Economic Update

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Oil markets

OPEC+ agrees to increase oil output to resupply tighter markets

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Highlights

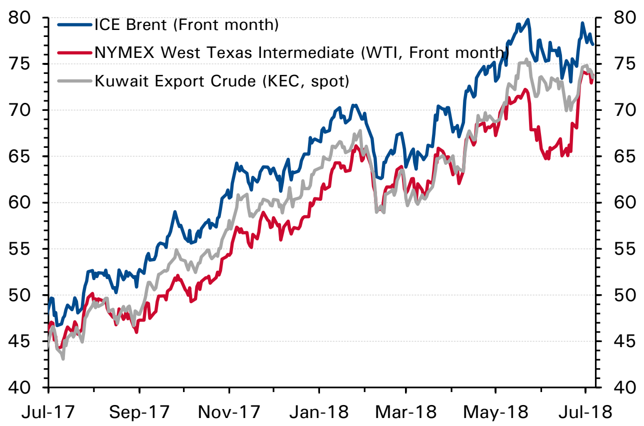
- **OPEC and its partners agree to boost crude output by a nominal 1 mb/d to contain the recent surge in oil prices.**
- **OPEC intends to reduce compliance from 162% in May to 100%, but no individual country quotas have been announced.**
- **Despite the prospect of greater supply from OPEC+, Brent and WTI rose to near three-and-a-half-year highs before settling last Friday at $77.1/bbl and $73.8/bbl, respectively.**
- **The rally has been motivated by fears of a global supply shortfall due to declining production in Venezuela, Libya and potentially in Iran amid limited spare global production capacity.**
- **The US's pursuit of a "zero tolerance" policy towards importers of Iranian crude is expected to lead to a more aggressive decline in Iranian supply than earlier envisaged.**

OPEC agrees to boost output to resupply tight markets

The much-anticipated OPEC ministerial meeting concluded on 23 June with oil producers agreeing to effectively boost aggregate output to resupply markets that had visibly tightened over the last year. This tightening has come about through a combination of burgeoning global oil demand and falling supply due to production outages, for example, in Venezuela, Angola and Libya, and has sent oil prices up to three-and-a-half year highs of $80 per barrel (bbl). (Chart. 1)

Chart 1: Crude oil prices

($/bbl)



Source: Thomson Reuters Datastream, Kuwait Petroleum Corp. (KPC)

In its official communique, however, OPEC was deliberately vague about which producers will make up the shortfall and by how much, stating only that the aim was to bring collective compliance with the November 2016 production cut agreement down to 100% from May's figure of 162% (OPEC-12). Oil ministers later indicated that this would be a nominal production increase of around 1 million barrels per day (mb/d).

It is not yet clear how this figure was derived. The aggregate supply shortfall among OPEC countries compared to the Vienna Agreement targets was around 720,000 b/d in May, stemming mainly from Venezuela, which accounted for the bulk of the loss with production at least 580,000 b/d below the level the country was officially required to reduce its output to—achieving 711% compliance. Lower supply was also the case with Angola (148,000 b/d below target) due to underinvestment amid maturing oil fields and Saudi Arabia (67,000 b/d below quota), which deliberately overcut in an attempt to stimulate higher prices. (Chart 2.) We assume, however, that the figure of 1 mb/d, which applies to both OPEC and non-OPEC producers, is probably predicated on the expectation that Venezuelan production will continue to decline in the second half of the year, Iranian output will fall after the re-imposition of US sanctions and global oil demand will continue to be robust.

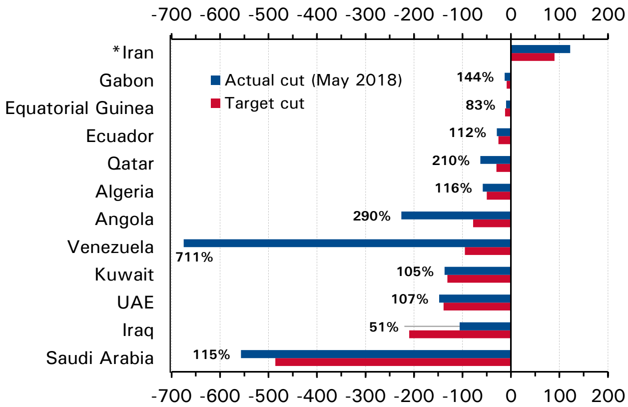
Saudi Arabia has reiterated its commitment to supply the markets with enough crude to ensure that they remain in balance. It was reported recently that the Saudis are planning for a sizeable increase in production of at least 600,000 b/d,and possibly up to 800,000 b/d to top 10.8 mb/d, which, if true, would be a record, surpassing the 10.6 mb/d the kingdom pumped in November 2016.

Indeed, it was reported that President Trump had asked King Salman of Saudi Arabia to pump up to 2 mb/d of additional crude, effectively the kingdom's entire spare production capacity, in order to offset the expected loss of Iranian barrels once US sanctions kick-in.

