Oil markets

Prices depressed as markets await stock drawdowns and tighter supplies

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Highlights

- Oil prices declined for a second consecutive month in June, with both Brent and WTI falling by 5% to $47.9/bbl and $46.0/bbl, respectively.
- Sentiment remains resoundingly bearish, despite a recent 8-day bull run that saw Brent approach the symbolic $50 level.
- US crude production continues to increase, rising to a high of 9.35 mb/d in June, driven by shale production.
- US/OECD crude stocks are not drawing down fast enough to buoy the markets.
- OPEC output rose in May to 32.1 mb/d, thanks to a ramp up in Libyan and Nigerian output, while compliance fell slightly to 105%.
- Markets swung into supply deficit territory in 2Q17, with the deficit expected to widen in 2H17; stock drawdowns should accelerate.

Wanted: Oil bulls

It was not meant to happen this way. Another month, another decline in oil prices. This time, in Brent's case, the drop was to its lowest level in ten months when it fell to $44.8 per barrel (bbl) on 21 June.

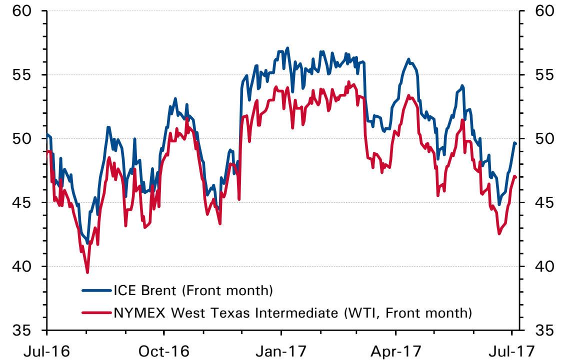
Since OPEC/non-OPEC rolled over their production cut agreement for an additional 9 months on 25 May, oil prices have fallen by 7%. Crude oil benchmarks, Brent and West Texas Intermediate (WTI), closed June at $47.9/bbl and $46.0/bbl, respectively, a decline of 15% in 2017 on average. (Chart 1.) Indeed, Brent's performance in the first half of this year was its worst since 1998.

While a late, 8-consecutive day gain at the end of June and in early July—the longest run of gains in seven years—helped spare some of Brent's blushes, there is little escaping the fact that oil bulls have largely deserted the scene and that the markets have fallen into a state of despondency. And the chief culprit is US light tight oil (shale), whose volumes are helping to both offset some of the supplies taken off the market by OPEC/non-OPEC this year and slow the drawdown of crude stocks from storage tanks.

Weekly metrics on these two dynamics are, along with counts of US oil rigs, the most closely watched data by the markets. And they have not made pleasant reading for OPEC in 2017. US crude production is up 5.5% to 9.25 mb/d as of 23 June —an additional 480,000 barrels per day (b/d) of crude to partly offset the 1.8 mb/d of supplies that OPEC/non-OPEC have withdrawn from the oil markets since January. (Chart 4.) US shale's resurgence is even more remarkable since bottoming out at 8.43 mb/d exactly a year ago: an impressive 822,000 b/d, which is a year-on-year (y/y) rise of almost 10%.

Chart 1: Crude oil prices

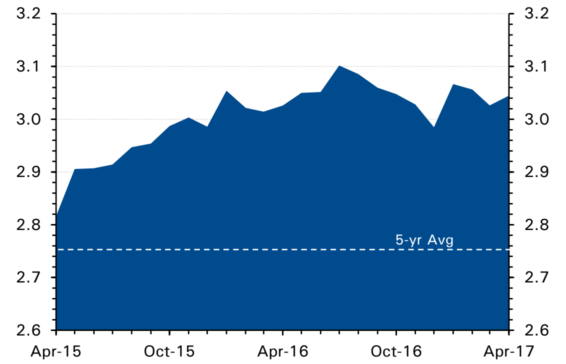
($/bbl)



Source: Thomson Reuters Datastream

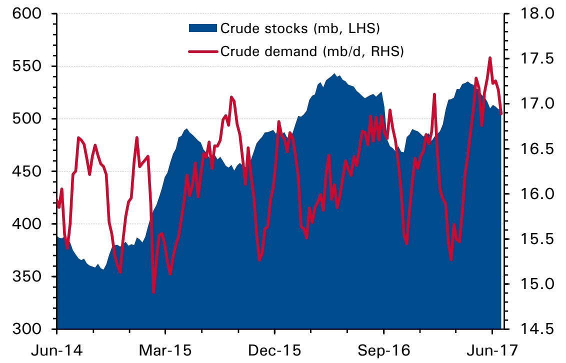
Chart 2: OECD commercial crude and product stocks

(billion barrels)



Source: International Energy Agency (IEA)

Chart 3: US commercial crude stocks and refinery runs



Source: US Energy Information Administration (EIA)

The closely-watched oil market report by the International Energy Agency (IEA) is also unlikely to provide much comfort. In its most recent edition, the IEA confirmed what many analysts and market traders had long suspected, which is that OECD commercial crude and petroleum product stocks increased rather than decreased in the first quarter of this year. Four months into the OPEC/non-OPEC agreement and total OECD stocks had reversed course and gained 60 million barrels to reach 3.044 billion barrels by April. (Chart 2.) OPEC's target of bringing global crude and petroleum stocks back to the 5-year average level of around 2.75 billion barrels appears to be even farther away, possibly into 2018 at the current rate.

