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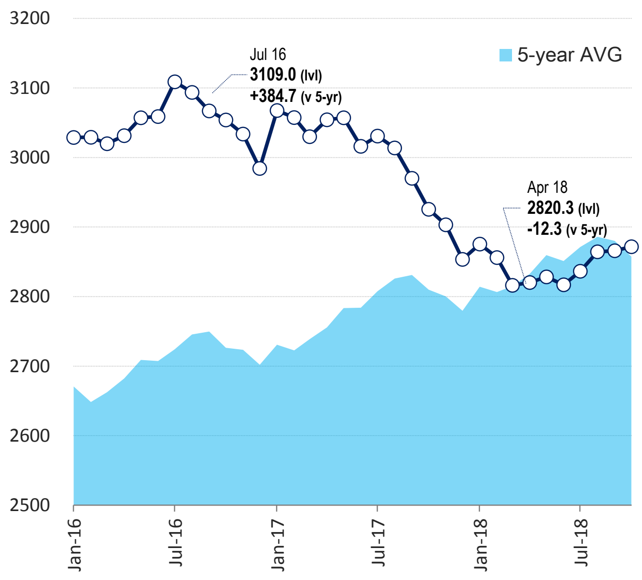
Oil prices to recover in 2019: barring sharp economic slowdown

After a sharp rise in oil prices to $85 per barrel (b) in October, Brent plummeted to around $54/b at the end of 2018. Despite a deteriorating geopolitical backdrop, concerns about the macro-economic picture, rise in output in the world's three largest producers, the US, Russia and Saudi Arabia, and drop in sentiment have been responsible for the majority of the decline. With US production expected to continue to remain strong in 2019, OPEC+ cuts will take time to balance the market. But by the second half of 2019, Brent is expected to trade between $60-70/b, barring a sharp economic slowdown.

The last quarter of 2018 has been quite tough for oil markets. After a sharp rise in the oil price, the sentiment turned sour and the year ended on a low note. This turn of events surprised many in the market. After all, given the fall in crude stocks in the first half of the year, supply shocks engulfing the market - including the loss of Iranian barrels following the US sanctions - the continuous decline in Venezuelan output, and the fragility of other sources of OPEC production such as Libyan and Nigerian output, many analysts were predicting a $100/b Brent price by the end of 2018. Against these supply losses from key OPEC members, US shale supply continued to surprise on the upside with the Energy Information Administration (EIA) now forecasting US crude production to average 10.9 mb/d in 2018 and 12.1 mb/d in 2019, an upward revision of 0.6 mb/d and 1.3 mb/d from its January 2018 forecast. There have also been growing concerns about the broader macro environment and the rise of protectionist policies, which are casting a dark cloud over oil demand. It is against this uncertain and geopolitically charged environment that OPEC and its allies need to navigate to balance the market and manage expectations and sentiment in 2019.

OECD commercial oil stocks (mbbls)

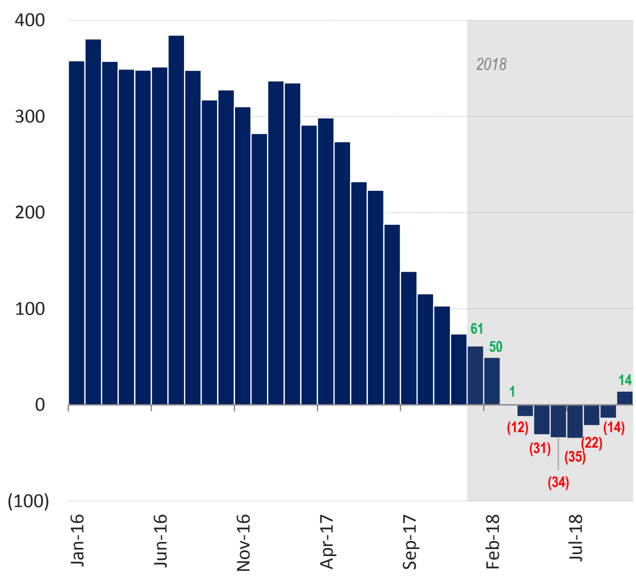


Source: IEA

After a balanced market in 2017, declining stocks in 2018 obliged OPEC intervention