So, the signs are that the oil producers intend to produce over and above the current supply deficit. In any case, only a handful of OPEC+ countries—mainly Saudi Arabia, Kuwait, the UAE, Iraq and Russia—have the spare capacity to ramp up output to reach this figure. But potential gains from Iraq are hampered by its dispute with the Kurdistan Regional Government (KRG) amid limited export infrastructure, leaving the remaining four producers, with estimated spare production capacity of around 3 mb/d, to fill the gap.

Chart 2: OPEC output cut quotas and compliance (May'18)

(thousand barrels per day; compliance denoted as % on chart)



Source: OPEC, IEA; * Iran was allowed to increase output, Libya & Nigeria exempt

Indeed, the ambiguous wording of the OPEC announcement and the move away from talk of individual production allocations in favor of a group-wide ceiling is seen as OPEC's way of appeasing Iran, which, along with Venezuela, has been the most vocal critic of the Saudi-Russian plan to increase production. These producers' resistance stems from the fact that their oil production is either in decline or at its limit ahead of the imposition of US sanctions. Neither is happy with the idea that they will not be able to increase output to compensate for the loss of revenue resulting from lower oil prices, and neither would accept the prospect of ceding market share to Saudi Arabia and its GCC allies. Iran went as far as warning OPEC that, by boosting output, it was in danger of becoming a tool of US President Donald Trump's foreign policy, implicitly referring to the president's complaint in May that OPEC was keeping prices "artificially" high.

Prices rally on supply shortfall concerns and eroding global spare production capacity anxieties

Once it became clear that OPEC+ was targeting 1 mb/d and not 0.5 mb/d, as had been reported on the Friday of the meeting, oil prices took their cue and fell, by more than 1% when the market opened on Monday, the first trading day after the agreement was announced. On Tuesday, when the higher Saudi output forecast filtered through, oil prices immediately dropped, climbing only on preliminary reports of a greater-than-expected stockpile draw in the US and after it emerged that US state department officials were unwilling to offer any waivers to countries that planned to maintain imports of Iranian crude—China and India, for example—after the US embargo commences in a few months' time.

Prices have since maintained their upward trend, with Brent and WTI closing last week at $77.1/bbl and $73.8/bbl, respectively—near to their three-and-a-half-year high.

The price whipsaw illustrates the diametrically opposed forces that will influence the trajectory of oil prices over the next six months and beyond: fears of too aggressive an increase in oil supplies from OPEC and Russia ranged against a possible supply crunch due to the loss of Venezuelan and Iranian oil barrels. The International Energy Agency (IEA), in its June report, outlined a scenario in which crude output from both countries by the end of 2019 could be 1.5 mb/d lower than it is today, based on, in Iran's case, sanctions having as great an impact on its exports now as they did last time around. And hanging over both scenarios is the market's anxiety about eroding global spare production capacity, which could fall from the current 3% of global demand to below 2%. This would be the thinnest buffer from which to draw supplies (to meet demand in the event of a supply outage) since 1984. The potential for price spikes and volatility is obvious.

Meanwhile, US shale growth, the predominant bearish force of the last few years, appears to be cooling amid pipeline constraints and infrastructure bottlenecks. While production has soared by more than a million barrels a day this year (+11.4%) to reach a record high of 10.9 mb/d in the week-ending 22 June, more and more voices are now warning of a slowdown over the next twelve months while new pipeline capacity is added.

On the demand side, the IEA pegs growth in 2018 at a robust 1.4 mb/d, which will continue at the same rate in 2019. While the pace has slowed since last year's rise of 1.6 mb/d, it is, nevertheless, backed up by solid macroeconomic fundamentals—for now. Of course, were the tariff dispute to deteriorate to the extent that global trade is adversely affected, then oil demand would naturally be impacted.

On the current trajectory, demand is expected to exceed supply in 2018 by a mere 30,000 b/d on average. Meanwhile, global crude and product inventories, OPEC's preferred metric for gauging the efficacy of its production cuts up until recently, have slipped below the group's five year average target, by 27 million barrels. These two factors could push the oil price up or at least maintain it within a narrow range.

Medium-term oil outlook highly uncertain, with risks to prices skewed to the downside

The outlook remains highly uncertain, however. The volumes OPEC and Russia intend to bring to the market and the volumes likely to be lost from Iran due to sanctions are still largely unknown. But the risk that OPEC+ overshoots on supply and global inventories rebuild as a result should not be discounted. Then there is US shale, which is expected to resume its break-neck pace of growth once infrastructure bottlenecks in Texas and Louisiana are solved. Moreover, in the medium term, global economic growth is expected to slow as many advanced countries will have reached their full capacity. Add to this the prospect of an unprecedented rise in protectionism that could turn into an all-out trade war that significantly impacts world economic growth and downward pressures on the oil price could feasibly ensue.

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