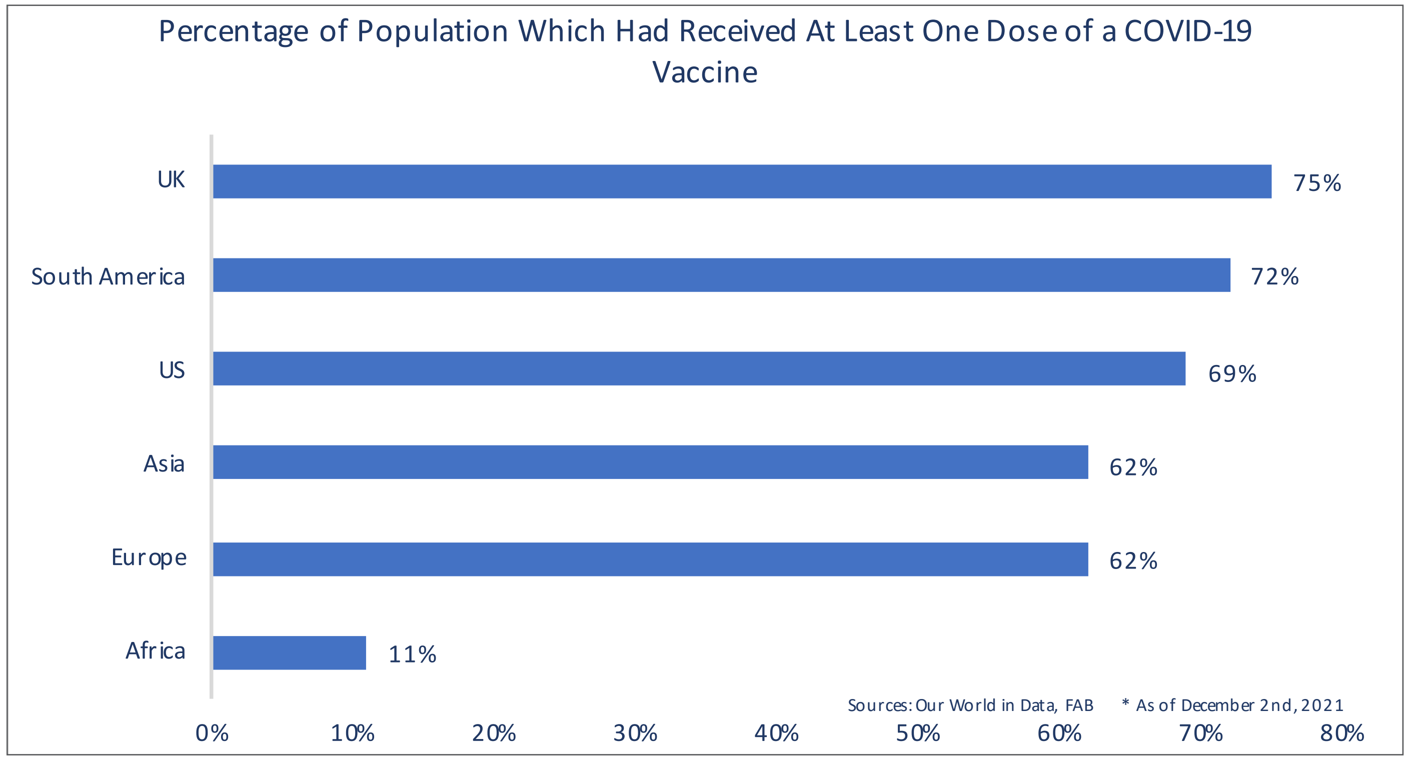
CRUDE OIL MARKET OUTLOOK – 2022

By Glenn Wepener, Executive Director & Senior Strategist Middle East & Africa

Known Unknowns

The World Health Organization's announcement of the discovery of the 'Omicron' COVID-19 variant in November last year reminded us that the battle to end the pandemic is not over just yet. At the time of writing, this variant, although more transmissible, appears not to be as deadly as first thought although, yet again, it highlights the fact that the developed world still needs to do much more to ensure that poorer countries are provided with sufficient supplies of the vaccine as soon as possible. This would reduce the number of deaths, but also the risk of further mutations.