Between July 2016 and April 2018, OECD commercial oil stocks fell from 3109 million barrels (mbbls) to 2820 mbbls and hence, from 385 mbbls above their five-year average to 12.3 mbbls below the average clearing the entire stocks overhang. This occurred despite the rapid growth in US shale, which increased by 1.3 mb/d in 2017 and the recovery of Libyan and Nigerian output, which increased by 0.31 mb/d and 0.25 mb/d respectively in 2017. Higher than expected oil demand growth both in OECD and non-OECD and the implementation of 2016 OPEC+ cuts have been the main contributors to the oil market rebalancing. Indeed oil demand in 2017 has been growing at around 1.7 mb/d, reflecting a robust global economic performance. High compliance from key OPEC members (reaching 180% in some months) and Russia and involuntary cuts from countries such as Venezuela, where output fell from 2.1 mb/d at the end of 2016 to 1.6 mb/d at the end of 2017, contributed to a sharp fall in commercial inventories.

OECD stocks v 5-yr AVG (mbbls)



Source: IEA

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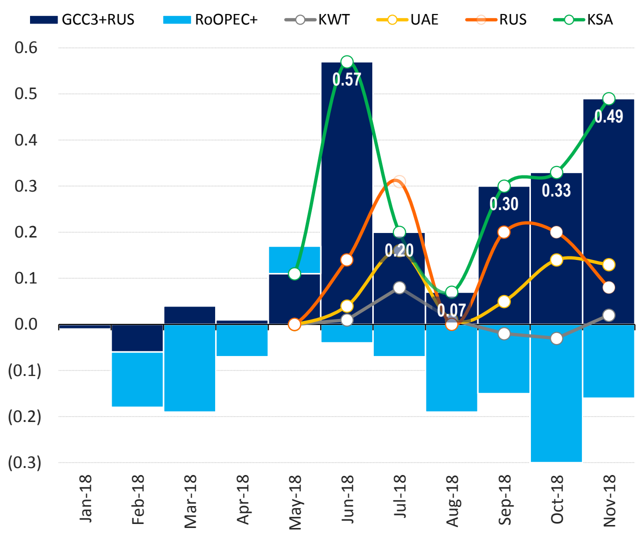
As we entered 2018, OPEC and its allies seem to have regained management of the oil market. Against this background of tightening market fundamentals, Brent gained momentum increasing from $33/b in January 2016 to $77/b in May 2018 and exhibiting gains in nine out of ten quarters from 2Q16 to 3Q18. Indeed, for the first quarter of 2018, the debate centred on whether OPEC and its allies should reverse the cuts and whether that decision to exit the OPEC+ 2016 deal should be based on falling OECD stocks alone.

This 'relative' stability in oil market fundamentals and expectations however was disturbed in May 2018 when President Trump announced the US withdrawal from the Joint Comprehensive Plan of Action (JCPOA) re-imposing sanctions on Iran.

This resulted in tremendous uncertainty, especially around the size of the potential loss of Iranian barrels with estimates varying widely, from as low as 0.4 mb/d to as high as 1.5 mb/d. As time passed, the market started factoring a big reduction in Iranian output. Alongside the continuing decline in Venezuela's production and other output losses (Libya and Canada), the supply picture looked bleak and amidst expectations of robust demand growth in the second half of 2018. As a response, Brent prices started rising in May and June trading above $75/b towards the end of June/early July.

To prevent prices from rising sharply, oil producers sent a strong signal to the market by pushing more supply. The first surge in output occurred in May, which saw the core GCC (i.e. Saudi Arabia, UAE and Kuwait) and Russia output increase by 0.7 mb/d in the months of May and June. This helped ease market concerns and prices fell temporarily in the months of July and August reaching low $70/b in mid-August. However, as we approached November, the month in which the US would reinstate the sanctions on Iran, prices started rising again in the second half of August/September. Expectations of large Iranian losses, scramble for barrels by refineries concerned about supply shortages, and doubts as to whether Saudi Arabia is capable of ramping up production above 11 mb/d pushed Brent prices above $85/b at the start of October.

