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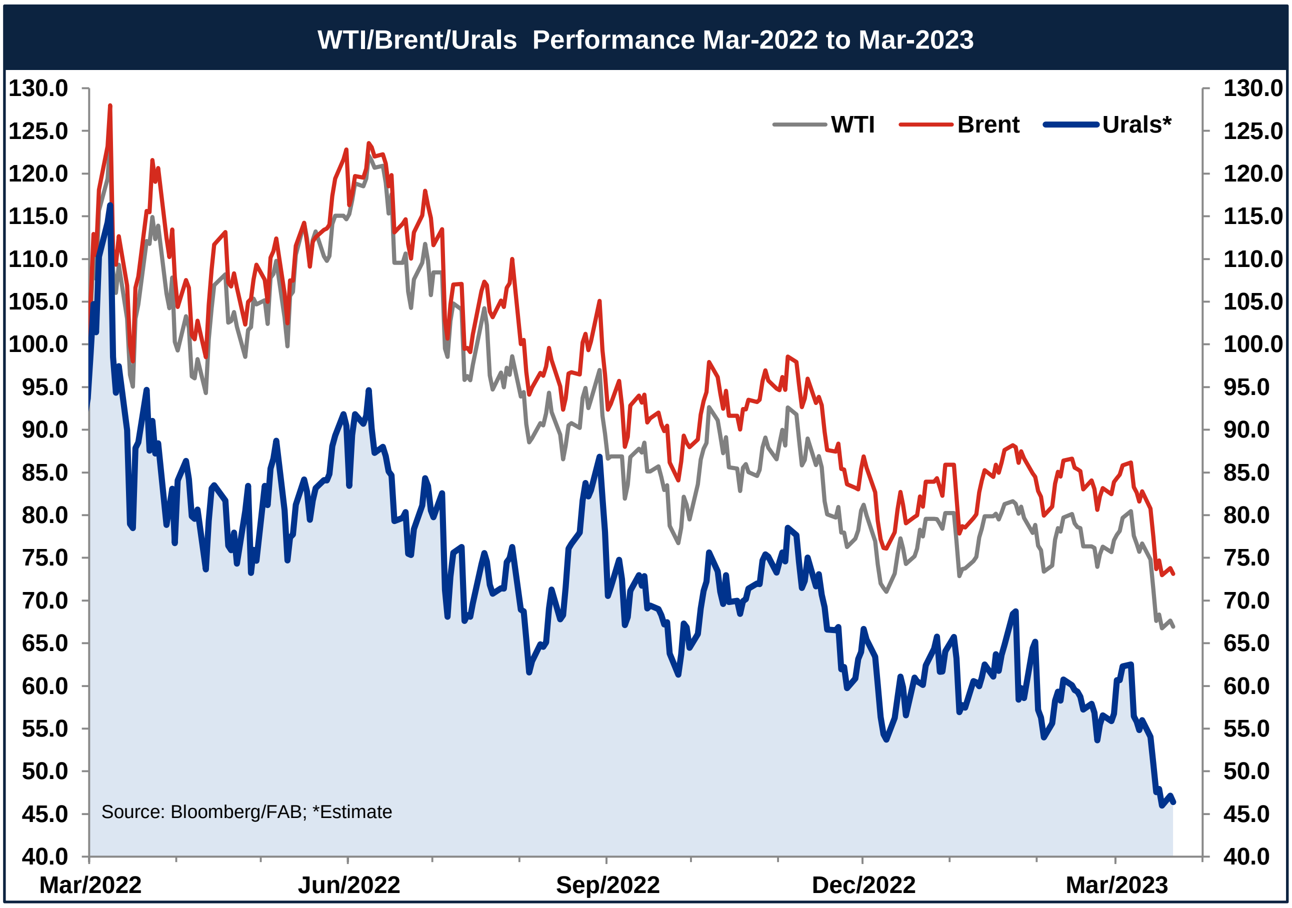
Oil Market Flash Note – Q1 2023

As we near the end of the first quarter of 2023, crude prices have recently come under strong downward pressure; due primarily to a fresh wave of risk aversion driven by fears of another potential global financial crisis in the making. However, such an event is still not a given at this stage and at the same time, hopes linger that a still sluggish rebound by China will begin to pick up speed in the months ahead. In this short note we review the current state of the oil market and the key factors to keep an eye on going forward.



