Economic Update

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Oil Markets

Oil heads towards $70 on oil demand optimism and despite India Covid worries

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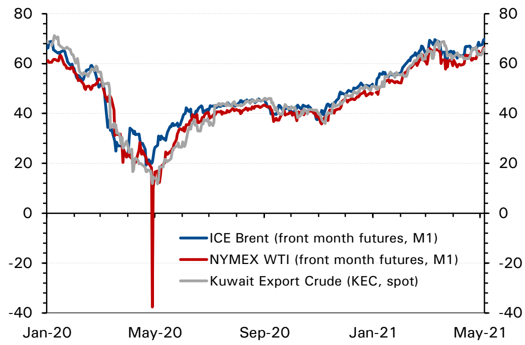
Summary

Oil prices are benefitting from renewed oil demand optimism as the vaccine rollout in advanced economies gathers pace, bringing with it hope of the removal of mobility restrictions and economic normalization. Brent is within touching distance of a two-year high of $70/bbl. Despite severe oil demand weakness in major oil consumers India and Brazil, where Covid-19 infections are surging, and increased OPEC+ supplies, tighter fundamentals are being priced in; OPEC estimates that the pandemic supply glut could be worked off by the end of 2Q21.

- Markets have grown more optimistic about the outlook for oil demand over the next few months as the vaccine rollout progresses, pushing oil prices to levels last seen in mid-March. International crude oil benchmark Brent closed on Wednesday at $68.96/bbl (+33.1% ytd), close to a two-year high, having posted gains of 5.8% in April. US marker West Texas Intermediate (WTI), which gained 7.5% in April, was up at $65.63/bbl, while local crude blend Kuwait Export Crude (KEC), reached $69.11/bbl on Wednesday (+36.5% ytd), having increased by 3.5% in April. (Chart 1.)
- Oil's increase is also part of a broader gain in the price of commodities. From energy to metals and foodstuffs, prices have surged, propelled by burgeoning demand from economies emerging from the pandemic. Demand for metals intrinsic to the clean energy transition, such as lithium and cobalt (used in batteries etc.), has skyrocketed. The Bloomberg Commodities spot Index, which tracks 23 raw materials including crude, foods and metals, is up more than 66% over the last year to its highest level in almost 10 years (470). (Chart 2.)
- In the futures market, the price of contracts across the 12-month Brent forward curve has shifted upwards over the last month. (Chart. 3) And despite pockets of serious oil demand weakness, notably in India, and the prospect of increased oil supplies from May onwards as OPEC+ eases its supply cuts, the forward structure remains firmly in 'backwardation' (near-term prices higher than later-dated prices). Speculative net length (the difference between the number of 'long' contracts bought on the expectation of the price increasing and the number of 'short' contracts bought on the expectation of the price falling), was up at 305,099 contracts in the final week of April—though still down 12.5% from the 2021 peak in February.
- World oil demand expectations for 2021 have generally brightened over the last month thanks to progress in the global vaccination drive, though the critical public health emergency in the world's third largest oil importer, India, and rising coronavirus cases in Brazil, remain key sources of near-term demand concern. In the US and Europe, road and air traffic has improved considerably, according to high frequency mobility data. In the US, demand for gasoline is within 5% of the pre-pandemic level for this time of the year, while in China, oil consumption is believed to be above pre-pandemic levels.
- In India, however, with cumulative coronavirus cases passing the 20 million mark and record numbers of daily deaths, economic activity has weakened considerably. Oil demand has been adversely affected: in April, oil shipments directed to public sector refineries fell to a 7-month low, according to Vortexa, an analytics firm, while gasoline and diesel sales dropped to their lowest levels since last August and October*, respectively.

Chart 1: Benchmark crude oil prices

($/bbl)



Source: Refinitiv

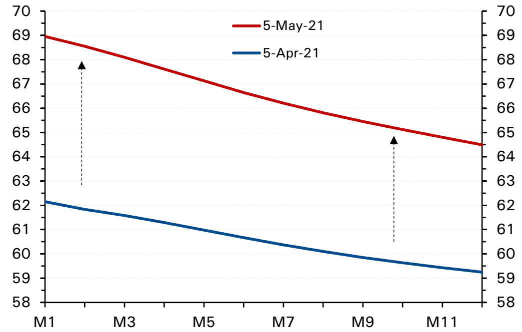
Chart 2: Bloomberg Commodities Spot Index

(Index)

Source: Bloomberg

Chart 3: ICE Brent forward curve

($/bbl)