At the same time, COVID-19 is not the only uncertainty to bear in mind when deliberating on an oil price forecast for the year ahead. For example, indirect talks between Washington and Tehran over a potential return to the JCPOA Nuclear Accord restarted last month, although admittedly many analysts believe that the chances of a deal being reached remain around 50/50. Separately, the risk of a major crude supply disruption in fragile countries like Libya remains high, while a rebound in output from the US shale oil patch has been rather sluggish this past year. But will this situation continue in 2022? We discuss these and other key issues to watch in more detail below.

Demand & Supply

According to the EIA's latest 'Short-Term Energy Outlook', which was published in December 2021, the agency estimates that 96.91 million barrels/day of petroleum and liquid fuels were consumed last year, while production averaged 95.63 million barrels/day. The agency expects the market to flip back into a small surplus in 2022, albeit a slim one. OPEC has similar forecasts, anticipating global demand to rise to 100.59 million barrels/day.

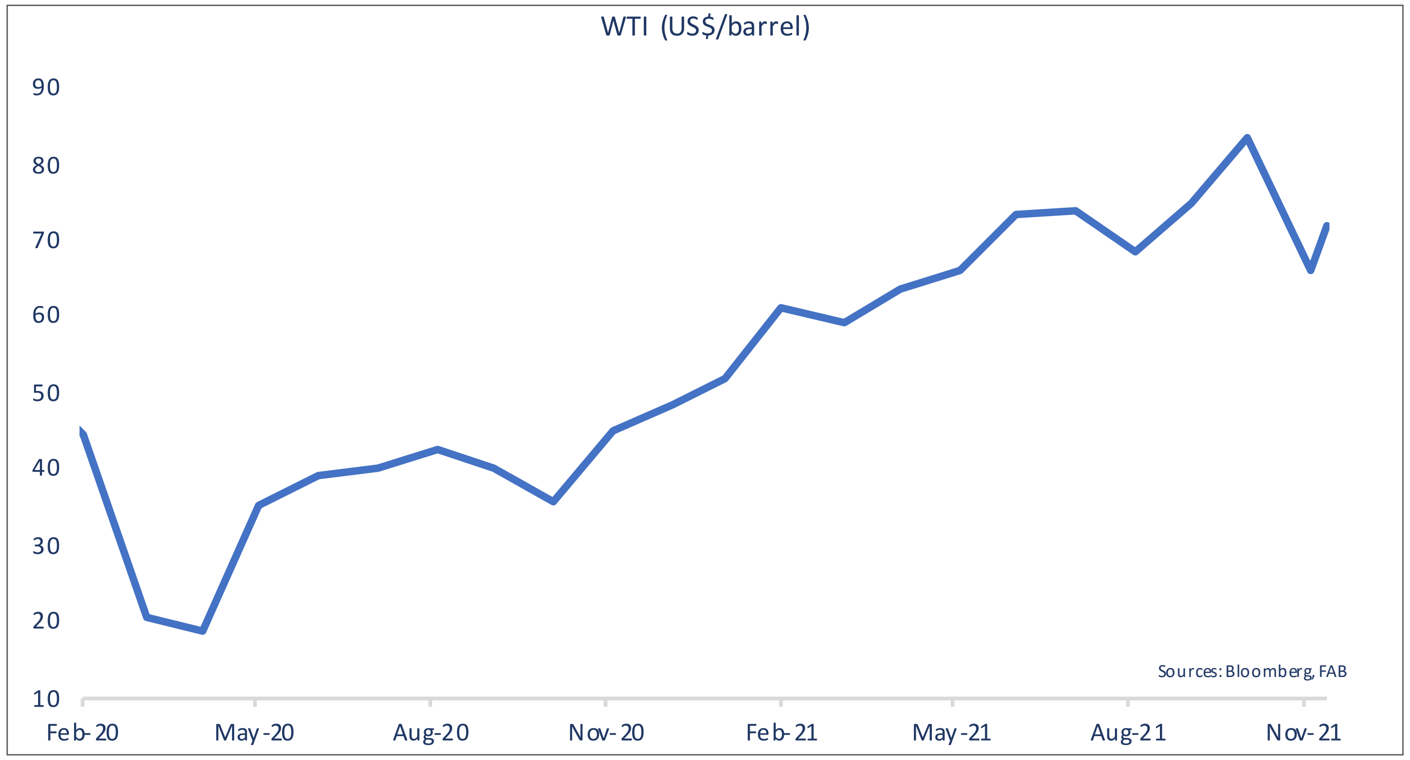
	2020	2021	2022
Total Global Production	93.84 million barrels/day	95.63 million barrels/day	100.93 million barrels/day
Total Global Demand	91.81 million barrels/day	96.91 million barrels/day	100.46 million barrels/day