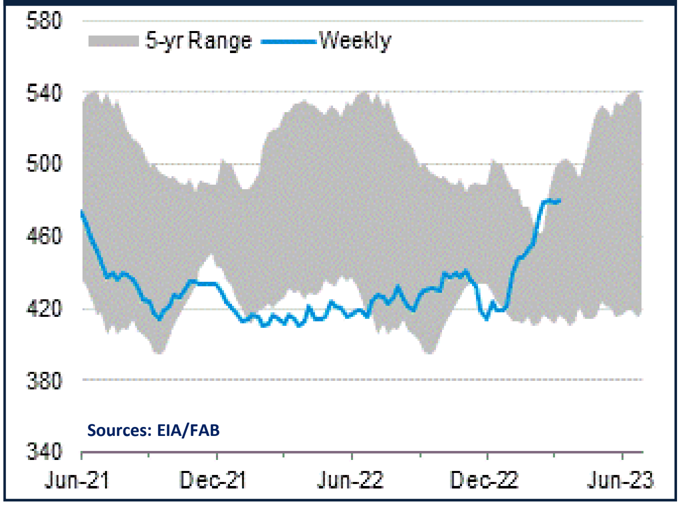
Mixed Signals

For a while now, the Federal Reserve's more hawkish interest rate policy had boosted the US dollar, which in turn capped oil prices and began to raise concerns over the impact these hikes will have on economic growth. More recently however, last week's sudden collapse of three US banks combined with stubbornly elevated inflation, has put the FED and other central banks into a bit of a quandary and triggered fears of another possible banking crisis. These concerns, which were further exacerbated by the demise of Credit Suisse, has led to another round of 'risk-off' trading, and triggered a large liquidation of long positions in the oil market over the past number of days, pushing WTI below US$70 a barrel for the first time since December 2021. Although the initial market panic appears to have started to ease since yesterday, general negative sentiment is unlikely to improve dramatically in the near term, at least until there is more clarity as to the actual state of the financial sector and of course how or if the FED begins to pivot in terms of its interest-rate policy at its meeting later today. On a brighter note, crude demand from China has been steadily recovering since Beijing finally decided to abandon its 'Zero-COVID' strategy. The latest data releases also show a rise in Chinese consumer spending, industrial output and fixed-asset investment, although the country's new Prime Minister, Li Qiang, has warned that the government's modest target of 5% GDP growth in 2023 will "*not be an easy task*" and "*requires redoubled efforts*". While bearing his comments in mind, we still feel that China's accommodative macroeconomic policies will help to speed up the country's overall recovery in the months ahead and thus remain a key supportive driver for oil prices.

Demand & Supply

Despite a sluggish start to the year, the IEA said in its March report that it expects oil demand to average 102 mio bpd in 2023, boosted by rebounding air travel and China's reopening. "*Global oil demand growth started 2023 with a whimper but is projected to end the year with a bang*," the IEA report read. This view was supported in the OECD's own latest publication, in which it lifted its forecast for global economic growth to 2.60% from 2.20% previously. Admittedly both reports were compiled just before the Silicon Valley Bank news broke.

US oil inventories in mio barrels



Conversely, global oil supply averaged 101.50 mio bpd last month, which represents a rise of 830,000 bpd from January, and on the inventory side, there has been a strong recovery in both US and European crude stocks over the past few months, helped in part by a milder than expected northern-hemisphere winter. At the end of last month, US commercial oil inventories stood around 480 mio barrels compared to their five-year average of 437 mio barrels, and according to IEA data, overall commercial OECD stocks now stand at 2,851 mio barrels, which is their highest level since September 2021. At the same time, the position in terms of fuel product inventories is more mixed, with US stocks of distillates, for example, sitting around 8% below their five-year average. It's also worth remembering that global spare capacity remains wafer thin at an estimated 2.50 – 2.80 mio bpd which may not be enough to fill a sudden major disruption of supply, and US strategic petroleum reserves stood at just 371.60 mio barrels at the end of February, its lowest level since December 1983. Meanwhile, overall US crude production averaged 12.20 mio bpd during the first quarter of this year, compared to 11.90 mio bpd in 2023. This higher output level will however, begin to slow if credit conditions continue to tighten and WTI remains below the US$70 handle. Looking across at Russia, it's clear that this key producer's oil exports did not decline as much as initially expected last year, due to both India and China in particular, continuing to suck up large quantities of Moscow's discounted Urals crude. In fact, these two major Asian consumers purchased more than 70% of Russia's oil exports in February 2023, according to the IEA.

