Economic Update

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Oil Markets

Oil prices rangebound in July as virus persistence clouds outlook

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

Highlights

- Oil prices rangebound in July, with oil demand worries due to resurgent Covid-19 capping price gains.
- Brent edged up to a 4-month high of $44.3/bbl last week, rallying on news of the signing of the EU recovery fund.
- OPEC+ supply cuts to begin easing in August as the producer group records 106% compliance in June.
- The IEA has reduced its estimate of the decline in oil demand in 2020 to 7.9 mb/d from 8.1 mb/d.

Oil prices rangebound amid rising Covid-19 infections

Oil prices have been rangebound for most of the last month, trading in the low $40s and inching up only in the last week to four-month highs of $44.32/bbl for the international benchmark Brent crude and $41.96/bbl for the US marker West Texas Intermediate (WTI). (Chart 1.) Gains stemming from a visibly tightening physical market have largely been kept in check by worries over prolonged oil demand weakness due to resurgent Covid-19 infections in the US and elsewhere.

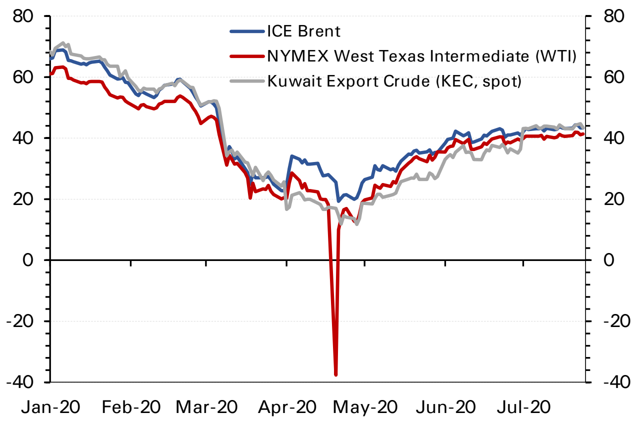
As proxies for oil demand, the weekly movements in US crude and product stocks and, to a lesser extent, refinery processing rates, have been the primary barometers of market sentiment and the triggers for movements in oil prices. This has been more pronounced since supply-side fundamentals are roughly pointing in the right direction thanks to the supply-tightening efforts of OPEC+.

Fiscal and monetary stimulus to mitigate the negative effects of the pandemic have also been significant price influencers. News of the European Union's EUR750 billion recovery fund propelled Brent crude to its four-month high last Tuesday. News on anti-Covid drugs and vaccine development has a powerful effect on the oil and broader financial markets.

Nevertheless, it has been the OPEC+ oil supply cuts and those involuntary supply curtailments in the US shale patch and Canadian tar sands developments that have really underpinned price gains since the end of April; a third consecutive month of price rises looks on the cards in July, with Brent up almost 6% this month (though still down more than 34% in 2020). The decision by the OPEC+ group after the recent JMMC meeting to begin tapering its 9.7 mb/d worth of production cuts and start pumping again in August for the first time since April had negligible impact on the markets, much of it having already been priced in thanks to careful signposting by the producer group. Moreover, expected additional volumes in August will be about half as much as initially scheduled, since producers such as Iraq, Nigeria and Angola will have to continue to make deeper cuts to compensate for not meeting their targets in May, June and perhaps even July.

Chart 1: Benchmark crude oil prices

($/bbl)



Source: ICE, Bloomberg, KPC

Kuwait Export Crude (KEC), has risen by a sizeable 19.5% this month; after months of heavy discounts, the medium sour blend finally caught up to the price levels of competitor crude grades of similar quality. KEC jumped above $40 on 1 July and was as high as $44.8/bbl last Thursday before slipping a little to $43.4/bbl on Friday.

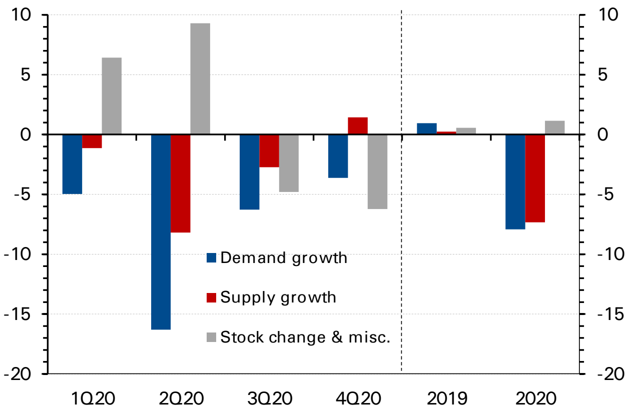
Indeed, medium crudes such as KEC, Saudi Arab Medium and Basra Light, which traditionally sell at a discount compared to lighter crudes that yield more gasoline, diesel and jet fuel per barrel, have had a good run in recent months, commanding higher than usual prices as a result of weak demand (and therefore refining margins) for diesel and jet fuel due to the coronavirus pandemic.