Moreover, OPEC's own production is heading in the wrong direction, away from its aggregate production target of 31.75 mb/d. According to OPEC secondary source data, the group's total output climbed back over the 32 mb/d level in May to 32.14 mb/d, thanks to output gains in Nigeria and Libya. (Charts 5 & 6). These two OPEC members are not subject to output restrictions under the terms of the November agreement. But compliance levels among quota members also deteriorated slightly in May, to 105% from 107% in April, as a result of output increases in Iraq, Iran and Algeria.

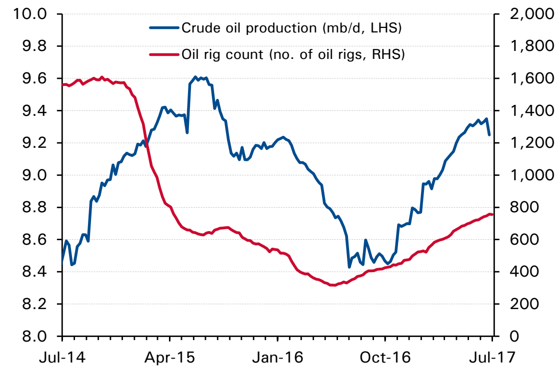
Little wonder that oil markets are despondent. Calls for OPEC to consider deeper cuts, in order to accelerate the stock drawdown, are growing louder. In view of the fact that previous instances of OPEC market intervention, most notably in late 2008, have tended to involve several production cuts, rather than one, it is not entirely wishful thinking on the part of the oil bulls.

Stock draws to accelerate in 2H17 but 2018 is looking more likely for OPEC's much-coveted 'balance'

Nevertheless, there may be a glimmer of light at the end of the tunnel. US crude and petroleum product stockpiles are slowly drawing down as the peak summer demand gets into full swing. (Chart. 3) And there is certainly scope for more sizeable inventory declines before the autumn refinery maintenance period. According to the IEA, demand growth is expected to firm up to an average of 1.5 mb/d in 2H17 compared to 1.1 mb/d in 1H17. (Chart 7.)

With demand outstripping supply since the beginning of 2Q17, the demand/supply balance or stock change has swung into negative territory. Barring demand growth moderating and/or supply growth accelerating during the remainder of the year, the much-touted stock draw should indeed finally take place. Based on our own estimates, for the end of 4Q17, a cumulative stock draw of around 240 million barrels could be on the cards. This would bring OECD stocks back down to 2.8 billion barrels, not far off OPEC's 5-year average target of 2.75 billion barrels. 2018 thus looms large as the make-or-break year.

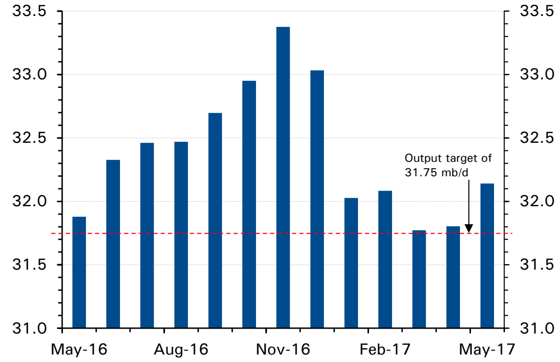
Chart 4: US crude oil production and rig counts



Source: US Energy Information Administration (EIA), Baker Hughes

Chart 5: OPEC crude oil production

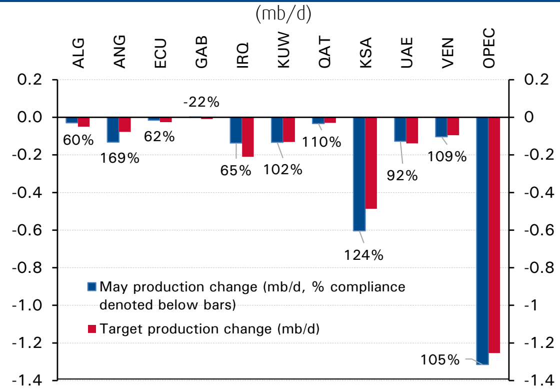
(mb/d)



Source: OPEC (secondary sources)

Chart 6: OPEC member* output change in May vs. target

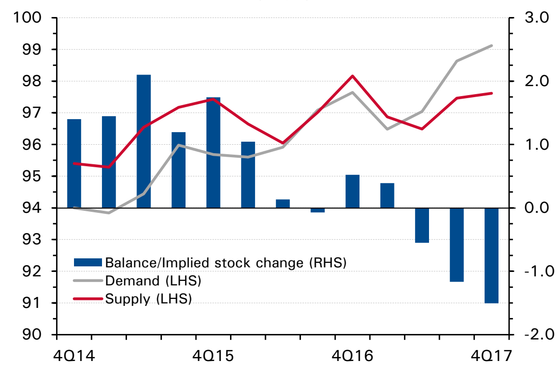
(mb/d)



Source: OPEC; * those members required to cut output

Chart 7: Balance of crude supply and demand

(mb/d)



Source: IEA; *assumes OPEC output at 1H17 average levels

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