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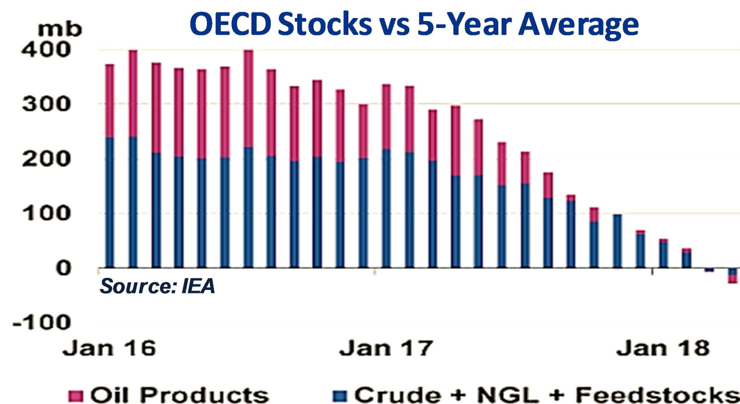
Oil Market Update
Push & Pull

The past 12 months have seen crude maintain its bullish mood and this was underlined when Brent tested the US$80 a barrel mark in May this year. Admittedly we have seen a minor technical retracement since then, but the fundamental and geopolitical environment overall still appears supportive for prices going forward. The question is how much further potential upside is possible in the near to medium term and what factors, both bullish and bearish do we need to keep an eye on?

Fundamentals

The world economy continues to improve with the IMF anticipating a global growth rate of 3.90% in 2018 against 3.80% last year. This in turn has boosted energy demand and combined with the OPEC/NOPEC output cut agreement, has also led to a sharp reduction in the heavy overhang of oil stocks which had been accumulated during the last market down-cycle. According to a recent report published by the IEA, commercial stocks held by OECD countries were 27 mio barrels below the 5-year average at the end of April this year. The agency also expects global demand for oil to rise from 97.8 mio bpd in 2017 to 99.1 mio bpd this year and to 104.7 mio bpd by 2023.



On the shale front rising production, especially in the giant Permian basin, helped total US crude output reach a record level in June (10.90 mio bpd), whilst technology in this area of the energy market continues to improve. However further large increases in output in our opinion appear to be limited for a variety of reasons; For example such heady growth has put inordinate pressure on related infrastructure with pipelines now struggling to cope with the current level of production, an issue which was highlighted in a recent report by Morgan Stanley who suggested that this constraint could reduce output growth in the Permian by almost two-thirds next year. This key basin's total pipeline capacity is currently estimated at 3.56 mio bpd but shale production is already consuming 3.47 mio bpd of that.

There is also a chronic shortage of experienced personnel and more importantly, difficulty in obtaining enough of the basic fracking materials such as sand, and dealing with the large amount of contaminated water each well creates. This now 'dirty' water, which is much larger in volume than the actual oil produced, needs to be transported to disposal sites that are usually many kilometers away from the relevant oil rig. All of this reportedly pushed the average shale company's costs up by around 15-25% last year.

16th July 2018

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The higher output of US crude and resulting pipeline bottlenecks has also created more price volatility between WTI and Brent, with the spread between both indexes widening to over US$11 briefly last month, (reportedly forcing some futures traders out of their long WTI positions) as US production surpassed its domestic storage capacity. This spread has however eased back to around US$5 since.

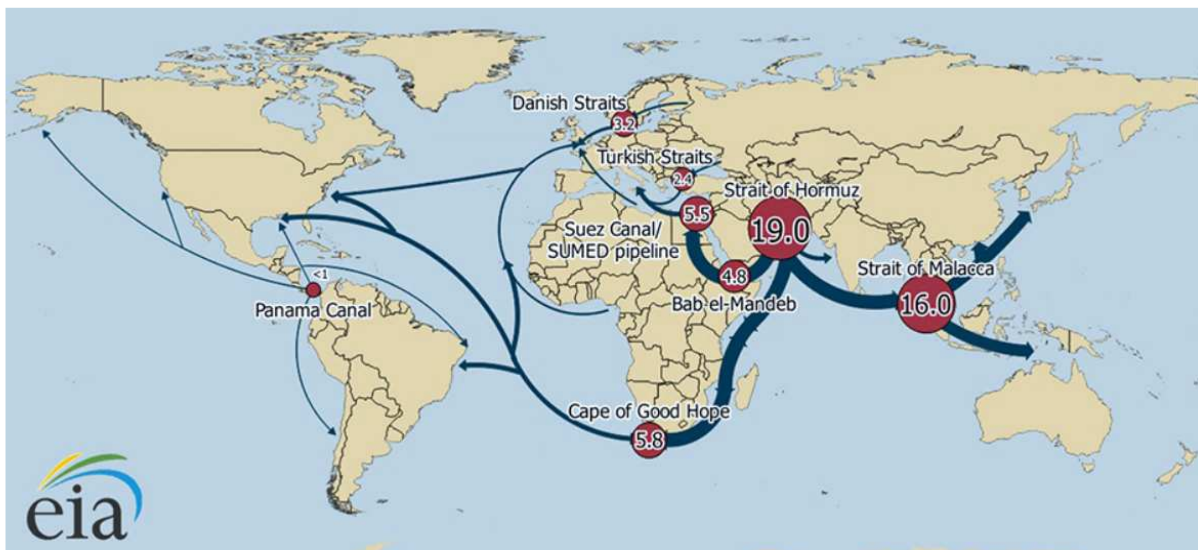
Meanwhile in the longer term, as we have mentioned in our previous commentaries on this subject, we also don't believe that shale is a sustainable resource due to its inevitable damage to the geological make-up of these fields, which has already resulted in fewer new 'sweet spots' and a decline in flow pressure in the Bakken and Eagle Ford basins. This shale conundrum also plays into the global supply side question, because if we are correct in our assumptions above, this sector may not be capable of relieving any sizeable future crude shortage, a potential situation which is still very possible if you consider the current geopolitical climate (discussed further below), the limited spare capacity most OPEC producers have and the still record low level of capital expenditure being allocated towards finding and bringing online new and accessible conventional sources of oil.

