and oil demand growth due to factors including fallout from the Russia-Ukraine conflict, weaker Chinese economic activity following months of Covid-19 restrictions, and tighter monetary policy as key central banks address spiraling inflation. The IMF in its April World Economic Outlook revised down its forecast of global growth from its January estimate by almost a percentage point to 3.6%.
- The International Energy Agency (IEA) and others have also lowered their 2022 oil demand forecasts once more. Citing 'soaring pump prices and slowing economic growth', the IEA reduced its estimate by 70 kb/d in May and now sees oil demand rising this year by 1.8 mb/d on average, a marked slowdown from 2021's post-pandemic bounce of 5.6 mb/d. (Chart 4.) In total,

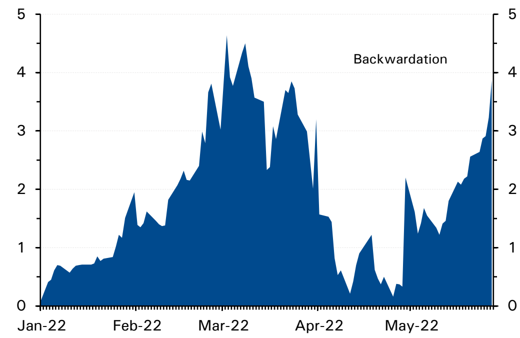
Chart 1: Oil futures (M1)



Source: Refinitiv

Chart 2: Brent time spreads (M1-M2)

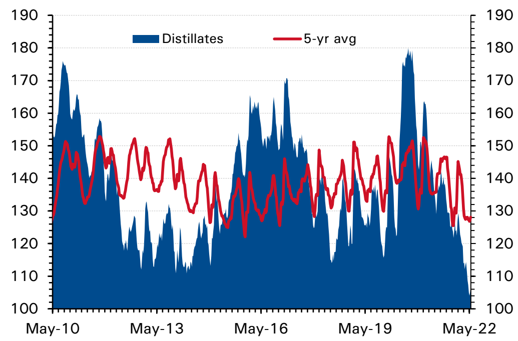
($/bbl)



Source: Refinitiv

Chart 3: US distillate inventory levels

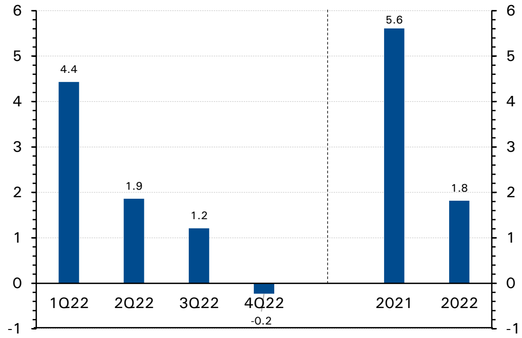
(million barrels)



Source: US Energy Information Administration (EIA) the agency has shaved 1.23 mb/d off its demand growth estimates since February. OPEC went further in its May revision, slashing this year's average oil demand growth by 210 kb/d, but sees demand rising by 3.36 mb/d, almost twice as much as the IEA.