Oil demand outlook improving but downside risks persist

The spike in coronavirus infections in economies newly emerging from weeks of lockdown has, however, been troubling, especially in the US. Some restrictions on mobility have had to be reimposed. Coming in the midst of the peak summer driving season, when gasoline usage usually rises, the persistence of the pandemic is bound to add to US oil demand woes especially. The threat of prolonged oil demand weakness was a major caveat in the International Energy Agency's (IEA) upwardly revised oil demand forecast for 2020. The agency, in its July oil market report, noted that its 360 kb/d upward revision to oil demand growth (vs. June estimate) in 2020 is contingent on the pandemic being brought under control. This would bring the year average contraction in global oil demand to 7.9 mb/d rather than 8.1 mb/d as forecast earlier. The estimate of the year-on-year decline in 2Q20 is an eye-watering 16.4 mb/d. These are unprecedented figures for demand destruction, and with the pandemic raging in large parts of the southern hemisphere and persisting in heavy oil consuming economies in the northern hemisphere, downside risks to the oil demand outlook are sizeable.

Chart 2: Global oil demand, supply growth and stock change

(mb/d)



Source: IEA, OPEC, NBK—assumes full OPEC+ compliance, OPEC-3 at June levels

For the time being, oil consumption is accelerating in countries emerging from lockdown. In the far east, in Europe and in the middle east, where summer temperatures typically drive increased domestic demand for power generation (cooling etc.) Indeed, Saudi energy minister Prince Abdlulaziz pointed to such seasonal oil demand effects being even more 'pronounced' this year as GCC populations stay indoors amid continued travel restrictions. The Prince assured market watchers fearful of a deluge of new Saudi supply that "not a single additional barrel will be exported". Russian energy minister Novak echoed the Prince's remarks, saying that he believed that most of the additional oil be consumed by domestic market rather than exported.

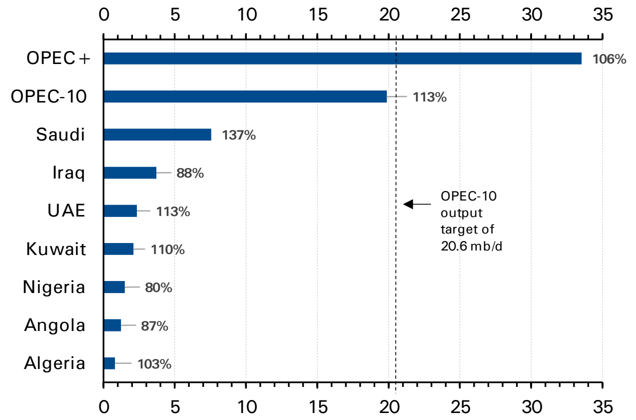
The improvement in oil demand has been most noticeable in China. Figures from the country's National Bureau of Statistics showed that crude refinery throughputs hit an all-time high of 14.14 mb/d in June, rising 9% y/y on the back of record-high crude import volumes (13 mb/d in June, according to General Administration of Customs data), much of which is admittedly opportunistic buying as China capitalizes on low oil prices. In India, petroleum product consumption is recovering from its 13-year low in April (9.9 mn tonnes), with fuel demand reaching over 92% of pre-Covid levels in June, the Ministry of Petroleum and Natural Gas reported. This has been led by gasoline and diesel demand, as commuters prioritize private over public transportation—a recurring theme of the post-lockdown global landscape. In contrast, aviation fuel demand remains considerably weak.

OPEC+ to taper supply cuts from August; group compliance reaches 106% in June

OPEC-13 crude production fell to a three-decade low of 24.3 mb/d in June as producers, led by Saudi Arabia, slashed output to bring supply and demand closer to balance. OPEC-10 recorded compliance of 110% in June (Libya, Iran and Venezuela are exempt from production quotas). After including the 10-non-OPEC members led by Russia, aggregate compliance reached 106% in June, up from 85% in May. (Chart 3.)

Chart 3: OPEC production and compliance in June

(mb/d; compliance denoted as a %)



Source: OPEC secondary sources, IEA, S&P Global Platts

The OPEC+ group therefore delivered around 10.3 mb/d of output cuts (or more than 10% of pre-pandemic global oil supply), exceeding their target of 9.7 mb/d, according to non-OPEC figures assessed by Platts. At July's Joint Ministerial Monitoring Committee meeting (JMMC), the group agreed to begin winding down these cuts, to 7.7 mb/d for the period of August to end-December.

In practice, however, only about half of the 2 mb/d of additional supply is expected in August, since non-compliant producers, such as Iraq, Nigeria and Angola, have promised to continue with deeper cuts to compensate other members for the months in which they failed to cut output to the required level.

Tighter supplies should see global inventories draw down in 2H20

According to our estimates, which draw on IEA demand and non-OPEC supply projections, global stocks should begin to decline from this quarter onwards—by 4.8 mb/d in 3Q20 and 6.2 mb/d in 4Q20 on average—having ballooned in 2Q20 (+9.3 mb/d) on the back of rampant oversupply and dramatic demand destruction. (See chart 2.) This should help OPEC+ achieve its key target of returning global inventories back to their five-year average. The IEA estimated that global (OECD) inventories stood at 3.22 billion barrels in May, 258.5 million barrels above the five-year average, the most recent month for which there is data.

The outlook, of course, is dependent on continued OPEC+ compliance and oil demand growth recovering in tandem with consumer and industrial activity. A persisting pandemic and/or a second flare up of infections in the autmum/winter represents a major downside risk factor for oil prices. News that a University of Oxford Covid-19 vaccine has shown promise and moved into phase three clinical trials would be just the right medicine for the oil market as well.

Head Office

Kuwait

National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
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

Jordan

National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

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

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France

National Bank of Kuwait
(International) Plc
Paris Branch
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
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
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