Economic Update

NBK Economic Research Department I 9 January 2023

Oil Markets

Oil prices end 2022 on positive note despite global recession and oil demand fears

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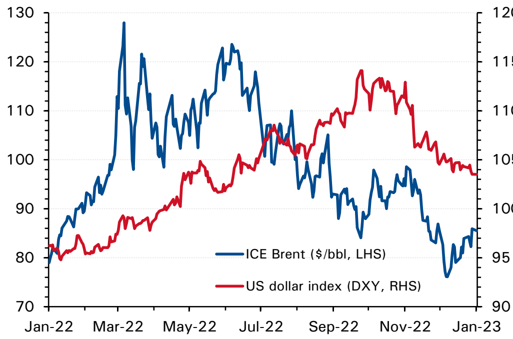
Summary

Oil prices ended 2022 on the up, with markets looking to China, after it dropped its Zero-Covid policy, to drive oil demand growth in 2023, a year in which a global recession is looking more likely. On the supply side, the EU embargo and G7 price cap on Russian oil went into force in December, while OPEC+ reaffirmed its 2 mb/d of production cuts for 2023. The market should tighten through the year, firming oil prices from current levels.

- A last-minute rally on the final trading day of the year helped oil prices close out 2022 with gains of 10.5% (Brent) and 6.7% (WTI), rare positives in what was a turbulent and poor-performing year for financial markets in general. Brent closed at $85.9/bbl, gaining 0.6% in December, while WTI finished at $80.3/bbl (-0.4% in Dec). (Chart 1.) Local crude marker, Kuwait Export Crude (KEC), ended the year at $82.0/bbl (-2.1% in December), posting a more modest gain of 3.8% in 2022.
- The uptick in end-of year oil futures came amid a traditionally subdued period for financial markets and in the wake of a double-digit retreat in prices from their fourth quarter high of $98/bbl in early November. The impetus was the expectation that China's economic prospects would improve significantly after the authorities abandoned their Zero-Covid policies—though with the virus rampaging through post-lockdown cities, near-term risks are predominantly to the downside. Also a factor in oil's rise in December was the weaker US dollar, which dropped 2.3% (US dollar Index) during the month.
- Money manager net length (the difference between bets on prices increasing and prices falling) increased markedly (+44% w/w) in the week-ending 27 December to its highest in more than a month (143k contracts). Open interest, the number of outstanding Brent futures and options contracts, was back up to around 1.9 million contracts, having been as low 1.78 million in September when liquidity was at its most challenged. Thin liquidity and its corollary volatility were especially pronounced in 2022.
- The last day of trading saw the front part of the Brent forward curve revert to the 'backwardated' structure prevalent for most of 2022 (where near-term prices are higher than prices a few months out) after several weeks in 'contango'. (Chart 3.) This tends to signal a tightening in term-term supply-demand dynamics and is likely linked to the northern hemisphere cold snap and the deep freeze experienced in the US that knocked out power and energy production while pushing demand for heating oil (and natural gas) higher. US EIA data showed crude and refined product stocks, especially propane, declining by more than 22 mb/d in the two weeks to 20 December.
- While the cold northern hemisphere weather might be expected to support consumption over the next few months, the trajectory for oil demand will be shaped more by global economic growth, and specifically its main engines, the US, China and Europe. Only a few days into 2023 and the IMF has already warned that all three are economies are slowing simultaneously and that 2023 will be "tougher than the year we leave behind". Economic growth has been decelerating since mid-2022 amid a multitude of negative forces including the Russia-Ukraine war, soaring inflation and energy prices, the tightest US monetary policy since the financial crisis and, of course, a raging pandemic in China. According to the International Energy Agency (IEA), world

Chart 1: Oil prices

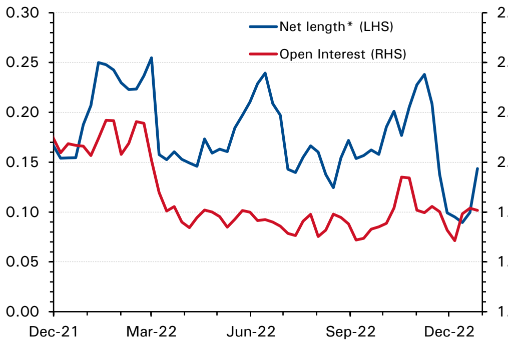
($/bbl)



Source: Refinitiv, Bloomberg

Chart 2: Money manager net length

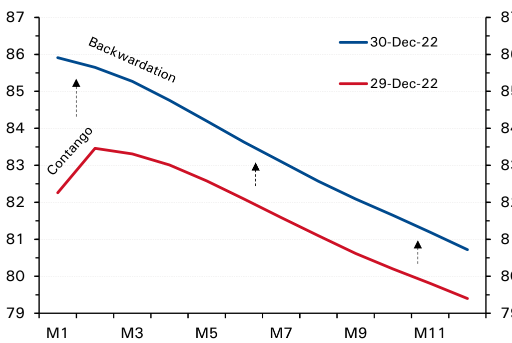
(million contracts*)



Source: Bloomberg, Refinitiv; *futures and options

Chart 3: Brent forward curve

($/bbl)



