Economic Update

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Oil markets

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Oil prices soften as markets refocus on fundamentals after Iran-US standoff

Highlights

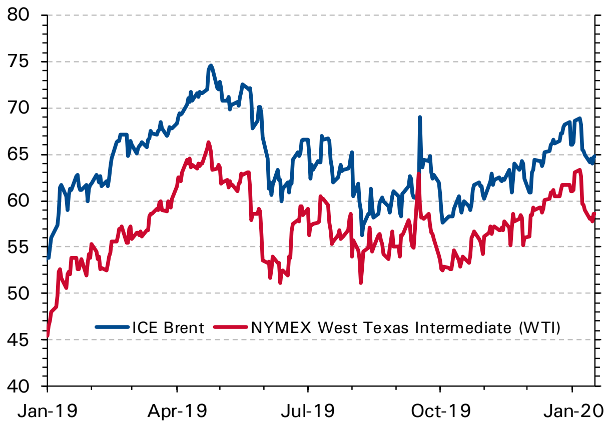
- Brent down to around $65/bbl from a high of almost $69/bbl as markets adopt a geopolitical risk-off stance.
- This follows the US and Iranian move to lower tensions and as supply-demand fundamentals reassert themselves.
- The oil market's recent enthusiasm over US-China trade tempered by refined product builds in the US.
- IMO 2020 regulations come into effect, but heavy sour crude continues to trade at a premium to light sweet crudes.
- IEA pegs 2020 oil demand growth at 1.2 mb/d in 2020 from 1.0 mb/d in 2019, on an improved global economic outlook.
- OPEC+ deepens production cuts by 0.5 mb/d to 1.7 mb/d effective January, with Saudi promising an additional voluntary adjustment of over 0.4 mb/d so long as non-compliers reduce output to their new targets.
- Balance of oil price risks remains on the downside, but geopolitical risk remains a factor.

Oil prices soften as Iran geopolitical risk deemphasized

2020 started with geopolitical risk back on the oil market's agenda. Oil prices jumped more than 3% after the US targeted Iranian general Qassem Soleimani, leader of Iran's Quds brigade, in a drone strike in early January. Despite regional tensions spiking as countries braced themselves for an Iranian response, when the retaliation came—a salvo of missiles against two US bases in Iraq without reported casualties, it was restrained. With both the US and Iran looking to pull back from the brink and cap the incident, oil's direction has been downward. International benchmark Brent crude closed on Friday 17 January at $64.9/bbl—down 1.7% in 2020—having been as high as $69/bbl just ten days earlier. West Texas Intermediate (WTI), the US marker, closed at $58.5/bbl.

Chart 1: Crude oil prices

($/bbl)



Source: Refinitiv

While the recent signing of the US-China phase one trade deal was met enthusiastically, rising US refined product inventories amid the broader reassertion of supply-demand dynamics has had a moderating influence.

Oil finishes 2019 on a high due to prospect of US-China trade deal

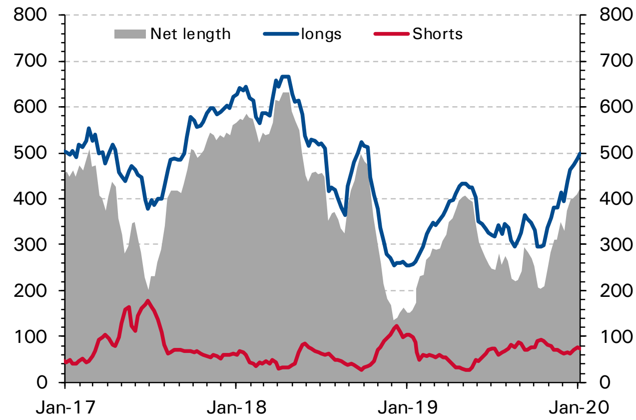
Oil's performance in 2019 was its best since 2016, with Brent and WTI posting annual gains of 23% and 35%, respectively. Local crude grade, Kuwait Export Crude (KEC), ended the year up 31% at $68.4/bbl. Since the beginning of the third quarter of 2019 oil prices benefitted tremendously from an apparent thaw in US-China trade tensions. This culminated in the announcement in November of the first phase of a trade deal between the world's two largest economies and oil consumers. The deal was signed on the 15 January 2020, much to the relief of the financial and economic community. The risk that degenerating US-China relations would trigger a global descent into trade-tariff protectionism has been the most dominant negative factor hanging over global markets and the global economy.

Oil price gains were also driven by the OPEC+ group's decision in early December to deepen production cuts by an additional 500 kb/d effective January 2020. The oil production cuts orchestrated by the Saudi and Russian-led 21-member group that amount to 1.2 mb/d—or roughly 1.2% of estimated global oil demand in 2019—have been broadly effective in reducing the oil market's supply overhang, minimizing crude stock increases and, importantly, supporting the oil price over the last 12 months of the existing agreement.

