Economic Update

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Oil Markets

Oil prices under pressure over oil demand worries due to spiking Covid-19 infections

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Summary

Oil prices have been on the back foot due to the resurgence in Covid-19 infections that could further undermine the economic recovery and weaken oil demand. Global oil demand growth has been revised down by the IEA and OPEC, under the shadow of perhaps permanently lower growth according to BP's accelerated energy transition scenarios. With demand weak, OPEC+ compliance is key in the months ahead.

- Demand-side pressures have weighed on oil prices in September, with both benchmark crude oil futures, ICE Brent and NYMEX West Texas Intermediate (WTI) down more than 7% so far in the month. The bearish market sentiment that saw Brent fall back below \$40 and to a near-two month low of \$39.6/bbl has persisted, despite the marker regaining some ground to reach \$43 a few days later after Saudi's Prince Abdulaziz Bin Salman provided strong words on OPEC compliance and hints of further supply cuts if needed by December. Brent closed at \$41.77/bbl (-36.7% ytd) last Wednesday and WTI at \$39.93/bbl (-34.6%). (Chart 1.)

- Oil markets have grown increasingly agitated about the rise in Covid-19 infections, particularly in Europe, and the prospect of a second, autumn wave that could presage a return to mobility restrictions. The fear is that this would cause the already-weak economic recovery to stall and push back oil market rebalancing to 2021. The UK already introduced some restrictions and more countries are expected to follow in the coming days.

- The negative mood has been compounded by further downgrades to global oil demand growth this year by both OPEC and the International Energy Agency (IEA) in their September oil market reports. Having already reduced its 2020 oil demand growth forecast by 90 kb/d in August, OPEC followed it up this month with a sizeable cut of 400 kb/d to -9.46 mb/d. Oil demand in 2020 would therefore fall to 90.23 mb/d, an 8-year low. 2021 demand growth projections were also slashed, by 770 kb/d to 6.62 mb/d.

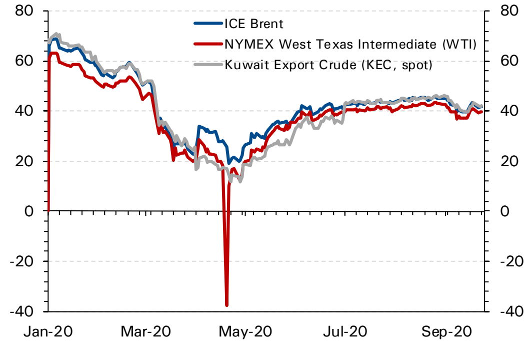
- The IEA, meanwhile, said the outlook appeared 'fragile' and revised down its 2020 growth assumption by 250 kb/d to -8.43 mb/d. (Chart 2.) The agency pegs global oil consumption this year at 91.70 mb/d—also an 8-year low—and next year at 97.15 mb/d, implying a modest rebound of 5.45 mb/d. Aviation fuel remains a major weak spot, with air passenger traffic not expected to return to pre-pandemic levels until 2022.

- Global crude and petroleum stocks remain at record high levels, not helped by still-weak refining margins due to depressed gasoline, diesel and product demand. The IEA estimates that OECD industry stocks rose in July by 13.5 mb to 3,225 mb. While they may have fallen in August, all the indications are that they are set to increase in September following Hurricane Laura and the onset of the autumn refinery maintenance period.

- Earlier, oil major BP dropped a bombshell when it announced in its World Energy Outlook 2020 that the era of oil demand growth ('peak oil') may have come to an end with the coronavirus pandemic. BP reckons that the pandemic has accelerated the transition away from fossil fuel usage and

Chart 1: Crude oil prices

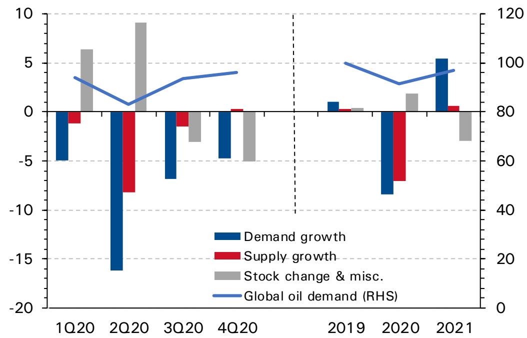
(\$/bbl)



Source: ICE, Bloomberg, KPC

Chart 2: Balance of oil supply and demand

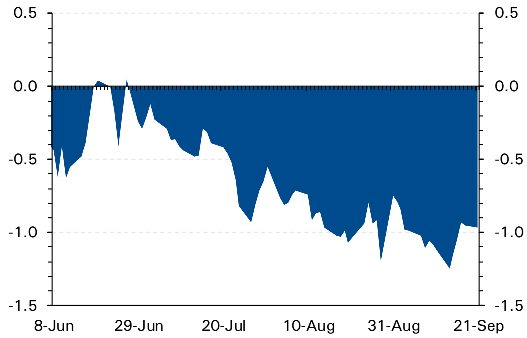
(mb/d)



Source: IEA; NBK estimates

Chart 3: Brent futures time spreads (M1-M3)

(\$/bbl)



Source: ICE

has mapped three scenarios over the next thirty years. Two of these show oil consumption contracting, by between 50% and 80%, as stricter emissions standards are introduced by governments, consumers change their behavior (more remote working, for example) and as renewables become more competitive and widespread. Even in the more optimistic 'business as usual' scenario, consumption is not expected to top 2019 levels; instead plateauing at around 100 mb/d over the next twenty years.