GCC core and Russian production (mb/d, m/m change)



Source: IEA

But the market was wrong footed. First, by November, Saudi Arabia's output had reached a record level of 11.1 mb/d.

In fact, it is estimated that between May and November, OPEC increased its output from 31.7 mb/d to 33.0 mb/d, despite the fall in Iran and Venezuela output by 810k b/d and 120k b/d respectively during this period. Second, in late November, Russia's finance minister announced an improved budget surplus of 2.5% of GDP for 2019 and was therefore less concerned with oil prices and more focused on maintaining output. Russia's output increased by more than 440 kb/d between May and October 2018, signalling the country's ability to rapidly boost production. Third, rather than pursuing a policy to cut Iranian exports to zero, the US surprised the market by granting temporary waivers to eight countries to continue importing Iranian oil, citing concerns about the negative impact of high oil prices on the economy. This highlights the ability of the US administration to heat up or cool down the market and – at least in the short term – influence oil prices.

1.2 mb/d cut might not be enough

OPEC members and its allies met in December in Vienna, agreeing to reduce output by 1.2mb/d in order to bring the market into balance again. The cuts exempt Iran, Venezuela and Libya, and would last six months from January 2019, but could be extended until the end of the year. While the initial response was positive, the oil price gains following the OPEC meeting were quickly reversed and the market entered into a downward spiral, reinforced by massive liquidation of net lengths by hedge funds and financial investors. Macro fears clouding the prospects of oil demand, the increase in output from the world's three largest producers US, Russia and Saudi Arabia, and concerns that Saudi Arabia might reverse its cuts are keeping the market in a wait-and see-mode.

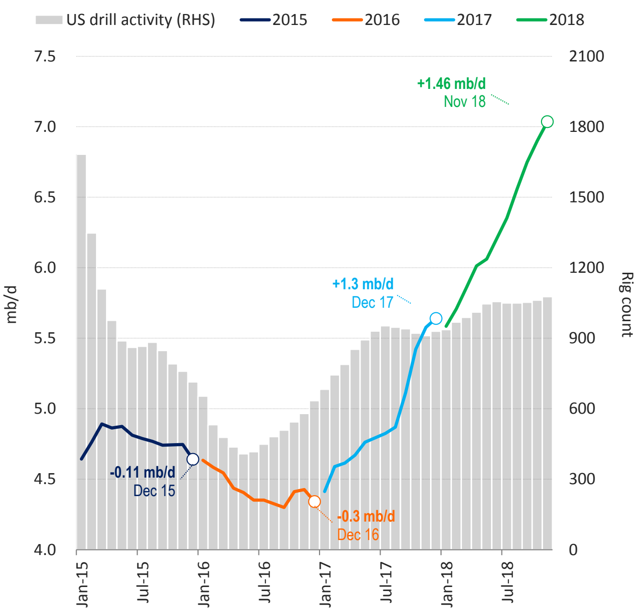
The dynamics of oil prices in 2019 will also depend in large part on OPEC's effectiveness in implementing the cuts, balancing the market and reinforcing the credibility of its signals. First, there is the issue of whether the agreed cut is big enough. In its December report, the IEA estimates the call on OPEC at 31.6 mb/d. Assuming that the cut is implemented in full, OPEC's reduction of 0.8 mb/d from October level, estimated by secondary sources at around 33 mb/d, will keep OPEC output at about 32.2 mb/d, implying that stocks would continue to build at a rate of around 0.6 mb/d.

Second, OPEC output may fall by more than 0.8 mb/d due to declines in Iran and Venezuela. Iran's production has already fallen by 0.8 mb/d between May and November and Venezuela continues to grapple with economic collapse and uncontrollable inflation. Last, there are uncertainties outside OPEC+, for example the government of Alberta, Canada has announced mandatory reduction of 325 kb/d starting from January, as rising crude stocks in the absence of outlets has led to the collapse of prices in Canadian grades.

