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Economic Update

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Oil Markets

Oil prices reverse all gains from OPEC+ cut decision in April amid recession fears

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Summary

Oil prices retraced their early April gains to end the month slightly lower on recession fears and entrenched inflation. They fell further in early May on underwhelming macroeconomic data from China and the OECD. Looking ahead, OPEC+'s surprise production cut of more than 1 mb/d from May onwards should tighten the market significantly in 2H23, allied to rebounding Chinese consumption. We expect prices to firm from current levels.

- Oil prices closed lower in April as economic recession fears in the US and EU dominated sentiment. International benchmark Brent crude ended the month at $79.5/bbl (-0.3% m/m; -7.4% ytd), reversing all the gains that followed OPEC+'s production cut announcement from early April amid intensifying economic headwinds. (Chart 1.) Local marker Kuwait Export Crude (KEC), in contrast, closed the month at $80.9/bbl, up 2.0% m/m (-1.3% ytd) in April.

- Earlier in April, Brent rallied by more than $7.5/bbl to a high of $87.0/bbl in the wake of the announcement by several OPEC+ members including Saudi Arabia, Kuwait and the UAE that oil production would be voluntarily cut by around 1.2 mb/d from May until the end of 2023. Russia, in turn, promised to complement these cuts by extending its own 500 kb/d cut from March to the end of the year, despite any meaningful drop in its export volumes, as shown by tanker tracking data. These moves by OPEC+ members were ostensibly a response to a softening global economy, still reeling from turmoil in the US banking sector and weighed down by tighter global monetary policy amid stubbornly high inflation.

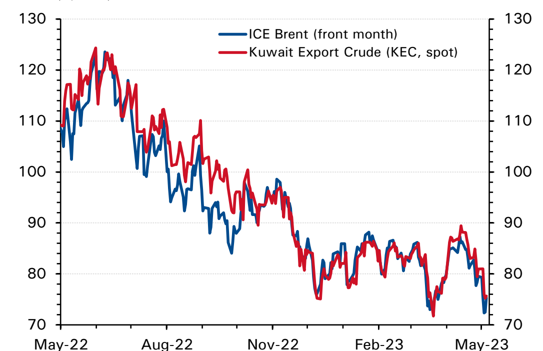
- The global economic growth forecast this year was trimmed by the International Monetary Fund (IMF) in its April World Economic Outlook (-0.1% pts to 2.8%), citing higher interest rates and heightened risk of financial system turmoil. Underwhelming economic readings in the US, particularly GDP, retail sales and jobs also added to headwinds, while in China manufacturing unexpectedly contracted in April, according to the official PMI. These developments as well as more recent concerns about the US defaulting on its debt in the absence of congressional approval to raise the debt ceiling were behind oil's tumble to a fresh year-low of $72.3/bbl in early May. Moreover, refining margins for petroleum products such as diesel, a key gauge of industrial activity and transportation, have also signaled some weakness in the Far East, amid sub-optimal demand and stock builds.

- Compounding matters and stoking volatility has been the decline in oil market liquidity. Open interest (the number of outstanding Brent futures and options contracts) declined by 4.7% w/w to 2.15m contracts by 2 May, while money manager net length continued to retreat as speculators increased positions on prices falling ('shorts') amid palpable bearish sentiment. (Chart 2.)

- Nevertheless, the consensus among energy agencies and analysts is that global oil demand will eventually accelerate in the second half of the year, led mainly by China and other non-OECD countries. Despite the near-term softness, Chinese GDP growth in 1Q23 actually surprised on the upside at 4.5% y/y, and both the International Energy Agency (IEA) and OPEC see China as the impetus for their improving oil demand forecast through the rest of the year. (Chart 3.) They left their demand growth forecasts (annual average)

