Oil Markets

Oil prices rangebound in July as virus persistence clouds outlook

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 had 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

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.

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 Abdulaziz 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.)
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 autumn/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.