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Economic Update

NBK Economic Research Department I 28 June 2022

Oil Markets

Oil prices retreat as global recession fears weigh on sentiment

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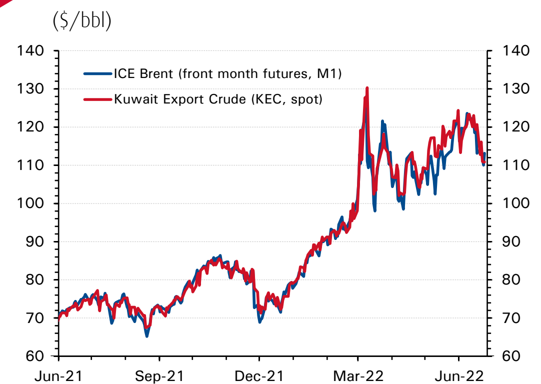
Summary

Oil and financial markets more broadly have been hard-hit by worries over slowing global economic growth and a potential recession in advanced economies. Energy reporting agencies have lowered their oil demand growth estimates, leaving prices looking to the supply side for support. The IEA expects tightness to intensify in 2023 as oil demand accelerates, OPEC+ supply gains slow and Russian output declines further on the EU embargo.

- Oil prices have been in retreat in recent weeks over worries about weakening US and global economic growth amid aggressive monetary policy tightening by the US Fed and other central banks to combat surging inflation. At its close last week, Brent was down 8.9% in June at $113.1/bbl, having fallen to its lowest in more than a month in the previous trading session. (Chart 1.) Brent is on course for its first monthly decline since November. Local marker, the medium sour Kuwait Export Crude (KEC), dropped to $110.9/bbl (-10.9% in June), having traded at a premium over the light sweet Brent due to increased demand from Asian refineries amid constrained Russian crude supplies.
- Market fears of a global recession amid soaring prices and tighter financial conditions appear to growing more acute. June's 75 bps interest rate hike by the US Fed and recent comments by Chairman Powell that a recession was 'certainly a possibility' have rattled markets, spurring sell-offs across asset classes, with oil caught in the crossfire. Worries about oil demand-destruction due to high prices have also gained traction. Energy watchdog, the International Energy Agency (IEA), has been building this into its oil demand estimates, which have been repeatedly lowered since the start of the year.
- Oil market bears took the most recent week US petroleum data release that showed a second consecutive week of commercial crude inventory builds in the US (+1.9 mb to 418.7 mb), an easing in refinery runs and below-seasonal levels of gasoline demand, as evidence that record high fuel prices are beginning to crimp demand just as the peak US summer driving season gets underway. Retail gasoline prices have topped $5/gallon in the US, forcing President Biden to take the unusual step of proposing a three-month suspension of the federal gasoline tax.
- Nevertheless, the oil market remains structurally tight, in terms of crude and especially refined products supplies. Brent futures remain in 'backwardation', where near-term prices are higher than longer-dated prices. Indeed, prompt time spreads (M1-M2), the price difference between Brent's two nearest contracts, has actually widened in recent days, to over $4.0/bbl. (Chart 2.)
- The IEA, having trimmed its oil demand growth estimates for the fifth consecutive month since January, now sees global oil demand rising by 1.8 mb/d to 99.4 mb/d in 2022, a marked slowdown from the 3.3 mb/d it was forecasting at the start of the year. (Chart 3.) Among forecasts by energy reporting agencies and research houses, the IEA's is probably the most conservative. The US Energy Information Administration (EIA) puts growth slightly higher at 2.2 mb/d this year, while OPEC expects growth to be a far more robust 3.4 mb/d. The agencies differ largely in the extent to which they see the Chinese economy being negatively affected by the protracted Covid-19 lockdowns, the extent of the slowdown in global economic growth due to inflationary pressures and the direct economic fallout from the Russia-Ukraine

Chart 1: Oil prices

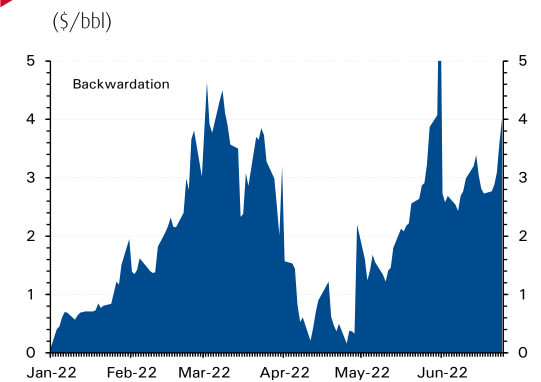
($/bbl)



Source: Refinitiv

Chart 2: Brent time spreads (M1-M2)

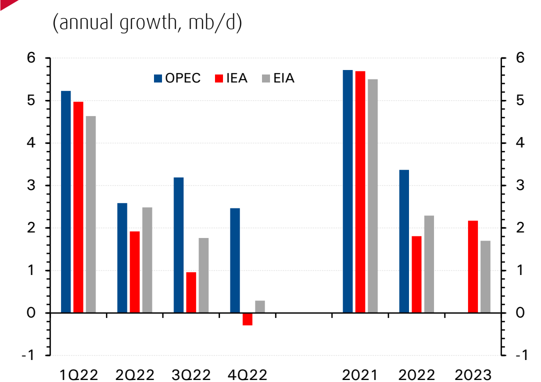
($/bbl)



Source: Refinitiv

Chart 3: Global oil demand growth forecasts

(annual growth, mb/d)



Source: IEA, EIA, OPEC

conflict. For the IEA, 2023 should see higher oil consumption from a resurgent China, driving oil demand to gains of 2.2 mb/d and pushing global oil demand to finally surpass pre-pandemic levels, at 101.6 mb/d. Implied stock changes will shift from a build in 2Q22-4Q22 to a draw in 2023. (Chart 4.)