Chart 1: Oil prices

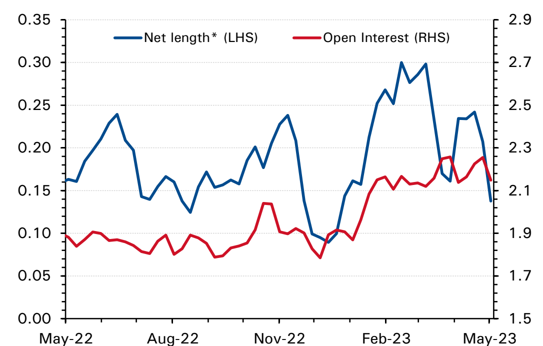
($/bbl)



Source: Refinitiv, KPC

Chart 2: Money manager net length*

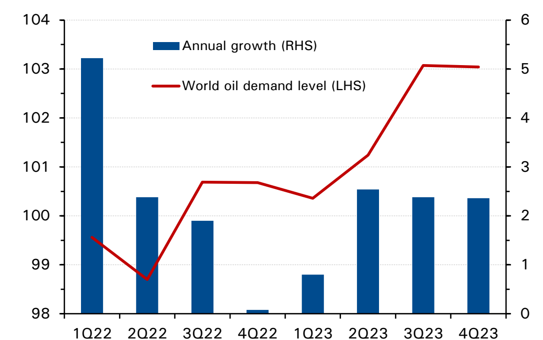
(million contracts)



Source: Refinitiv, Bloomberg; *as of 2 May

Chart 3: IEA world oil demand

(mb/d)



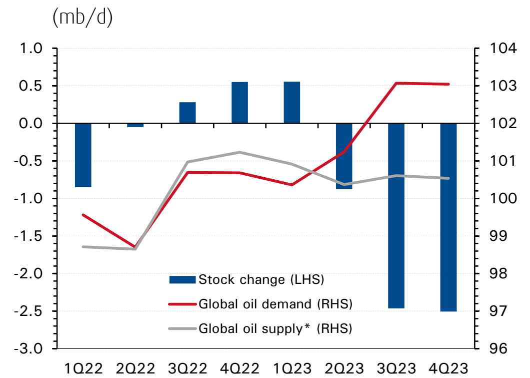
Source: IEA, mees

unchanged for 2023 at 2.0 mb/d and 2.3 mb/d, respectively in their April oil market reports.

- On the supply side, OPEC+'s surprise output reduction will likely deepen the anticipated supply shortages in 2H23, with the result that oil supply will likely start undershooting oil demand before the end of the current quarter. Based on IEA oil demand and non-OPEC crude projections and assuming OPEC+ cuts are adhered to for the rest of the year and there is no meaningful increase in output by members currently under-producing relative to their targets, we see the supply deficit widening and implied stock draws of as much as 2.5 mb/d in 4Q23. (Chart 4.)
- The buildup in global oil inventories over the last year could, however, cushion some of this expected tightness. According to OPEC, commercial OECD oil stocks stood at 2.8 billion barrels in February (+237 mb y/y), 18 mb over the five-year average. (Chart 5.)
- OPEC secondary sources showed OPEC-10 production in March falling by 79 kb/d to 24.4 mb/d on broad-based declines in members' production but especially Angola, which saw its output fall by 6% (-65 kb/d to 1.0 mb/d) due to field maintenance. Among non-OPEC members, according to S&P Global, Russia's crude production retreated by 260 kb/d (-3.0% m/m) to 9.6 mb/d after instigating its own voluntary production cut, though March's drop is only around half of the volume Russia said it would pare back. Total production among OPEC+ members subject to quotas therefore fell to 37.7 mb/d in March, with the supply shortfall extending to 2.3 mb/d. (Chart 6.)
- In Kuwait, official sources showed crude production relatively unchanged month-on-month in March at 2.68 mb/d, now only 2 kb/d above its OPEC+ quota. Kuwait has also agreed to cut output voluntarily by 128 kb/d from May, bringing its production to a target level of 2.55 mb/d. In order to reconcile the reduction in crude production with the need to ramp up more valuable refined products exports to a diesel-short European products market from the nearly fully operational Al-Zour refinery— the third and final crude distillery unit (CDU) is due online this quarter—Kuwait will likely redirect crude intended for export to Al-Zour instead. An unintended shutdown in the facility's first CDU in early April did temporarily halt exports, though.
- Outside of OPEC+, US crude production reached 12.3 mb/d by the end of April, up 200 kb/d so far in 2023, according to weekly US Energy Information Administration data (EIA) data. (Chart 7.) The EIA expects US crude oil output to average 12.5 mb/d this year and 12.8 mb/d in 2024, with annual gains of 657 kb/d and 211 kb/d, respectively, coming amid elevated oil prices and a fundamentally tighter oil market that is spurring upstream oil investment. However, forecasts may not play out entirely that way, with the number of active US oil rigs continuing to trend lower. By 5 May, oil rig counts had fallen to 588 (-4.8% ytd), their lowest level in almost a year.
- The outlook for the oil market and prices in 2023 remains highly uncertain amid a myriad of negative and positive risk factors. While the outlook for the next couple of months remains weighed down by demand-impacting macroeconomic concerns, specifically OECD recession fears and lagging Chinese consumption growth, in the second half of the year, supply-side pressures stemming from OPEC+ production cuts will increasingly come to the fore. Allied to expectations of increased oil consumption over the summer months and especially in China and the Far East, the market is expected to flip from a surplus to a deficit, with the result that prices should begin to firm quite a bit from current levels.

