Economic Update

NBK Economic Research Department I 10 March 2021

Oil Markets

OPEC+ supply restraint decision sends oil prices towards $70

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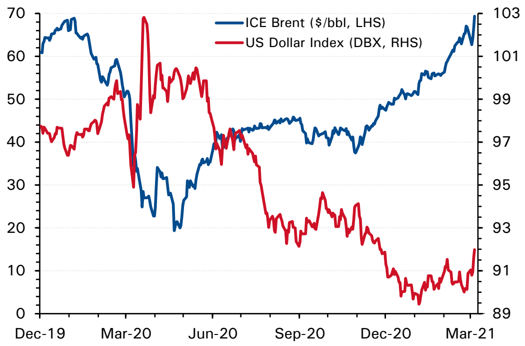
Summary

The recent OPEC+ decision to roll over supply cuts until May sent oil prices surging as surprised markets started to price in the prospect of tighter supplies amid expectations of a vaccine-mediated economic and oil demand recovery this year. Brent futures looked to break through $70, in the face of a near-term supply deficit and more rapid drawdown of global crude stocks. Oil price expectations for the year have been raised upwards, though these favorable dynamics are unlikely to persist beyond this year.

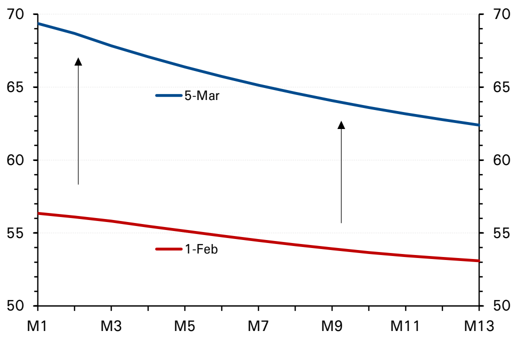
- The Saudi-inspired decision by OPEC+ to restrain crude output in April for at least one month sent oil prices surging by as much as 8% by Friday's close. ICE Brent, the international crude benchmark, settled at $69.4/bbl, its highest close since May 2019 and a seventh consecutive weekly gain. (Chart 1.)
- Brent is up almost 34% so far in 2021—one of its best ever starts to a year—and 69% since the start of 4Q20 as traders reckon on tightening oil markets thanks to the efforts of Saudi Arabia and its allies.
- The prospect of a significant economic and oil demand rebound this year made possible by the rollout of vaccines in some major oil importing countries has been the oil rally's main driving force. Global economic stimulus, such as the $1.9 trillion package of pandemic support measures on the verge of being approved by the Biden administration is seen as exceptionally supportive.
- Financial flows into oil and changing market expectations about near-term supply tightness are best reflected in the steepening backwardation (where futures prices are cheaper than prompt prices) of the Brent forward curve since the middle of January. Speculative net length (the difference between the number of 'long' and 'short' contracts that bet on prices falling) has surged in recent and is back near record, pre-pandemic highs. (Charts 2 and 3.)
- The OPEC+ decision once again surprised the markets that had been expecting the group to respond to market tightness and falling inventory levels by opening the taps. At the very least, 500 kb/d of additional supply was expected, with the only uncertainty being whether Saudi Arabia would return its additional 1 mb/d of supply cuts in April all at once or gradually. Saudi Prince Abdulaziz had been urging caution for months as oil demand growth remained uncertain while the coronavirus pandemic still raged. "The right course of action now is to keep our powder dry and to have contingencies in reserve to insure against any unforeseen outcomes", he remarked before the close.
- In the end, OPEC+ rolled over its nearly 8 mb/d of production cuts, equivalent to around 8% of pre-pandemic supply, for an additional month until May. However, it did concede a second round of output increases to Russia and Kazakhstan of 130 kb/d and 20 kb/d, respectively, to reflect 'seasonal consumption patterns'. (Chart 4.)
- This outcome was by far the most bullish among the range of scenarios being considered ahead of the meeting. The group anticipates in the near term a period of oil demand weakness and crude stock builds associated with the Spring refinery maintenance season before oil demand growth recovers ahead of the summer. The priority remains bringing global crude stock levels

Chart 1: ICE Brent crude price
($/bbl)



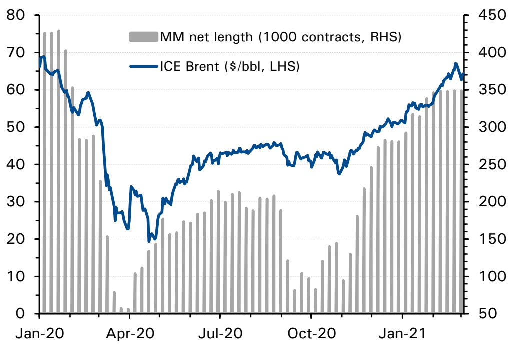
Source: Refinitiv

Chart 2: ICE Brent forward curve
($/bbl))



Source: Intercontinental Exchange (ICE)

Chart 3: ICE Brent vs. money manager net length



Source: Refinitiv, Bloomberg

down to within its target 5-year avg. range. OPEC+ is more concerned about overshooting rather than undershooting oil demand.