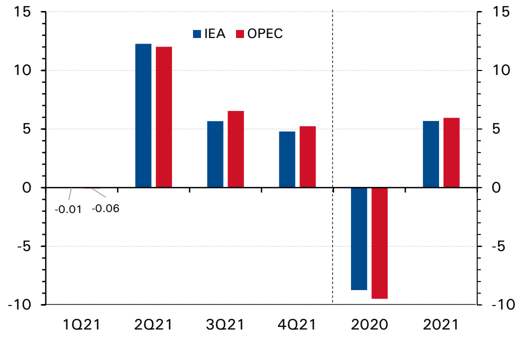


Source: Refinitiv

- Both OPEC and the International Energy Agency (IEA) in April revised up their global oil demand estimates for the year, by 70 kb/d to 5.95 mb/d and by 230 kb/d to 5.69 mb/d, respectively. This will bring average oil demand in 2021 to around 96.6 mb/d—still short of pre-pandemic levels. (Chart 4.) The bulk of the agency's revisions centered on Q3 and Q4 of this year. Oil demand growth in the current quarter is up more than 12 mb/d year-on-year (y/y) and reflects the base effect of the massive, unprecedented drop in oil demand in 2Q20 at the onset of the pandemic.
- Both agencies reiterated that continued gains in oil demand are contingent on an acceleration in the rollout of vaccines and robust efficacy against new Covid variants. Fears of viral resistance to the currently available vaccines and another round of mobility restrictions being triggered as a result is the key downside risk factor. (Chart 4.) In upgrading their forecasts, OPEC and the IEA have also taken their cues from the International Monetary Fund's (IMF) upward revision in April to global economic growth this year and in 2022, to 6% y/y and 4% y/y, respectively.
- OECD oil stock data shows a seventh consecutive monthly decline in total crude and petroleum product inventories in February to 2,978 mb (-44.9 mb m/m; +94.1 mb y/y). (Chart 5.) This leaves total stocks 29 mb/d above the latest 5-year average and providing cover for 68 days of oil demand. Crude stocks, however, gained slightly in February to 1,498, and preliminary estimates for March in Europe, Japan and the US point to another stock build.
- OPEC+, in its brief 27 April meeting, though, estimates that the glut that accumulated during the pandemic will have been worked off by the end of June as the global economic recovery proceeds. The exporters' group therefore agreed to continue with its planned output increases for May (+350 kb/d), June (+350 kb/d) and July (+450 kb/d). Saudi Arabia will also restore its 1 mb/d of withheld production over these months. Therefore, OPEC+ supply, excluding Iran, Venezuela and Libya, is expected to rise by more than 2.6 mb/d to 38.094 mb/d by end-July. This level also does not take into account volumes that need to be cut as compensation by members for failing to fully comply during the last year. OPEC+ Compliance was 115% in March.
- Looking ahead, the bullish outlook for 2H21 is predicated on global demand growth outpacing supply growth leading to sizeable stock draws. That, in turn, will depend on a much higher level of vaccine penetration facilitating a return to more robust economic activity. Transportation fuel consumption will be key over the next few months as northern hemisphere countries take to driving and travel during the summer.
- While the market tightens in the Atlantic basin, though, the situation in emerging economies, with the exception of China and a few others, is more uncertain. Given that non-OECD countries account for the majority of global oil demand, for prices to stay 'higher for longer', markets will be looking for more effective virus containment and more widespread vaccination that could then set the stage for a more robust economic recovery.
- On the supply side outside of OPEC+, potential supply gains from the US, Canada, Brazil and Norway is an obvious downside risk factor for oil prices, though oil production in the US has struggled to top 11 mb/d (-2.2 mb/d from its peak) even while oil rig counts continue to rise, albeit slowly. (Chart 7.) Iran is another wildcard with the potential to contribute significant volumes to global markets. Some progress appears to have been made in the current nuclear negotiations, but it is still too early to estimate timelines for a sanctions-free Iran to reemerge on the global oil scene. *on a 30-day month basis

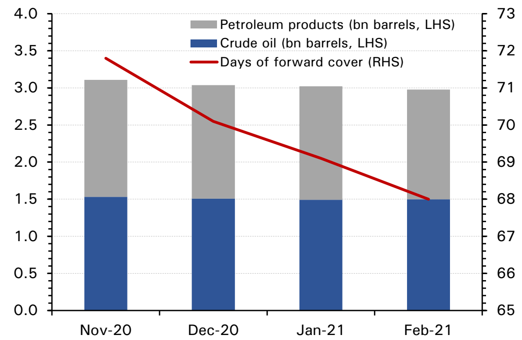
Chart 4: Global oil demand growth

(mb/d)



Source: IEA, OPEC

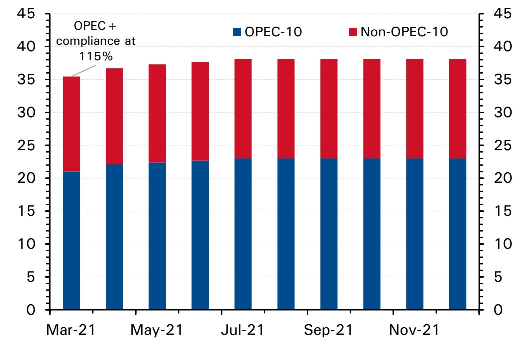
Chart 5: OECD industry stocks



Source: OPEC using data from IEA, EIA, Argus, METI, Euroilstock

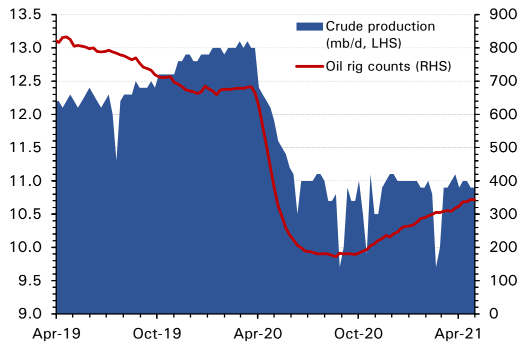
Chart 6: OPEC+ supply

(mb/d)



Source: OPEC; Apr-Dec output assumes 100% quota compliance

Chart 7: US oil production and rig counts



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

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