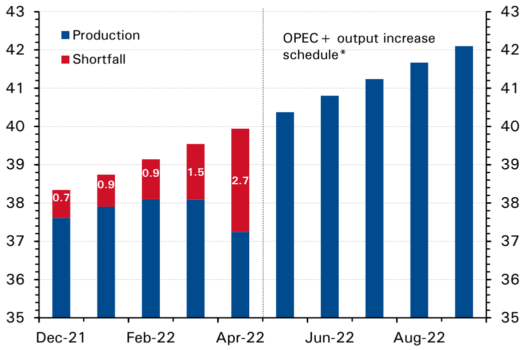
- On the supply side, the disruption to Russian crude flows due to oil embargoes by the US and its allies hangs heavily over the market. The IEA estimates that 1 mb/d of Russian crude was shut-in in April, a figure that could treble to 3 mb/d from June onwards after major trading houses ceased oil purchases with government-owned Rosneft, Gazprom Neft and Transneft on 15 May. Should the EU-27 reach an agreement on banning Russian oil imports by year-end, Russian oil losses could extend to 4 mb/d.
- The decline in Russian crude was behind the substantial, 846 kb/d fall in aggregate OPEC+ output (excluding Iran, Libya and Venezuela) in April to 37.2 mb/d according to OPEC secondary source data. This is the lowest figure in six months. Once again, the group fell short of its target, but this time by a massive 2.7 mb/d. (Charts 5 & 6.) OPEC-10 in April actually increased output by 284 kb/d (m/m), more than the 254 kb/d mandated by the supply increase agreement. This was largely due to Iraq's quota-busting monthly gain of 103 kb/d (versus 44 kb/d). But OPEC-10 production of 24.5 mb/d in April is still 800 kb/d below the target for that month, largely due to serial under-producers Angola and Nigeria, whose production capacity has likely shrunk due to chronic under-investment.
- The OPEC+ undersupply picture is quite stark: by April, the group should have collectively returned 7.4 mb/d of the original 9.7 mb/d of supply cuts, but they only managed to resupply 4.7 mb/d of that target. As was agreed at April's OPEC & non-OPEC ministerial meeting, the broader OPEC+ group will be looking to increase the rate of monthly supply increases to a combined 432 kb/d from May onwards. There is little likelihood of that happening, however, given the preponderance of supply outages and limited spare capacity. Only the Gulf Arab oil exporters appear able to post production gains.
- US crude production has also continued to underperform relative to expectations, much to the frustration of the Biden administration, which is counting on a ramping up of domestic supplies to cool surging gasoline prices. According to weekly EIA data, output has hovered around 11.8-11.9 mb/d for nearly two months and up only 100 kb/d since the start of the year. (Chart 7.) Shale producers continue to show restraint in the face of $100 plus oil—far above break-evens—prioritizing dividends and cash flow over growth. But the industry itself has also struggled with inflationary pressures, particularly labor and material costs. Nevertheless, with oil rig counts continuing to tick up to near-pre-Covid levels, output is expected to show more rapid gains later in the year.
- Strategic Petroleum Reserve (SPR) releases, meanwhile, both those announced by the IEA as part of its OECD mandate and the 180 mb being auctioned by the US, have helped cool prices. The scale of the combined oil release is unprecedented, equivalent to about 1.3 mb/d over six months, which has gone some way to help alleviate the supply-demand mismatch. In tandem with the slowdown in global growth, SPR releases may even help balance the market by year-end.
- Nevertheless, price risks this year still appear biased towards the upside, given the potential for substantial Russian oil losses in view of the EU's planned embargo, continued OPEC+ supply shortfalls, low oil inventory levels and limited spare oil production and refining capacity. Oil demand could also surprise on the upside once China settles its pandemic.

Chart 4: World oil demand growth (annual)
(mb/d)



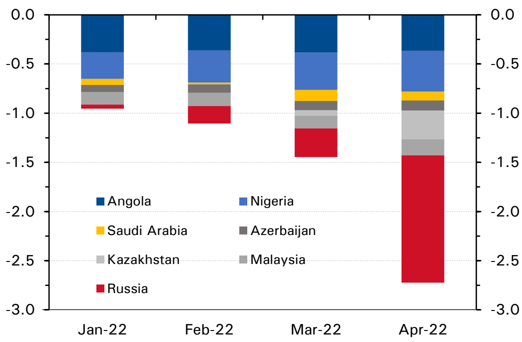
Source: IEA, mees

Chart 5: OPEC+ crude oil production*
(mb/d)



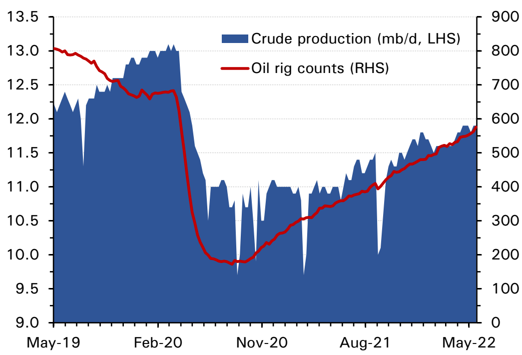
Source: OPEC, IEA, S&P; *excludes Iran, Libya, Venezuela & Mexico

Chart 6: OPEC+ member* supply shortfalls
(mb/d)



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

Chart 7: US crude oil production and rig counts



Source: EIA, Baker Hughes

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