Evidence of the increased bullish sentiment has been evident in the futures markets, where money managers have been piling back into oil funds since mid-October. Net length—the difference between the number of future contracts that take a 'long' position by betting on prices rising and the number of contracts that take a 'short' position by wagering on prices falling—has increased in all but one of the last twelve weeks. As of 7 January, the net long position in Brent futures and options stood at 425,763 contracts (426 million barrels of oil), more than double the number on the 8 October and the highest level since October 2018. (Chart 2.)

Chart 2: Money manager net length

(thousand futures and options contracts, Brent crude)



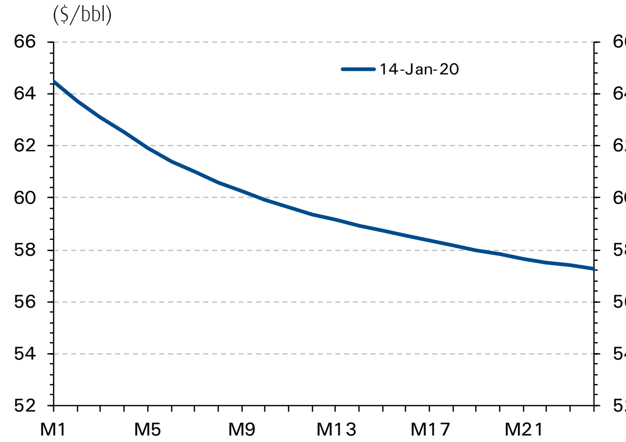
Source: Bloomberg

Moreover, the Brent forward curve remains in backwardation (downward sloping), a structure where near term oil prices are higher than future prices. This is a reflection of robust seasonal demand and a tighter physical market, especially in sour crudes.

A decline in seaborne tanker freight rates has also helped boost loadings, though prices remain elevated due to a shortage of vessels—some are out of service awaiting the installation of scrubbers to meet International Maritime Organization (IMO) 2020 regulations—and since the US imposed sanctions on Chinese shippng firm COSCO last September. (Chart 3.)

Chart 3: Brent forward curve

($/bbl)



Source: Bloomberg

Sour crude at a premium as new IMO 2020 regulations come into effect

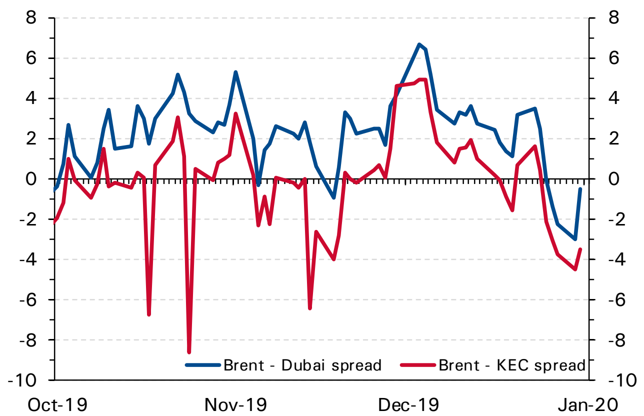
The current tightness in the medium and heavy sour crude market, which is evident in the premiums commanded by regional crude grades such as Kuwait Export Crude (KEC), Saudi Arab Medium, Dubai and Omani crudes over lighter, lower sulfur variants such as Brent and WTI, has caught the market somewhat by surprise.

With the new IMO regulations coming into effect on 1 January to limit sulphur emissions in fuels used by seagoing vessels (bunker fuels) to 0.5% from 3.5%, it was expected that the price of medium/heavy sour crudes, which yield refined products containing a greater percentage of sulphur (e.g. High Sulphur Fuel Oil, HSFO) compared to light sweet crudes and therefore trade at a discount, would fall in relation to the price of sweeter crudes (sweet-sour crude spreads would widen and become more positive). Instead, prices have risen and spreads have turned negative. (Chart. 4)

This phenomenon can best be understood by considering that Asian refineries, where the bulk of crude flows to these days, have historically been configured to more readily process medium and heavier sour crude grades, and by noting that at this time, with the market suffering from a shortage of medium and heavy sour crudes due to both involuntary supply cuts (e.g. US sanctions on traditional suppliers such as Iran and Venezuela) and voluntary cuts (OPEC+ production cut agreement), the demand for these grades is exceeding the supply. Medium/heavy sour crude demand was especially high in the

Chart 4: Light sweet – medium/heavy sour differential

($/bbl)