However, it should also be noted that this discount, combined with the introduction of the EU embargo on Russian fuel product imports, caused Moscow's total oil related revenues to fall to US$11.80 bio last month from US$13 bio in January, and represents a 45% drop compared to February 2022.The research firm 'Energy Intelligence' predicts a 25-30% drop in the value of Russian oil exports in 2023, which if accurate would push the country's budget deficit (which hit US$34 bio during the first two months of 2023) further into the red.

OPEC+

The recent sharp sell-off in crude prices has put OPEC+ back into focus, with traders waiting to see if the grouping will decide to reduce their overall output in order to stabilize the oil market again. The chances of such a move are building, highlighted by a joint-statement issued by OPEC's Secretary General and Iraq's Prime Minister last weekend, which stressed the need for coordination by all oil producers to ensure that market prices do not fluctuate too much and negatively impact both exporters and consumers. However, we also anticipate that OPEC+ will hold fire until there is a clearer picture on the impact this latest upheaval will have on the global economy.

Geopolitical Risks

Earlier this month, a bi-partisan group of senators made a fresh attempt to get the 'No Oil Production and Exporting Cartel' (NOPEC) bill passed into law. This bill aims to remove the sovereign immunity that has protected OPEC+ members and their national oil companies from US antitrust laws up to now. Were it to be implemented and utilized, it would cause a major upheaval in the oil market and risk a chain of tit-for-tat actions. However, there have been several attempts to pass various versions of this bill over the past 20 years and all failed due to strong lobbying by oil industry groups across the spectrum. Mike Sommers, the CEO of API, warned in a letter to senators in May last year that NOPEC would "*clearly have a negative impact on US operations and investments in those countries across all sectors, which, given the current geopolitical environment, could create significant unintended consequences*". It is also not clear how a US court could enforce judicial antitrust decisions on a foreign country. In any case, this latest attempt still has to be debated by judicial commissions and thus it will take several more months before it's possible to ascertain if it might be successful.

Closer to home, the Beijing-brokered rapprochement between Saudi Arabia and Iran that was announced on March 10th 2023 came as a major surprise but will hopefully help to reduce tensions in the region. The deal saw the two countries agree to restore diplomatic relations and, more importantly, to reassert their commitment to working towards the revival of a 2001 security cooperation pact. It also increases the chance of a potential end to the conflict in Yemen and may even break the ongoing political stasis in Lebanon, which has continued to prevent the formation of a new government in Beirut and the implementation of much needed economic reforms there. Meanwhile, in terms of geopolitical shifts, the agreement highlights China's growing influence in the Middle East and how it can play honest broker in a region where the US has traditionally been the key foreign player. At the same time, however, we think it's unlikely to lead to a resumption of talks over the JCPOA in the near term, while tensions between the US/Israel and Iran look set to remain high.

Conclusion

Concerns surrounding the banking sector will continue to dominate the headlines in the coming days, as will the direction of interest-rate policy, not just by the Federal Reserve but also the world's other major central banks. A greater focus by Western banks on shoring up their balance sheets could well lead to much tighter credit conditions and thus become a fresh headwind to the global economy and overall oil demand. All this will keep the oil bulls cautious for the time being, but we still expect the US and European authorities to be able to prevent these current financial difficulties from broadening into something much bigger. At the same time China's economy should continue to rebound, Russia's seaborne oil and fuel exports could well decline further during the coming quarters, OPEC+ members have the ability to reduce their output again and spare production capacity remains thin. Taking all of the above in mind we have adjusted our initial forecast for Brent and now look for it to average US$89 a barrel this year compared our original target of US$93.

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