US expected to maintain growth at 1.2mb/d in 2019 bearing uncertainties

While OPEC is expected to cut its output in 2019 in an attempt to balance the market, US production should maintain its upward momentum. In 2018 and despite infrastructure constraints, US crude and NGLs increased by more than 2.0 mb/d led mainly by rapid growth in US shale and in response to the higher oil price environment. As of November 2018, US shale output was up by 1.46 mb/d than the previous year, which is already higher than the 2014 record-expansion of 1.32 mb/d. The rig count has increased massively by 669 rigs from its low level in 2016 (408 rigs as of May 2016) although it has broadly flattened in 2018. In 2019, lower oil prices and infrastructure constraints will slow down activity as companies reassess their spending plans, but US production is expected to continue to grow robustly as productivity gains consolidate and some of the infrastructure constraints are removed. The EIA estimates US crude output growth of 1.2 mb/d in 2019 reaching 12.1 mb/d in 2019, with growth tilted towards the second half of 2019.

US shale production (mb/d) and drilling activity



Source: EIA

Russia can surprise again beyond 2019

removed. Russia is aiming to continue to improve recovery and control decline rates, particularly from major producing oil fields in Western Siberia and Volga Ural basin. Russian oil producers had plans to increase production in 2019 including an increase of 200 kb/d from four Rosneft fields. But these plans are likely to be pushed back to the 2nd half of 2019 and 2020, following the OPEC+ agreement among other reasons.

Russia's energy minister is expecting oil production to peak at around 11.45 mb/d by 2021. The growth will continue to be driven by government incentives, in addition to the benefits to cash flows and costs brought by the Ruble devaluation. In early June, the Russian Finance and Energy Ministries announced an agreement with oil companies to phase out oil export duties by 5% annually – from 30% in 2018 to 0% in 2024. The existing mineral resource tax will be replaced with a profit-based tax to stimulate investments in production expansion. However, Russian companies' ability to secure technology and financing is constrained by existing US and EU sanctions affecting mainly Arctic, deepwater and shale resources. They are seeking alternative, non-Western funding and equipment.

Global demand more important for oil prices

According to recent research from the OIES, stronger than expected oil demand growth has been responsible for 80% of the market rebalancing and thus any slowdown in the global economy that results in lower demand growth will have a drastic effect on oil prices. And concerns about the global economy have been mounting. The US-China trade war is already casting clouds on the global economic outlook. China's economy has been slowing down, prompting top policy makers that more monetary and fiscal support will be rolled out in 2019. There have been also worrying signs from the US, with a recent Reuters poll of over 100 economists predicting a slowdown in the U.S. economy in the coming quarters with annualized gross domestic product growth easing to 1.8 percent by mid-2020, about half the latest reported rate of 3.5%. Despite these concerns, the IMF maintained the 2019 global growth forecast at 3.7% and China's and India's growth at 6.2% and 7.4% respectively, which should provide a reasonably healthy backdrop to oil demand. Indeed, the IEA predicts global oil demand growth in 2019 of 1.4 mb/d similar to 2018, although not as high as the 1.7 mb/d registered in 2017.

Oil prices to trade between $60-70/b in 2019 as markets balance

In conclusion, purely based on fundamentals, a collective cut of 1.2 mb/d between OPEC and its allies, high probability of supply losses from Iran, Venezuela, Libya and Canada, and global oil demand growth of 1.4 mb/d, the market will achieve balance in 2019. A balanced market is consistent with a wide range of prices, and until the market starts showing signs of stock drawdowns, oil prices will continue to be under pressure. As market fundamentals re-assert themselves, the oil price will recover some of its current losses and our base case forecast is for the oil price to trade between the $60-70/b range towards the second half of the year, barring a sharp slowdown in the global economy.

2018 showed quite clearly that this is a market not only driven by fundamentals, but also expectations and market sentiment. In the last few months of 2018, the tensions between fundamentals, sentiment and prospects about the macro environment all shaped price behaviour and this will continue in 2019. OPEC's primary challenge will be to address the physical market imbalances, and assert its credibility to consistently manage expectations and sentiment.

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