**December 2021 EIA estimates*

The resumption of the OPEC+ output cut accord (along with the appearance of COVID-19 vaccines) was instrumental in driving the rebound of crude oil prices in 2021 and helped to reduce the overhang in global inventories which are now mostly back below their five-year average. Close adherence to the terms of the agreement by the majority of its signatories has been key to its success and, at their final official meeting for 2021, the grouping agreed to keep their current production schedule in place, while stating that they were ready to act 'at any time' should market conditions change dramatically.

Their decision to continue to follow a cautious approach and not increase production at a faster rate when oil moved above US$80/barrel in November 2021 (despite calls from the US and other major consumers to do so) turned out to be prescient. Just a short time later, the discovery of the more infectious Omicron variant immediately led to fresh travel restrictions and tighter movement guidelines across a number of countries, which in turn saw WTI crash back below US$70. If OPEC+ keeps to their current schedule in the months to come, it means that they will continue to add 400,000 barrels/day to the market until April 2022 when certain members will have their allocations raised slightly for the subsequent months, and then by September the cuts will have been phased out completely. However, one issue to watch will be the performance of two major African producers, namely Nigeria and Angola. They are both still struggling to raise their crude output to even reach their current allocated limits due to various factors, including underinvestment over the past decade and ongoing maintenance problems.

In the US, an overall production increase was relatively sluggish last year when compared to the jump in WTI prices. This is due primarily to the fact that North American shale firms were forced to focus more on costs than output in 2021 following the collapse in crude prices the previous year, which had also driven a number of them into 'Chapter 11' bankruptcy. This situation means that a return to the record US production level of 13.20 million barrels/day achieved in February 2020 is unlikely to be repeated, however the EIA does expect the country's output to rise to 11.85 million barrels/day this year, from an average of 11.18 million barrels/day in 2021.



