Economic Update
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NBK

Oil markets

Oil prices slip on expectations of surging US shale growth in 2018

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Highlights

- **Oil prices slipped recently on concerns that rampant US shale growth is compromising OPEC's efforts to clear the global supply glut.**
- **US inventories built for the second week in a row and US crude output hit 10.1 mb/d in January—the highest since 1970.**
- **Oil was also a casualty of the broader commodity/equity markets sell-off; Brent closed down -2.0% year-to-date at $65.5/bbl.**
- **Tighter supplies and burgeoning oil demand have so far supported prices; OECD stocks are down to 2.9 billion barrels and within 65 mb of OPEC's 5-year average stock level target.**
- **Reflecting the prospect of further US output gains in 2018, many oil sector analysts see Brent trading below its current level at $62/bbl on average for the year, though history has taught us that oil prices are very hard to predict.**

Oil prices fall on bearish US petroleum data and contagion from the broader capital markets sell-off

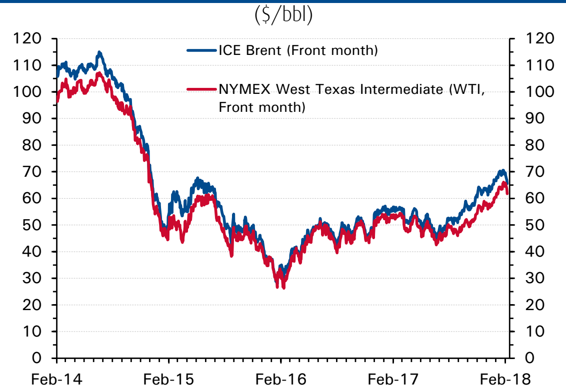
The positive momentum that propelled oil prices to four year highs appears to have slipped since the start of the month. A combination of bearish oil data out of the US showing crude stocks building for the second week in a row and US crude production breaking through the symbolic 10 mb/d level and contagion from sell-off in the equity, debt and broader commodity markets were the main factors.

Prices have fallen in six of the last eight trading sessions. The international crude benchmark, Brent, closed at $65.53 per barrel (bbl) on Wednesday, moving down into negative territory on a year-to-date basis, at -2.0%, for the first time this year. And since hitting a four-year high of $70.5 on 24 January, Brent has fallen by 7%. West Intermediate (WTI), the US crude marker, closed at $61.76/bbl on Wednesday, falling 6.6% since reaching its four-year high of $66 (Chart 1.)

A tightening oil market had supported oil prices in the past few months, with global stocks drawing down and the oil futures curve firmly in backwardation

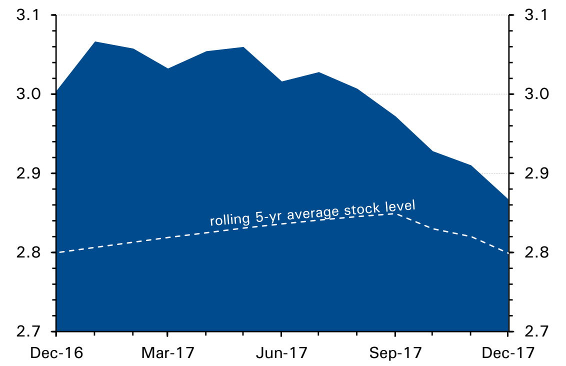
Supply and demand fundamentals have supported oil's near 70% rise since late June 2017. Thanks primarily to the efforts of OPEC and its ten non-OPEC partners led by Russia to rein in the supply surplus, the oil market has visibly tightened. (OPEC output rose slightly to 32.4 mb/d in December, but compliance reached a high of 128%—see Chart 4.) In their efforts, the oil producers have also been aided by a price-positive mélange of robust oil demand, supply outages, heightened geopolitical risk premia and, up until recently, a weaker US dollar.

Chart 1: Crude oil prices
($/bbl)



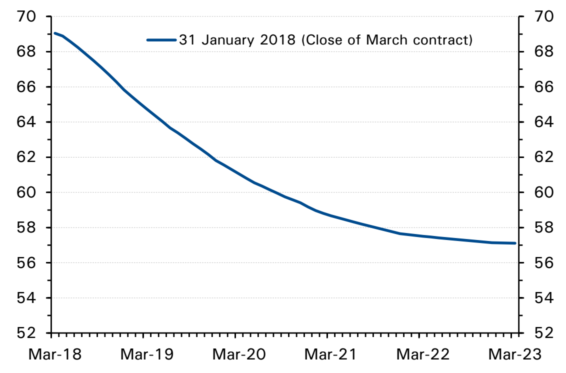
Source: Thomson Reuters Datastream

Chart 2: OECD commercial crude & product stocks
(billion barrels)



Source: IEA; December 2017 data is preliminary

Chart 3: Brent forward curve
($/bbl)



Source: Bloomberg

A reading of the most recent International Energy Agency (IEA) estimate of the amount of crude and petroleum stocks in storage across the OECD, one of the key metrics by which OPEC is gauging the efficacy of its supply cuts, is certainly encouraging as far as the oil producers' group (and oil bulls) is concerned.