Source: Bloomberg

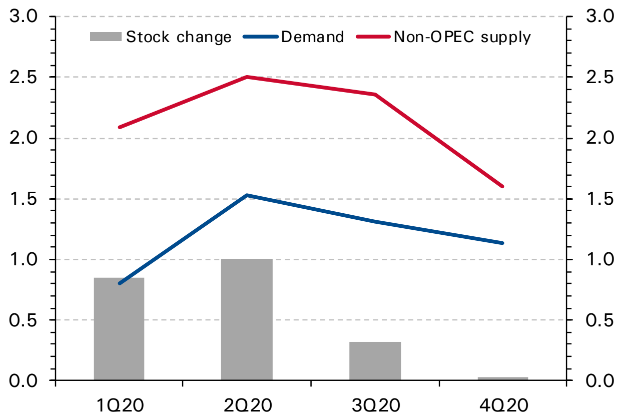
latter half of 2019 as refineries rushed to secure supplies before the IMO January 2020 deadline. Conversely, there is a surplus of light sweet crudes in the Atlantic basin, due to the tremendous growth of US shale, so the pressure on prices is downwards. The current situation is not likely to persist, however, as refineries and the shipping industry move more firmly towards sweeter, low sulphur crude varieties. [Ships that choose to continue burning higher sulphur fuel could also comply with the new regulations by installing 'scrubbers' to remove the sulphur, but this may be costly.]

World oil demand rising but non-OPEC supply growing at a faster rate

The IEA pegs global oil demand growth this year at 1.2 mb/d, a modest improvement on 2019's multi-year low of 1.0 mb/d. (Chart 5.) OPEC also sees global oil demand rising to around 1.2 mb/d this year. Both agencies cite an improved economic outlook spurred by better US-China trade relations; the signing of the phase one agreement between the two powers—which also has among its terms a Chinese commitment to buy $52.4bn worth of US energy products over two years—has been met with a mixture of enthusiasm and relief. And while US trade tariffs remain on two-thirds of Chinese imports at least until a second phase deal has been agreed, the overall direction appears to be towards trade reconciliation.

Chart 5: Demand, non-OPEC supply & stocks in 2020

(mb/d)



Source: IEA, MEES

On the supply side, expectations of continued robust US shale growth should propel non-OPEC supply to increase by 2.1 mb/d, almost twice the rate of demand growth, according to the IEA. Notable supply gains are projected in Brazil, Canada, Australia and Norway. With supply growth outpacing demand growth, global stocks will likely continue to accumulate in 2020 (+0.55 mb/d on avg.), with the bulk of gains occurring during the first half of the year. (See chart 5.) Consequently, the demand for OPEC crude (the "call') is expected to fall in 2020, to 29.5 mb/d, according to the OPEC Secretariat. This is 1.2 mb/d lower than last year's average and similar to December 2019's OPEC-14 output of 29.4 mb/d.

OPEC acknoweledges 2020 challenge and cuts further

Recognising the demand-supply imbalance, OPEC+ deepened production cuts by a further 500 kb/d to 1.7 mb/d, with OPEC reducing output by a further 372 kb/d from its Oct/Nov 2018 baseline and the Russian-led non-OPEC group by an additional 132 kb/d. Furthermore, Saudi Arabia announced that it would maintain crude output during 1Q20 at around 9.7 mb/d, in effect an additional voluntary cut of 444 kb/d, so long as producers that had yet to comply, such as Iraq and Nigeria, brought their own output down to the new target levels. The total OPEC+ output adjustment would therefore amount to more than 2.1 mb/d. OPEC+ is expected to meet again in March to assess compliance and the state of the oil market. It is likely, but by no means certain, that the current deal will be extended to at least June, when the Secretariate holds its official biannual meeting.

Softer oil price outlook but geopolitical risk cannot be discounted

Downward pressure on oil prices is expected to be greatest during the first half of 2020, with supply in excess of demand and stocks rising. Geopolitcal risk, though de-emphasized, remains a constant factor. Recent troubles in Libya, where armed forces shut down an oil pipeline and the Iran-US standoff, which is likely to be played out in the Iraqi arena, are significant hotspots. Supply outages in the latter, OPEC's second largest producer, at 4.6 mb/d, might be expected to have a sizeable impact on the oil market. Markets, feasting on robust US shale growth, have tended towards complacency about geopolitical supply risks, but should remember that the bulk of global spare oil production capacity resides in the region.

Local oil developments

Kuwait and Saudi Arabia to restart Neutral Zone production

- Kuwait and Saudi Arabia reached an agreement to bring back on-line shuttered crude oil production from the 500 kb/d Partitioned Neutral Zone (PNZ), more than five years after the offshore Khafji field was closed. Oil flow from the onshore Wafra field, which ceased in May 2015, is also expected in 2020. The two countries share PNZ production equally.
- The two countries also signed an agreement to clearly demarcate their territorial sovereignty. Kuwait's share of output should reach 250 kb/d by year-end, Kuwait's oil minister, Khaled al-Fadhel, told parliament recently.
- With both countries committed to OPEC+ oil production quotas, any PNZ crude produced would have to be offset by lower output from other fields.
- Moreover, PNZ crude is typically of the heavy sour variety, so it will likely sell at a discount to KEC and lighter, less sulphorous grades in the context of the IMO 2020 regulations.

Source: Bloomberg, MEES

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