Economic Update

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Oil markets

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Oil prices battered by concerns over weakening global economic growth

Highlights

- **Oil prices plunge into bear territory on global trade and economic tensions, sparked by further US tariffs on China.**
- **Brent crude declines almost 25% since its 2019-high of $74.6 in April to $56.2; WTI is down at $51.1/bbl.**
- **The IEA expects oil demand to grow by 1.2 mb/d, reflecting softer economic data.**
- **OPEC+ production cut compliance falls from 152% in May to 114% in June mainly on Kazakhstan output increase.**
- **There is scope for additional supply tightness were the 10 non-complying OPEC+ members to reach full compliance.**

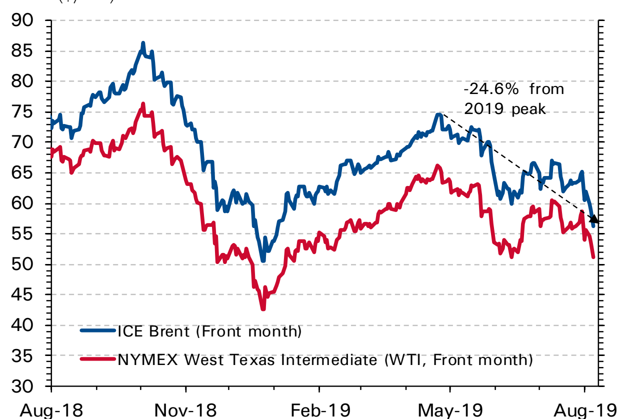
Oil prices fall into bear territory on economic woes

Oil prices are once again under pressure due to overarching concerns about global economic growth which have been sparked by deteriorating US-China trade relations. Brent , having fallen 2.1% in July to $65.2/bbl, dropped to $56.2/bbl on 7 August and further into bear territory (a decline of 20% or more from recent highs); Brent's decline since hitting its 2019-peak of $74.6/bbl in late April has been almost 25%, and the marker is close to reversing all its gains in the year so far (+4.5% ytd.).

Oil has been left reeling by President Trump's decision to impose a 10% tariff on an additional $300 billion worth of Chinese goods effective 1 September and by generally deteriorating trade relations between the world's two largest economies. On 5 August, Brent breached the $60/bbl price floor for the first time since January when the US labelled China a currency manipulator after the Yuan depreciated to below 7 to the dollar, allegedly in retaliation for the tariff increase.

Chart 1: Benchmark crude oil prices

($/bbl)



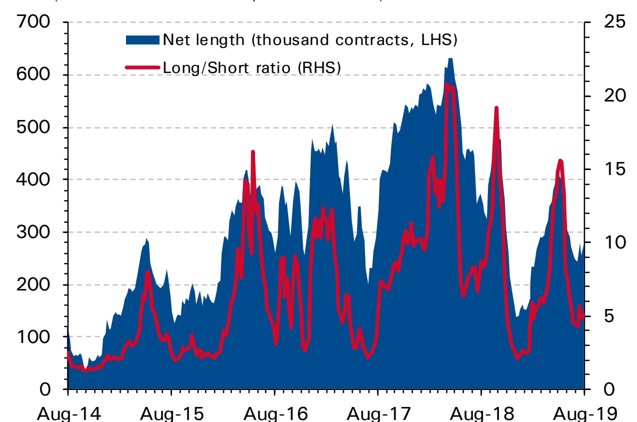
Source: Refinitiv

The latest salvos in the trade war came on the heels of the US Federal Reserve's decision on 31 July to cut interest rates for the first time in a decade by 25 bps, in what was a precautionary move to support a potentially flagging US economy. The oil and the broader financial markets had initially reacted positively, but the effect proved to be short-lived when US Fed Chairman Jay Powell cautioned that the rate cut should not be taken to mean a return to another cycle of monetary easing.

Anxieties over a slowing global economy appear difficult to shake off when one of the key downside risk factors, trade tensions, as highlighted by the IMF in its recent downgrade of global economic growth (by 0.1% to 3.2% in 2019), appear to be on the rise. The International Energy Agency (IEA), for its part, has already assumed weaker macroeconomic fundamentals in its projections, having lowered its estimate of global oil demand growth in 2019 twice this year, by about 200 kb/d to 1.2 mb/d.

Chart 2: Money manager positioning on Brent

(combined futures and options contracts)



Source: Bloomberg

The pessimism can be seen in the Brent futures market, where 'net length', the difference between the number of 'long' futures and options contracts (bets on prices rising) and the number of

'short' contracts (bets on prices falling) has declined by 32% since early May, from 406,175 contracts to 276,340 contracts as of 30 July. (Chart 2.) The ratio of 'longs' to 'shorts' is back down to around 5 from a 2019-peak of 15.6 on 7 May.