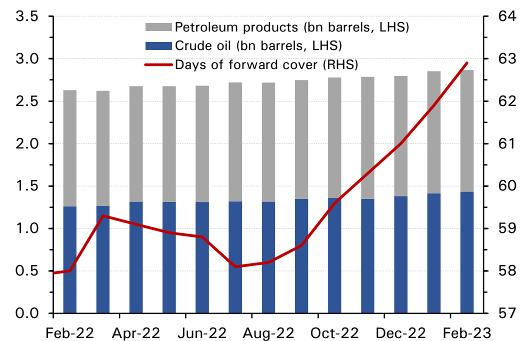
Chart 4: Balance of supply and demand

(mb/d)



Source: OPEC, IEA, NBK estimates

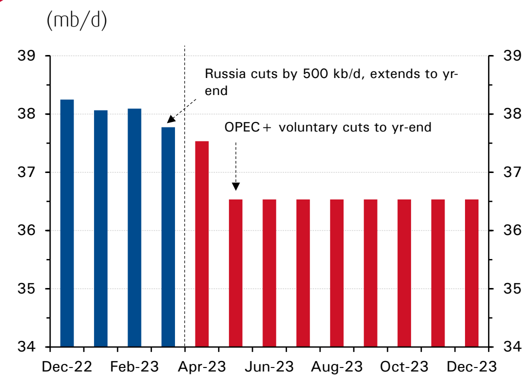
Chart 5: OECD commercial oil inventories



Source: OPEC using OPEC, Argus, EIA, IEA, Euroilstock and Meti

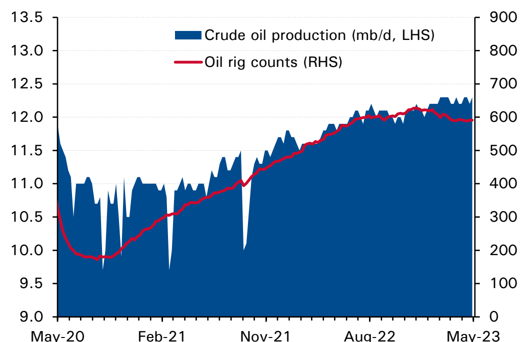
Chart 6: OPEC+ production schedule

(mb/d)



Source: OPEC, S&P Global; *excludes Iran, Libya, Venezuela & Mexico

Chart 7: US crude oil production and rig counts



Source: EIA, Baker Hughes

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