- On the supply side, OPEC+ continues to struggle in resupplying the market at the rate it set in its production schedule. OPEC+ crude output (excluding Libya, Iran, Venezuela and Mexico) reached 37.6 mb/d in May. While the group increased supplies by 335 kb/d over April, aggregate production remained below target in May, by 2.75 mb/d, with the group slipping further behind schedule after the monthly quota increase to 432 kb/d from 400 kb/d in that month. (Chart 5.) Of course, Russian production curtailments—about 750 kb/d in May, according to Platts—due to self-sanctioning by its customers are a major factor, but the OPEC+ members' inability to raise monthly output in line with their higher quotas has been a long-running issue. While field maintenance and disruptions caused by civil strife and sabotage have undoubtedly played their part, the shortfalls are also a consequence of under-investment in oil field production and maintenance; the IEA had been warning about this eventuality for several years even before the pandemic caused prices to crash in 2020. Among OPEC-10 members, Angola and Nigeria have sustained considerable production losses. (Chart 6.)

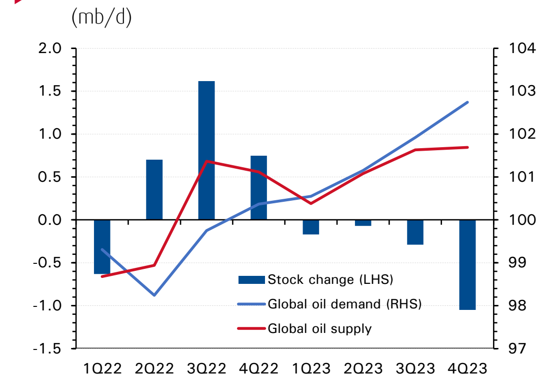
- Responding to calls from the international community to alleviate ongoing global supply shortages, OPEC+ ministers agreed at their early June meeting to accelerate the scheduled pace of supply increases. The group decided to increase its collective output by an additional 216 kb/d (to 648 kb/d) in both July and August. Essentially, rather than signify new supplies, this decision – if it is delivered upon – will merely bring forward by one month from September the date by which all pandemic era supply cuts would have been reversed and OPEC+ production restored to pre-pandemic levels. For OPEC+ to bring new supplies to market, a new agreement would need to be thrashed out, likely requiring Russia's blessing, which may prove difficult with the country's output hamstrung by sanctions. It is also unclear where the higher reference production baselines negotiated in July 2021 fit in. These were meant to apply from May onwards but the levels proposed—11.5 mb/d for Saudi and Russia, 2.96 mb/d for Kuwait, 3.5 mb/d for the UAE and 4.8 mb/d for Iraq—have rarely if ever been attained from domestic production alone.

- The issue of spare capacity has taken on increasing importance in recent months amid OPEC+ supply shortages. It was highlighted by the IEA in its recent report, when it reckoned that global supply in 2023 would struggle to match demand. The agency puts the 'call on OPEC' in 2023 (the supply that OPEC will need to provide to balance demand) at 30.52 mb/d, which is far higher than current production of 28.5 mb/d and still in excess of levels after all supply cuts are fully unwound in August. OPEC-10 spare capacity could fall to about 1.2 mb/d in 2023, held mostly in Saudi and the UAE, which is too thin a buffer to compensate for any potential supply shocks in the future and prevent oil price volatility.

- Notwithstanding expectations of softer oil demand growth in 2H22, we continue to see oil prices being supported at over $100/bbl by an oil market that is structurally tight. Supplies from outside the OPEC+ group, especially from the US, which has so far only managed incremental output gains, would need to be more forthcoming to help loosen the market and balance expected Russian supply losses once the EU embargo kicks in fully. (Chart 7.) Also, additional supplies from Iran, second behind Saudi Arabia in terms of available spare capacity, remains an uncertain prospect even though stalled nuclear talks are reportedly being re-started.

Chart 4: Demand-supply balances

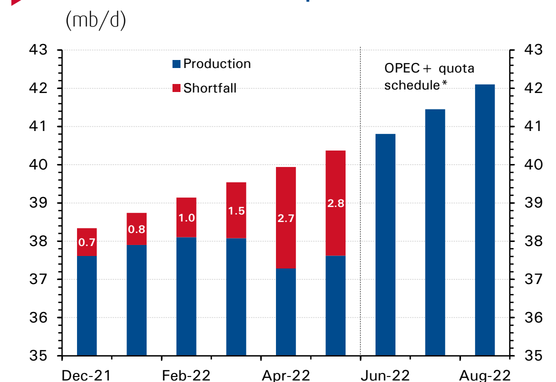
(mb/d)



Source: OPEC, IEA, NBK est.; assumes OPEC output at 30 mb/d in 2023

Chart 5: OPEC+ crude oil production

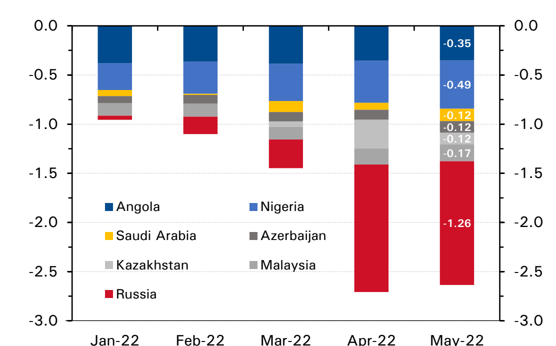
(mb/d)



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

Chart 6: Select OPEC+ member supply shortfalls*

(mb/d)



Source: OPEC, IEA, S&P; * relative to target

Chart 7: US crude oil production

(mb/d)

Source: EIA

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