Thanks to burgeoning demand for middle distillates such as diesel, global stocks were down for the fourth consecutive month in November, at 2,910 billion barrels, which would bring OPEC to within 65 million barrels of its target five-year average (rolling) stock level—the level at which the oil producers' group sees global inventories as having 'normalized'. (Chart 2.) Stocks had been as high as 366 million barrels over the five-year average back in July 2016. Indeed, according to the IEA, preliminary estimates of December's inventories show that they were on track to close the year down by 137 million barrels at 2.87 billion barrels.

Meanwhile, over in the futures market, a glance at the Brent forward curve shows that prices for crude deliveries all the way through to 2022, were lower than prices for nearer-term and immediate (spot) deliveries. (Chart 3.) Backwardation, as the structure is known, typically reflects strong demand and tighter supplies; the last time the trend was this pronounced was back in 2014.

...prompting a slew of upward price forecast revisions for 2018...

Reflecting the changing landscape, money managers amassed record bullish positions (net 'longs') in crude futures and options worth more than half a billion contracts in anticipation of firmer prices. Commodities traders and investment houses have, in turn, responded by raising their forecasts for oil this year. Noted commodities trader, Goldman Sachs, even went as far as to predict a headline-grabbing price of $82.5 for Brent within six months.

But lower consensus forecasts for crude in 2018 reflect concerns about rising US shale supply

Consensus forecasts appear to favor prices settling at $62 on average this year. Even though it represents a rise of 13% compared to last year's average of $54.8, it is lower than the current oil price. The lower price forecast for 2018 largely reflects the markets' expectation of quite dramatic increases in US shale growth this year. These concerns have once again resurfaced with US crude production recently topping 10 mb/d, a level last witnessed in 1970. (Chart 5.)

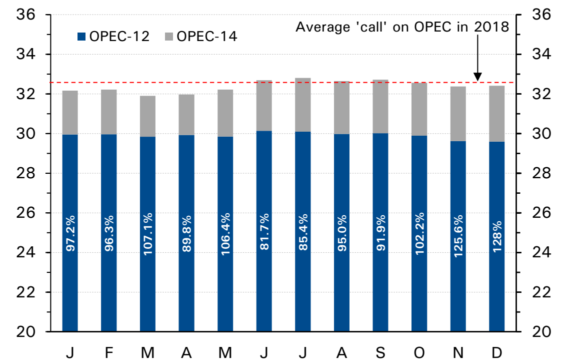
The IEA, in its monthly oil market report, noted that surging US oil production, itself motivated by higher oil prices, will be responsible for 80% (1.35 mb/d) of the 1.7 mb/d in non-OPEC supply growth expected in 2018. US crude expanded by more than 1 mb/d in 2017, replacing effectively 55% of the crude taken off the market by OPEC and its non-OPEC partners last year. Output in Canada and Brazil is also projected to increase substantially this year.

Global oil demand and supply to roughly balance in 2018, with little scope for further stock draws

World oil demand and supply are expected to track each other quite closely in 2018, rising to 99.1 mb/d on average, following demand growth of 1.3 mb/d and supply growth of 1.8 mb/d, respectively. (Chart 6.) This does assume that output by OPEC and its partners will remain constant in 2018 as per the terms of the production cut agreement.

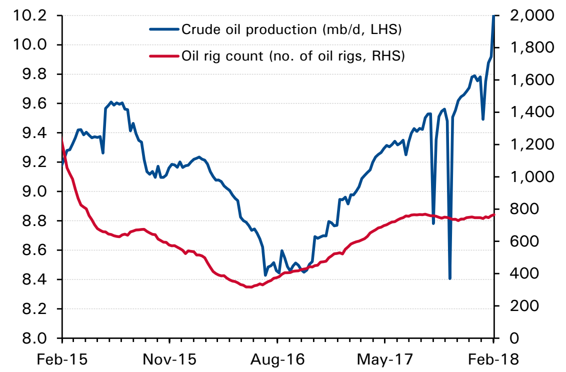
Chart 4: OPEC crude oil production in 2017

(mb/d)



Source: OPEC (secondary sources); compliance represented as a %

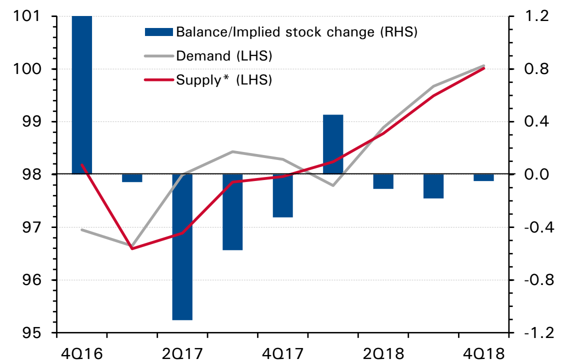
Chart 5: US crude oil production and rig counts



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

Chart 6: Balance of oil supply and demand

(mb/d)



Source: IEA; assumes OPEC supply in 2018 of around 32.3 mb/d

Global oil demand has benefitted from better-than-expected economic activity, some of which has been stimulated by lower oil prices. The International Monetary Fund (IMF) recently revised up its forecast of economic growth in 2018 to 3.9% from 3.7% in 2017.

With scope for further stock draws this year limited given that the market is roughly in balance, much of the attention will inevitably switch to the unfolding shale story in the US and focus on the demand side of the equation. Turbulence is certainly envisaged, especially over the next few weeks when oil enters a period of seasonally weaker demand due to refinery maintenance. Market participants should prepare for a bumpy ride.

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