Commodities Research: Crude Oil

Doha Talks to be a watershed event?

Wednesday, April 13, 2016

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

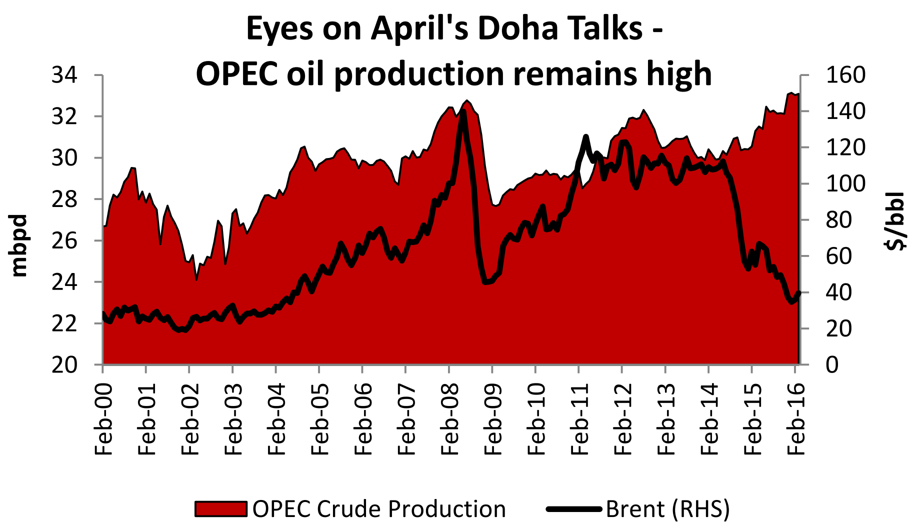
GT Institutional Sales
Tel: 6349-1810

Highlights

- It was as if like yesterday, when market-watchers cheered on Saudi Arabia's call (by a senior OPEC delegate in late March) to participate in an oil output freeze on April 17 when producers meet in Doha. Oil prices surged considerably to touch above $41/bbl then in response.
- Still, there was a lingering concern that a production freeze may be contingent on Iran's participation, one that the nation has repeatedly rejected. The said concern resurfaced in early April, now with Saudi Arabia crown price commenting that the Kingdom's eventual decision to freeze its own production will still be dependent on Iran's participation.
- On fundamentals however, it is still encouraging to see stronger net-long speculative oil positions, while US oil production maintained its decline for the fourth consecutive month to 9.1mbpd in March. All-in-all, oil prices are likely to take cues from whatever agreement (or the lack of it) in the upcoming Doha Talks, though the rebalancing story is to persist into 2H16.

Stop working harder

Humans are perhaps, biologically wired to be lazy, or so concluded by a Canadian study in Sept 2015. While laziness may eventually cost investors a great deal in the financial world, it seems that the market itself is begging for oil producers to do the exact opposite: stop working the pumps harder.

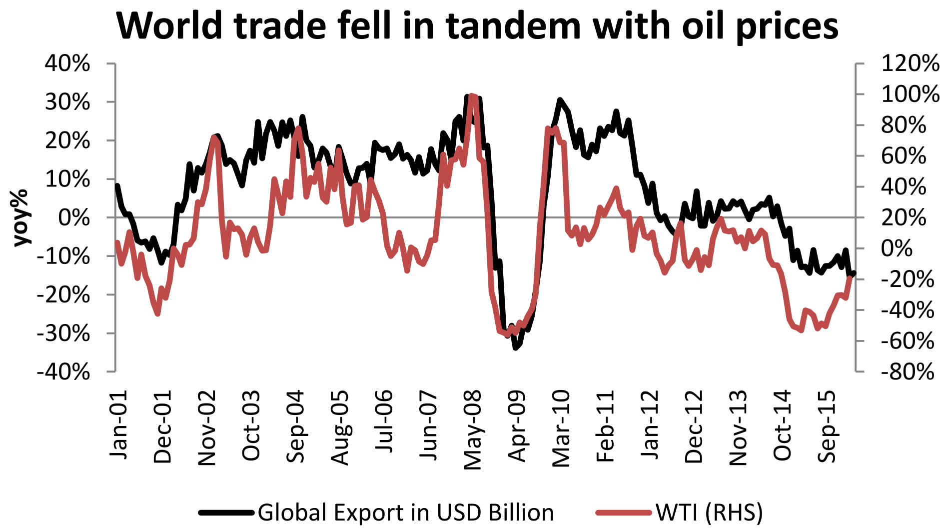


Source: Bloomberg, OCBC Bank

Statistically, the collective increase in OPEC's oil production is mind boggling. The thirteen-member cartel has been rather unrelenting in flooding the markets with the sticky liquid, with overall production levels increasing from a mere 30 million barrels per day (mbpd) to March 2016's 33.1mbpd. The numbers are unsurprisingly closely monitored by market-watchers especially during this time of oversupply, even as

Barnabas Gan
Tel: 6530-1778
BarnabasGan@ocbc.com

Iran reiterates its plans to re-capture lost market share. No wonder the markets cheered when Saudi Arabia, Russia, Kuwait and Venezuela saw unanimous consensus to freeze production in February's Doha talks, leading to crude oil's rally to above $40/bbl then. Now, the market should be readying their pom-poms and champagnes for another session of consensus at the upcoming Doha Talks… should any consensus come to pass.