A Chinese Puzzle

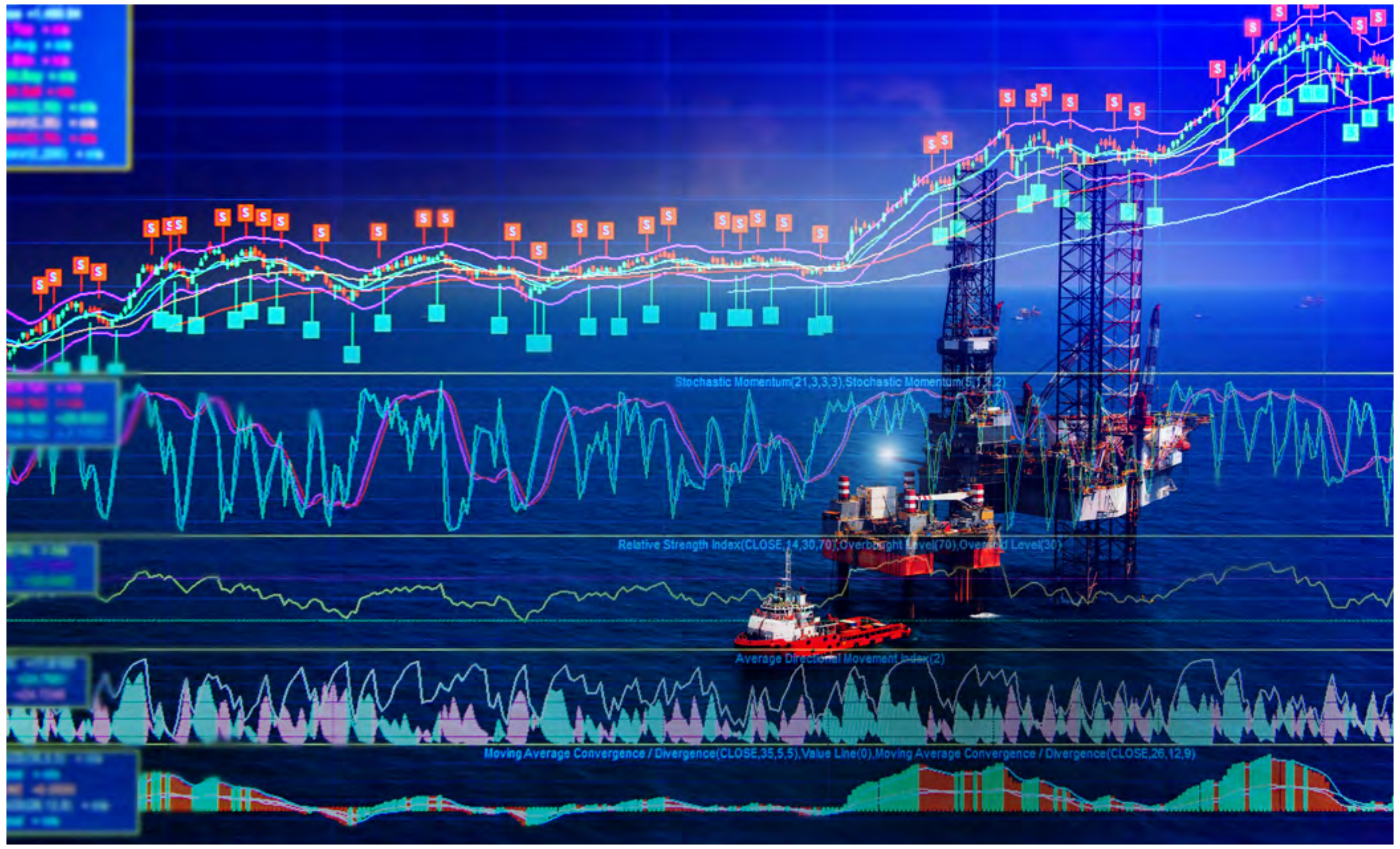
The ongoing reopening of the global economy (especially the travel sector) will continue to support oil demand in 2022, with China, the US and India retaining their positions as the world's top three consumers. However, after many years of breakneck growth and a reasonably quick rebound out of the pandemic, China has been recording more subdued economic data over the past few months. In December last year, this slowdown led the PBOC to reduce its reserve requirement ratio for banks by 0.5 percentage point in another attempt to lower overall financing costs and provide a boost to businesses. The Asian giant is currently battling a number of issues aside from sporadic localised outbreaks of COVID-19, an ongoing trade dispute with the US and the recent property market slump. For example, its natural resources are in decline, which in turn has raised the amount of capital that needs to be invested in order to generate growth. This was highlighted in an official survey published late last year, which calculated that the country's total arable land had shrunk by almost 6% between 2009-2019 compared to the previous decade, due primarily to rapid urbanisation. This could be one of the reasons why China has overtaken both the EU and US to become the world's largest importer of agricultural products. Meanwhile, its working population is shrinking sharply due in part to its former 'one-child' policy, and this situation was underlined in an official government census report published in May 2021. This showed that China's population growth over the past 10 years was the weakest on record, while the number of citizens who are 60 years of age or older has increased to almost a fifth of the total population. Admittedly, Beijing is trying to reverse this trend by amending the child quota for couples, which was raised again last year from two children to three, but these actions will take time to have a material impact.

Of course, these are also symptoms of a maturing economy and so the heady years of an 8%-10% average growth rate appear to be over, with the IMF now predicting China's GDP expansion to be 5.6% in 2022, slipping further to 5.1% by 2025. Lower but more sustainable and inclusive growth in China is a good thing in the long-term, but it will also mean that their crude purchases may not continue to be at the same levels to which we have become used up to now.