- The bearish turn has also been evident in the futures market. The contango structure of the Brent forward curve—where nearby crude prices are lower than prices in future months—has steepened. Brent time-spreads (M1-M3), the difference in price between a futures contract that expires in the front month (November) and one that expires two months later in January 2021, have widened to more than $-1.0/bbl in recent weeks. (Chart 3.) Widening negative differentials and relatively cheap freight rates make storage economics more viable.

- Oil producers have responded by cutting their official selling prices (OSPs) for the second month in a row. Saudi Aramco lowered the OSP of its crudes in October to all its customers. The price of its benchmark Arab Light crude to key Asian markets was reduced by $1.40/bbl, from a September premium of $0.9/bbl vs. the Dubai/Oman average to a discount of $0.50/bbl in October. Kuwait's KPC followed suit by cutting the price of its medium sour crude blend, Kuwait Export Crude (KEC), by $1.2/bbl to a discount of $0.5/bbl vs. the Dubai/Oman average. (Chart 4.)

- Producers may also have to rely less on Chinese crude purchases over the next few months as well. Chinese imports of crude oil have fallen for three months in a row to 11.2 mb/d in August, according to National Bureau of Statistics (NBS) data. (Chart 5.) Preliminary indications for the first two weeks of September are that volumes could have dropped to below 8 mb/d amid high stock levels and weak refining margins.

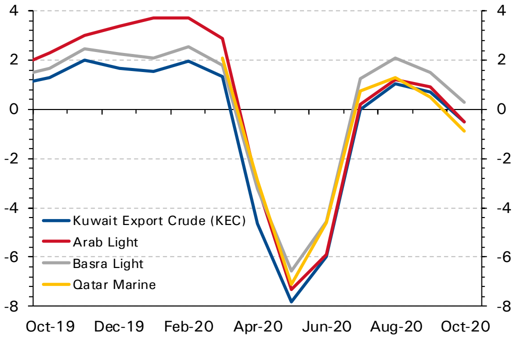
- The pressure is once again on OPEC+ to maintain collective compliance. In August, the first month in which oil producers were permitted to increase aggregate output, OPEC+ achieved compliance of 102%. (Chart 6.) Both OPEC-10 and non-OPEC-9 hit their targets, pumping 21.6 mb/d and 12.6 mb/d, respectively. Among OPEC members, Saudi (105%), Kuwait (102%) and Algeria (105%) once again over-complied; Iraq also surprised, hitting and exceeding its target (118%) for the first time under the current agreement. The UAE, however, missed its target (80%), overproducing by 110 kb/d. Along with Iraq, Nigeria and others, the UAE will have to compensate for this overproduction in the coming months. As of August, non-compliant producers will need to make up more than 1.6 mb/d of cuts collectively—little wonder the Saudis took such a firm line at the JMMC meeting. The compensation period was extended to year-end.

- Returning Libyan production is also problematic for OPEC. Russia reportedly brokered a deal between the two warring factions that would see General Haftar's forces lift their blockade on crude exports. Libya's National Oil Company (NOC) just responded by lifting the force majeure. Production has plummeted to 106 kb/d, having been as high as 1.2 mb/d in 2019.

- US crude production fell to 10.7 mb/d in the week-ending 18 September following a spate of bad weather. Crude output has declined about 2.4 mb/d (-18.3%) from its peak of 13.1 mb/d in late February. (Chart 7.)

Chart 4: Regional medium/light sour crude OSPs

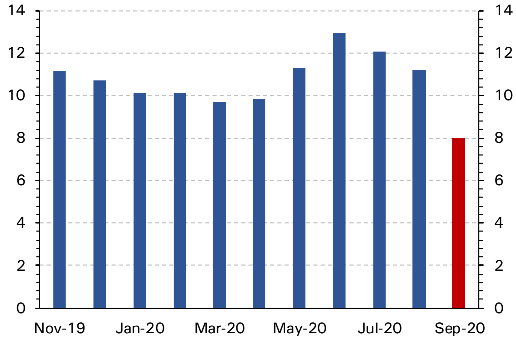
($/bbl vs. Platts Dubai/Oman benchmark for Asia deliveries)



Source: MEES

Chart 5: Chinese crude oil imports

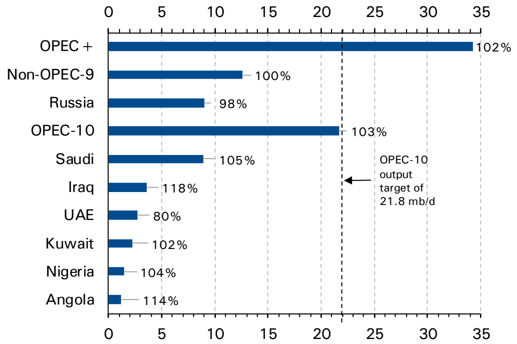
(mb/d)



Source: NBS; Note: Sept data is preliminary

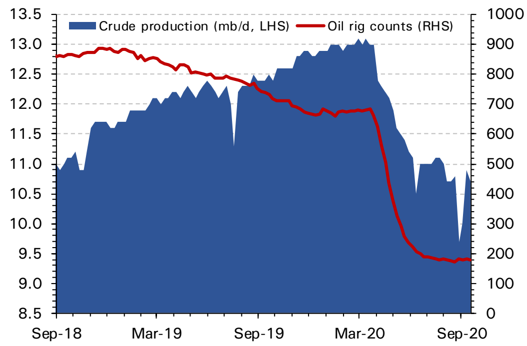
Chart 6: OPEC production and compliance in August

(mb/d, % compliance indicated above bars)



Source: OPEC, IEA

Chart 7: US oil production and rig counts



Source: EIA, Baker Hughes

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