At the end of 2017, Rystad Energy published a study in which it too warned about the chronic drop in new conventional oil discoveries as well as a fall in the potential capacity of most recent finds, describing it as a situation that has not been seen since the 1940s. This view was further supported in a report published by Bernstein Research earlier this month in which they highlighted the fact that only two of the world's fifteen largest energy companies, who account for 80% of the world's reserves, have restarted investing in the long-cycle projects that can produce sizeable payloads of crude. "At some point the proverbial chickens will come home to roost. The impact will be production declines and another super-cycle in oil prices," the report's contributors claimed.

Saudi Arabia remains one of the few key swing producers, but the IEA estimates that even the Kingdom could struggle to pump more than 12 mio bpd for an extended period, and Riyadh has already indicated that it could lift its output from its current level of 10.5 mio bpd to 11 mio bpd next month, leading to an even smaller amount of excess capacity.

Geopolitics

Geopolitical events have been the prime driver for oil prices over the past few months, with the decision by the US to withdraw from the JCPOA agreement with Iran in April probably the most important given its longer lasting implications on supply and the possible risk of conflict, especially after the Iranian regime warned that it could attempt to block the flow of oil transiting via the Strait of Hormuz in response to fresh US sanctions.



As the above EIA map from 2017 illustrates, the Strait of Hormuz is the most strategic global chokepoint for the transport of crude by sea with an estimated 19 mio barrels passing through this narrow trade route daily.

The impending resumption of these sanctions on Iran's oil sector in November could knock a sizeable chunk of supply off the market next year, with predictions of a potential 0.5 – 1 mio bpd drop in Iranian production. The P5 grouping are busy trying to find ways to keep the nuclear accord in place, but we think this agreement's lifespan now looks precarious at best, especially as a number of foreign firms have already begun suspending or ending their business ties with Iran, and certain large oil importers are proactively seeking new suppliers. Meanwhile other events are also keeping the market on its toes, such as the ongoing economic and social meltdown in Venezuela which is home to the world's largest proven oil reserves and where production fell to 1.4 mio bpd last month compared to an average of 1.91 mio bpd in 2017 and far from the 3 mio bpd last recorded in 1997. In Libya the general security situation remains fluid with ongoing strikes and militant attacks continuing to disrupt both the production and export of the country's crude on a regular basis despite a decent recovery in overall output last year. Other areas to keep an eye on going forward include; Iraq where domestic political risks remain a concern, Nigeria where the potential for renewed militant activity in the Niger delta region has not disappeared completely especially ahead of the 2019 general elections, and finally those black swan events which are always difficult to predict but guaranteed to occur from time to time such as the recent power outage at one of Canada's oil sand facilities that took 350,000 bpd off the market.

Of course risks on the downside for oil prices also still exist, such as the US administration's recent hardnosed attempts to renegotiate its trading agreements with various countries, including its longstanding allies. If this strategy should backfire and lead to a global trade war, this would subsequently impair economic growth and the demand for oil. Our hopes are that this noise is just a negotiating tactic by President Trump and that the issue dies down somewhat following the midterm US elections in November. A sharp shift in prices back above US$100 a barrel for an extended period could also severely crimp growth, and in the worst case scenario even trigger a recession leading to yet another boom and bust cycle for crude. Using his twitter account, the US president has also recently been targeting OPEC, over what he says are "too high" oil prices and calling for further increases in production by the group. It's likely he will raise this subject again during his Helsinki meeting with the Russian leader, Vladimir Putin today (16 July 2018).

Conclusion & Forecast

Taking all of the above into account and despite the fact that the oil market has made a sizeable recovery since the lows seen in early 2016, we believe that there are still clear risks for a further sharp spike in prices both in the near term (where geopolitical risks abound) and/or the medium term where fundamentals (such as a shortage of spare capacity) could well come home to roost. For the rest of this year however and barring such shocks, we see WTI and Brent prices remaining within a US$60–80 and US$65-90 per barrel range respectively, as we expect an increase in production from various sources, including Russia, Kuwait, the UAE and Saudi Arabia, supported by ongoing US output, to keep the topside technical resistance levels intact for now at least.

Next year is a little more opaque as we wait to see how large the anticipated drop in Iranian crude exports will be and if global trade tensions have eased off or not. In the longer term however we repeat our fear of a major supply/demand crunch driven by the lack of adequate investment in finding and developing new conventional fields.

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