Below-the-radar bullish impulses point to potential supply tightness

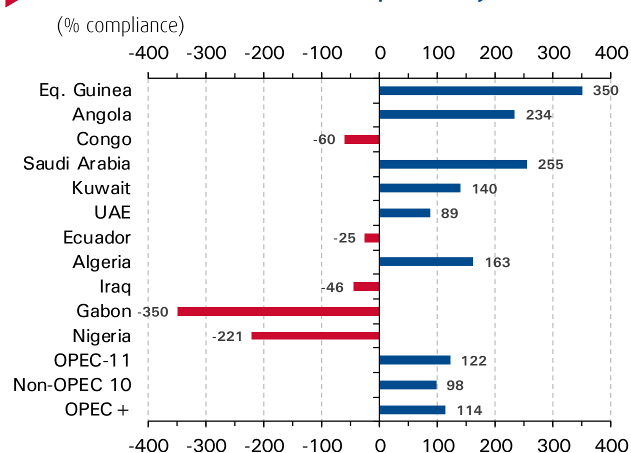
In this rather weaker economic environment, the few bullish stories for oil to emerge have struggled to resonate. In the US, for example, commercial crude stocks had, up until the most recent and unexpected stock gain, recorded six consecutive weeks of stock drawdowns. This is a sign that refineries have been busy meeting usually high summer demand for petroleum products such as gasoline and diesel.

Moreover, on the supply side, there are several dynamics in play that could result in additional tightness over the coming months. First, the 21-member OPEC+ group continues to restrict oil supplies. Overall compliance in June, though down from the 152% achieved in the month before, was still a respectable 114%, with members' cutting production by about 1.4 mb/d from the reference baseline level to 44.2 mb/d. (Chart 3.)

But there is considerable scope for even more reductions in supply given that only eleven members of the group are currently in full compliance with the agreement. Were the ten non-compliant producers, such as Iraq and Nigeria that have yet to comply and the UAE and Kazakhstan that have recently fallen out of full compliance, to have cut back production in 2Q19 to achieve their quotas, more than 0.45 mb/d of additional supply could have been taken off the market (based on average April-June production and no increases in output by Saudi Arabia and other compliant producers from those levels).

Chart 3: OPEC and non-OPEC compliance in June 2019

(% compliance)



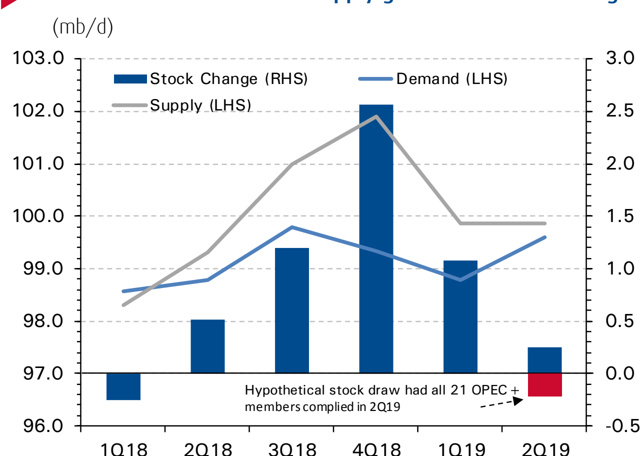
Source: OPEC secondary sources, Bloomberg, IEA

That figure equates to almost 90% of the entire oil inventory surplus that the IEA estimated had accumulated in 2Q19 (0.5 mb/d) and almost double our own estimate of a 0.25 mb/d surplus. This would have implied a supply deficit and a likely stock drawdown of around 0.20 mb/d in 2Q19. (Chart 4.)

And then there is Venezuela, Iran and Libya, members not subject to OPEC production cuts, but whose production is nevertheless falling involuntarily. Venezuela's output in June was at a decades-low of 734 kb/d, dropping almost 45% from a year earlier. Iran's production of 2.25 mb/d in June was the country's lowest since the mid-1980s, having fallen by more than 41% y/y. Its crude and condensates exports fell to a scarcely believable 64 kb/d in July, according to Bloomberg. While the Islamic Republic's exports have been in freefall since the US reimposed sanctions last year and terminated waivers in May, this figure almost certainly significantly underestimates and discounts volumes of Iranian crude that have been sold, smuggled or bartered outside of the normal channels.

Chart 4: Global demand & supply growth and stock changes

(mb/d)



Source: IEA, NBK (using OPEC secondary sources supply data)

Oil output in Libya also declined recently after the key Sharara field was shut down following intereference by an unidentified group.

With tensions still high around the Strait of Hormuz following Iran's seizure of a British and an Iraqi-flagged tanker, upside risks to oil prices from fraught geopolitics have not disappeared. With recent indications that Saudi Arabia intends to mobilise a response to the precipitous price drop—perhaps by urging non-complying OPEC+ members to fulfill their quota obligations—it seems likely that markets will sooner or later take notice of developments on the supply side and adopt a more balanced view of demand and supply dynamics.

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