- As for the risk of higher oil prices re-incentivizing further US shale production down the line, a frequently voiced concern for Russia, the Saudis believe that the era of "'drill, baby, drill', is gone forever". The view is that shale producers are now prioritizing profits and dividends over output growth. While US crude production is recovering, both from February's deep freeze—which knocked out around 1 mb/d of crude production and shuttered several key oil refineries—and last April's historic price drop into negative territory, it remains well below its record highs of early 2020.

- Prior to February's Arctic blast, US shale had recovered around 40%, or 1.4 mb/d, of the 3.4 mb/d of supply lost (peak to trough) due to the pandemic. The most recent EIA data shows production reaching 10 mb/d in the week-ending 26 Feb, still a way off peak output of 13.1 mb/d. This is despite an increase in US oil rig counts to last May's levels (310). (Chart 5.)

- On the oil demand front, recent economic and high frequency indicators from the world's three largest oil consumers are promising. Consumer spending over the Lunar New Year in China rose by almost 29% y/y amid travel restrictions, while India's economy, supported by government stimulus, returned to growth in 4Q20 (+0.4% q/q). The expectation now is that fuel demand growth will surge to a record high of 215.2 million tons by March 2022. In the US, work commutes hit their highest level since March 2020, according to Google Mobility Reports.

- The International Energy Agency (IEA), taking its cue from the IMF's recent World Economic Outlook Update, in which it forecast a 5.5% increase in global output (8.1% and 11.5% for China and India, respectively), expects oil demand to increase by around 5.4 mb/d in 2021, about 60% of the volume of oil lost in 2020 due to the pandemic. (Chart 6.) This would bring total oil demand back up to 96.4 mb/d by end-2021, led by gasoline, diesel and petrochemicals, but still short of the pre-pandemic 100 mb/d thanks to lagging aviation fuel demand.

- Oil price expectations have been revised upwards, with the year-average consensus for Brent settling firmly in the $65-75/bbl range. The balance of oil price risks for 2021 are tilted to the upside given the state of undersupply, though oil prices will not surge to levels that could dampen the pace of global economic growth. Downside risks to demand include delays in global vaccine penetration and/or the proliferation of new coronavirus strains. Beyond the near term, supply side factors such as OPEC spare capacity, returning Iranian production following renegotiation of the previous nuclear agreement (JCPOA) and recovering US shale will likely begin to influence prices.

- OPEC+ will meet again in early April to reassess the state of the market. It is likely that supply will increase in May, with domestic refining needs increasing ahead of peak summer electricity demand in this region and the onset of the northern hemisphere driving season.

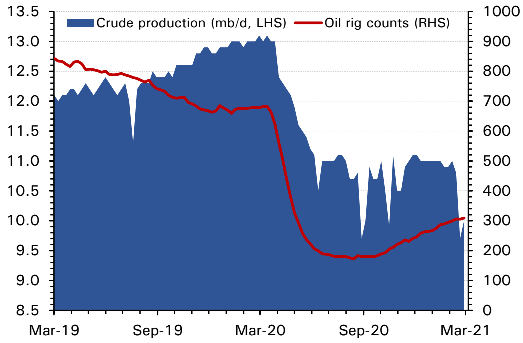
Table: OPEC+ crude production allocations

	Output (kb/d)	Compliance (%)	Allocations (kb/d)		
	Jan-21		Feb-21	Mar-21	Apr-21
Algeria	864	106.6	876	876	876
Angola	1,174	135.6	1,267	1,267	1,267
Congo	267	103.6	269	269	269
Equatorial Guinea	116	50.0	105	105	105
Gabon	173	155.0	155	155	155
Iraq	3,839	102.3	3,857	3,857	3,857
Kuwait	2,319	102.1	2,329	2,329	2,329
Nigeria	1,342	155.6	1,516	1,516	1,516
Saudi Arabia	9,054	103.5	8,119	8,119	8,119
UAE	2,612	102.6	2,626	2,626	2,626
OPEC-10	**21,760**	**105.0**	**21,119**	**21,119**	**21,119**
Russia	-	-	9,184	9,249	9,379
Kazakhstan	-	-	1,427	1,437	1,457
Non-OPEC	-	-	**14,609**	**14,684**	**14,834**
OPEC+	-	-	**35,728**	**35,803**	**35,953**

Source: OPEC secondary sources

Chart 4: US crude oil production and rig counts

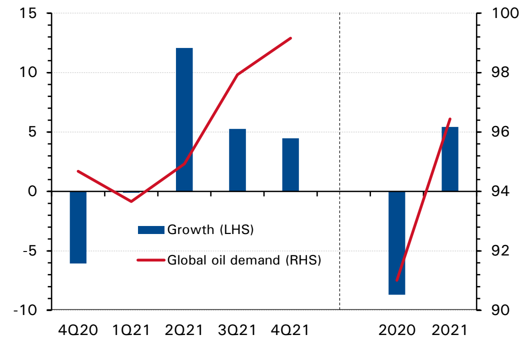
(mb/d)



Source: Energy Information Administration (EIA), Baker Hughes

Chart 5: Global oil demand

(mb/d)



Source: International Energy Agency (IEA)

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