

Economic Update

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Oil Markets

Oil rally extends into the New Year on resilient demand and tighter supply

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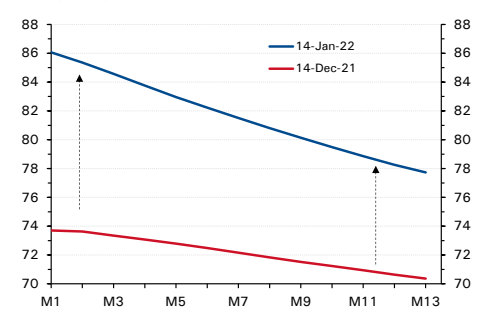
- The New Year kicked off with oil prices rallying further on tighter supplies, following supply outages in Libya and Kazakhstan, and increased optimism about the prospects for oil demand amid a more infectious but ostensibly less severe Omicron variant. Geopolitical risk, with Russia's troop build-up on the Ukrainian border, and a weaker US dollar also supported oil's recent surge. Brent crude, the international benchmark, has followed up its gain of 50% last year with a further rise of more than 10% so far in 2022, to settle at \$86.1/bbl in mid-January, a shade off its post-2014 high set last October. Brent has recouped all its losses since last November's Omicron-induced sell-off. (Chart 1.)
- In the futures market, Brent's 'backwardated' forward curve, where near-term prices are higher than future prices, has shifted upwards and steepened, a sign of current supply tightness. (Chart 2.) The rally has been underpinned by the return of substantial financial inflows to the oil market, only some of which has been motivated by inflation hedging concerns. Oil traders and investors are increasingly adopting a more bullish view of the near-to-medium term oil market outlook based on the expectation that (i) in the short term, new virus variants will only have a transient impact on oil demand and (ii) in the medium term, oil demand has further room to grow, especially in sectors where renewable energy substitutes for fossil fuels are either still undeveloped and/or economically unfeasible. It is in this context that the narrative of oil production lagging consumption due to chronic underinvestment or mismanagement is gaining more traction. Markets are now pricing in the erosion of OPEC+ spare capacity once supply cuts are fully unwound and demand tops 2019 levels, which is likely this year.
- Supply-side constraints have been evident in the inability of OPEC+ members, especially the African producers, to fulfill their quotas in line with the restoration of OPEC+ output at the monthly rate of 400 kb/d. Aggregate production figures compiled by Bloomberg show that in December, OPEC+ pumped below target (-625 kb/d) for the seventh consecutive month. Using OPEC data, November's OPEC-10 output of 23.5 mb/d was the fourth in a row that fell short of target (-570 kb/d). (Chart 3.) Sufficient OPEC+ spare capacity to reach even OPEC+ baseline levels resides in only a handful of oil producers, such as Saudi Arabia, Iraq, the UAE and Russia. Therefore, unless members with spare capacity open the taps to compensate, the group's target of restoring 3.4 mb/d of withheld supply by mid-year may not be reached.
- The implications for demand-supply balances have been playing out in January's oil rally, which has so far confounded expectations of downward price pressure and stock builds. Consensus forecasts of oversupply for 1Q22 have been downgraded, but for 2022 as a whole, inventory increases (+1.0 mb/d) are still expected based on supply (+5.0 mb/d to 101 mb/b) exceeding demand (+3.0 mb/d to 100 mb/d).
- With higher Iranian output looking less likely this year due to continued impasse at the nuclear negotiations, increased non-OPEC supply, led by a more price-responsive and less capital-disciplined US shale, is the major downside risk to oil prices. (Chart 4.) It could be the difference between prices at current levels and prices in the \$65-\$75/bbl range.

▶ **Chart 1: Brent crude oil price (ICE futures, M1)**
(\$/bbl)



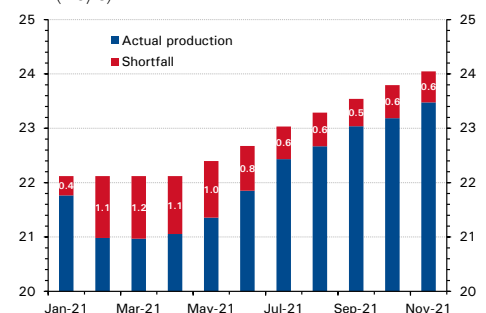
Source: Refinitiv

▶ **Chart 2: Brent forward curve**
(\$/bbl)



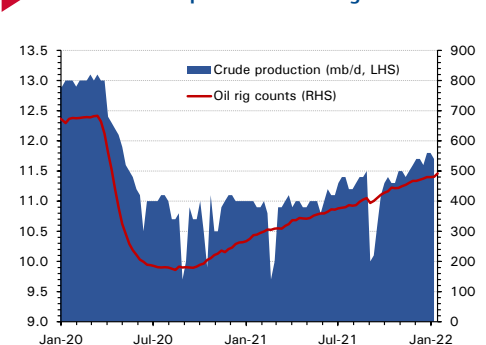
Source: Refinitiv; The current M1 contract expires in March

▶ **Chart 3: OPEC-10 production and shortfall**
(mb/d)



Source: OPEC

▶ **Chart 4: US oil production and rig counts**



Source: EIA, Baker Hughes

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