CAPEX Conundrum

As we highlighted in the previous GIO, the continuing low level of capital expenditure going into finding and developing new sources of conventional crude oil is potentially laying the ground for a major supply gap in the not-too-distant future. In an article published in July 2021, the Chairman of Wood Mackenzie, Simon Flowers, warned that the amount of CAPEX directed towards upstream oil and gas projects is now down around 50% compared to 2014.

One of the primary drivers behind this is the push towards renewable energy, and the increasing pressure on international oil companies (from both governments and activist investors) to focus more on reducing their carbon emissions and redirecting funds towards clean energy projects. While reducing fossil fuel emissions is an admirable cause, and something that does need to be prioritised in light of the already very visible impact of climate change, it is not a simple straight line and needs to be done in a balanced manner. If it is not, then the world could face regular socioeconomically damaging energy shortages on the road to a greener future. This issue was raised recently by the CEO of Saudi Aramco, Amin Nasser, who was quoted by the Financial Times late last year succinctly stating, "I understand that publicly admitting that oil and gas will play an essential and significant role during the transition and beyond will be hard for some. But admitting this reality will be far easier than dealing with energy insecurity, rampant inflation and social unrest as the prices become intolerably high and seeing net-zero commitments by countries start to unravel". This underinvestment in the conventional oil sector is also putting pressure on spare production capacity, and although there are some exporters such as the UAE and Iraq which have been busy in recent years expanding their ability to increase output, the estimated level of readily-available excess supply has shrunk over the past 12 months. This was highlighted in an IEA report published last October, which suggested that the margin of spare capacity could slip below 4 million barrels/day by the second quarter of this year. A major unexpected and sustained output disruption, such as when Hurricane Ida knocked out production in the Gulf of Mexico last year, could quickly eat into that slim buffer.



Geopolitical Fault Lines

There are various geopolitical risks that could impact the oil market now and in the future. In this section, we will focus on two of these, namely the situations in Iran and Libya, which are both still live and ongoing.

1. The seventh round of indirect talks between the US and Iran on a possible return to the JCPOA agreement restarted last month, but had not made any fresh progress at the time of writing. In fact, the new Raisi administration in Tehran has reportedly stepped back from some of the key compromises made by Iranian negotiators during the first six rounds of discussions, and submitted new demands such as the immediate lifting of US sanctions and a guarantee that no new measures will be imposed on Iran in the future. Despite these major hurdles, an eventual deal cannot be ruled out completely just yet, especially as it appears that the Biden administration remains keen to revive the accord while, on the other hand, Iran's economy desperately needs sanctions to be removed. If an agreement is reached, it would have an almost immediate impact on the oil market. This is because Iran is believed to have around 200 million barrels of crude stored both onshore and offshore according to Reuters, and thus up to 1 million barrels/day could be released over a six-month period, something that is not currently priced in. Conversely, should the talks collapse and Iran continue to pursue its uranium enrichment programme above the limits set within the 2015 accord, then the risk of a direct confrontation rises, although we feel such an outcome remains at the lower end of probability with indirect actions such as increased cyber warfare more likely.
2. In Libya, oil production rebounded from a record low of less than 100,000 barrels/day in 2020 to more than 1.2 million barrels/day in 2021 following the ceasefire agreement. Meanwhile, Fitch Ratings estimates that the country's real GDP expanded by 42% last year from a 36% contraction in 2020. Legislative elections are due to take place in January this year and the hope is that they will proceed peacefully, however, the political and security situation on the ground remains fragile and thus the risk of fresh disruptions to crude output there remains high.

Conclusion & Forecast

As outlined above, there are both potentially strong headwinds and tailwinds facing the oil market in 2022. On balance, we expect oil's generally bullish tone to remain in place, and warn that the ongoing issue of lower capital expenditure on conventional production in the years ahead could eventually trigger a major gap between global demand and supply. Despite the predicted slowdown in China – and barring a major reversal in the war against COVID-19 – we expect Brent crude prices to remain healthy in 2022 and to average US$75/barrel.

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