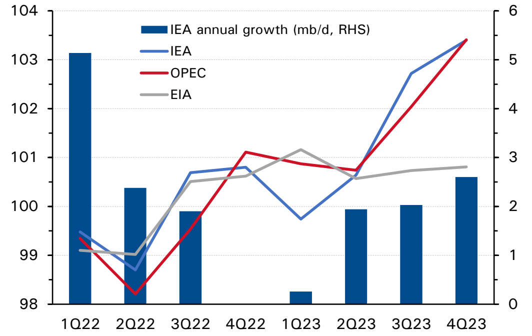
Source: Bloomberg, Refinitiv

oil demand, which was ranging around 100.8 mb/d in 4Q22 (and mostly flat in both quarterly and annual growth terms) is expected to fall this quarter by more than 1.0 mb/d q/q to 99.7 mb/d. The IEA's projection for 1Q23 is the most bearish among the three leading international energy agencies. (Chart 4.) It then sees oil demand accelerating from 2Q23 onwards to reach 103.4 mb/d by 4Q23, boosted primarily by the 'great reopening' in China—for which the IEA sees oil demand rebounding by 820 kb/d (+5.5% y/y) in 2023—and a pivot by global central banks away from monetary tightening. For 2023 as a whole, oil demand is expected to average 1.7 mb/d, down from 2022's estimate of 2.3 mb/d.

- Looking to the supply side, Russia's response to the EU's crude oil embargo (an embargo on refined products will kick-in next month) and the imposition by the G7 of a price cap on Russian crude exports will, along with OPEC+ supply management decisions, be the key determinants of global oil price movements. Russia has already announced that it will ban oil exports to any country participating in the G7 cap and has indicated that it might reduce output by 500-700 kb/d in response. OPEC+, for its part, intends to continue holding crude output lower by 2 mb/d for the entirety of 2023, having reaffirmed its October supply cut decision at the December meeting.
- Supply data for November 2022, the first month of cuts, showed OPEC-10 output dropping by 683 kb/d to 24.5 mb/d, according to OPEC secondary sources. Regional oil producers Kuwait, Saudi and the UAE were all largely in compliance, bringing output down by 121 kb/d (to 2.69 mb/d), 404 kb/d (10.47 mb/d) and 149 kb/d (3.04 mb/d), respectively, from October levels. (Chart 5.) However, higher output in Nigeria and in non-OPEC Kazakhstan (+180 kb/d to 1.58 mb/d) and Russia (+20 kb/d to 9.87 mb/d)—but all to well-below quota levels—offset some of the declines, according to S&P Global data. Aggregate production among quota-bound OPEC+ members therefore fell by 533 kb/d month-on-month to 38.18 mb/d, well below the 40.1 mb/d quota (excludes Iran, Libya, Venezuela and Mexico). Note the quota shortfall of 1.9 mb/d: aggregate OPEC+ supply could actually *increase* in 2023 if OPEC+ members, such as Nigeria, Angola and Kazakhstan and of course, Russia, with spare production capacity, find the means to raise output consistently.
- The oil supply response from the US in 2022, however, was lackluster. Crude output was up only 1.7% (+200 kb/d to 12 mb/d) in the week-ending 20 December, according to EIA data. (Chart 6.) Hopes had been high that the combination of high oil prices, shale production's traditionally short-time response and a commitment by the Biden administration to repurchase crude for its depleted SPR tanks (down 37% to 375 mb in the year-20 Dec), would be sufficient incentive for shale producers to ramp up output. Record volumes of crude and petroleum products were exported in 2022, though, as the US filled the void created by the West's shunning of Russian energy. This fact was not lost on administration officials, some of whom called for export restrictions to keep supply at home and lower pump prices for US consumers.
- The outlook for oil prices in 2023 remains uncertain, with global recessionary headwinds and increased non-OPEC and US oil supply on the bearish side and China's reopening (once it overcomes the current Covid-19 wave), reduced Russian supply post-embargo/price cap, and OPEC+ production restraint on the bullish side. However, we see these supply-side factors coming increasingly into play from 2Q23 onwards, with an anticipated positive impact on oil prices, potentially to around the $90/bbl level as a year average.

Chart 4: World oil demand

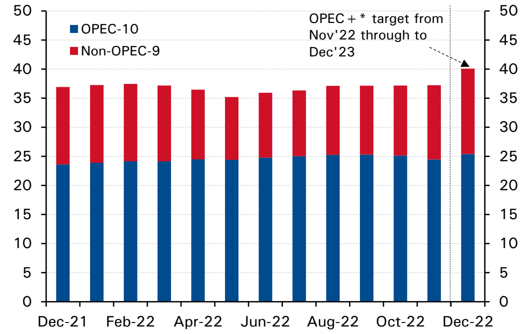
(mb/d)



Source: IEA, OPEC and EIA

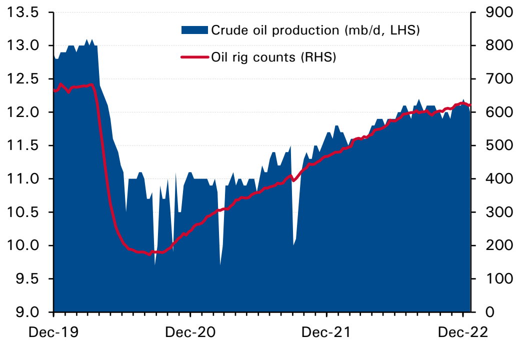
Chart 5: OPEC+ crude production

(mb/d)



Source: OPEC, S&P; *excludes Iran, Libya, Venezuela and Mexico

Chart 6: US crude oil production and rig counts



Source: EIA, Baker Hughes

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