Source: Bloomberg, IMF, OCBC Bank

Importantly, oil producers, including those in the US, will be cheering in unison with the markets especially if production freeze consensus is reached amongst the meeting members. Not only does this agreement lift oil prices and aid oil producers, many industry players would largely benefit too. This includes both upstream and downstream firms for the matter, giving some glimmer of hope to the otherwise bleak business outlook. On the economic front, the low oil prices had already injected growth concerns, given that crude oil prices acts as a barometer for global economic health. Central banks will also see less burden on their shoulders to inject further policy accommodation, as higher oil prices would lift overall domestic prices, and aid in lifting nominal external trade values.

All these will only happen if a production freeze materializes in the upcoming Doha Talks, and with it, the hopes for higher oil prices. The benefits are numerous no doubt, benefiting both economies and producers in both short and long-term horizon. The counteract to this decision especially in Saudi Arabia's terms, is the potential loss of market share. The kingdom has been ramping up production, statistically by more than 1.2mbpd since 2013, a move made in expense by the falling production seen in Iran and Libya. At least for the former, Iran has shown an observable distaste in the sudden shift in market share, and acting in a rather tumultuous fashion in voicing their intent to lift production back to its pre-sanction levels of 4mbpd. The question then, if Saudi Arabia, owing in fact to its position as a swing producer, is satisfied with the additional market share it has obtained over the last three years and agree to the production freeze, over the potential fall in oil prices once again if no consensus is reached. We view that the former scenario is increasingly more likely as we approach April 17.

Beyond 1H16 and the Doha Talks

What is more interesting then, perhaps, is the potential behavior oil prices may adopt into the second half of the year. And for the matter, the long-term outlook for oil prices does appear more certain when compared to the immediate-term risk owing to specific upcoming events.

Technically, there is little contention over how oil prices would rally into the end of the year. Both OPEC and the US Energy Information Administration (EIA), despite being two different unique entities, do agree on one thing: the rebalancing between supply and demand is ongoing. EIA itself also views that the oil markets will be fully balanced by 2017, thus reinforcing their view for higher oil prices till then.

This outlook is not surprising, given that oil production in the US has been falling rapidly, now to 9.1mbpd in the latest March print. Elsewhere, the need to prop up prices in the eyes of the Middle East producers are seen from the drastic income-churning measures being proposed, including those in Saudi Arabia where income tax and sale of a part of Saudi Aramco are actually being considered. In a nut-shell, the tenant of economics is already playing out here: low prices dissuade production, and US production has been falling. Should prices stay low despite the fiscal measures in place, the OPEC members will then have a greater need to 'adjust' production accordingly in its scheduled June OPEC meeting, and in our view, a 5.0% cut in overall production is a possible scenario.

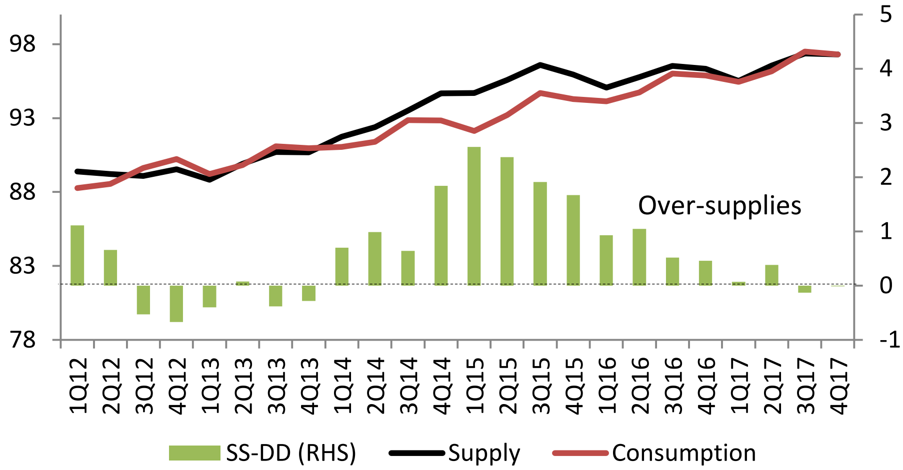
Production levels if a cut materialises in June

Production ('000 b/d)	June (5% Cut)	Feb	Jan
1. Total OPEC	**31,882**	**33,060**	**33,139**
Algeria	1,055	1,110	1,100
Angola	1,671	1,759	1,751
Ecuador	513	540	534
Indonesia	690	726	700
Iran^	3,325	3,000	2,860
Iraq	4,166	4,385	4,510
Kuwait	2,850	3,000	3,000
Libya	352	370	370
Nigeria	1,795	1,889	2,028
Qatar	618	650	650
Saudi Arabia	9,690	10,200	10,200
U.A.E.	2,831	2,980	2,970
Venezuela	2,328	2,451	2,466
2. Major Non-OPEC	**19,891**	**20,012**	**20,124**
US[1]	8,981	9,102	9,214
Russia*	10,910	10,910	10,910
OPEC + Major Non-OPEC	**51,773**	**53,072**	**53,263**
Fall of (in mbpd)	-1.30		

^ Priced in Iranian's increase in oil production by 500kbpd
* Assumed production freeze in Russia
[1] Assumed constant rate of decline to 8.8mbpd

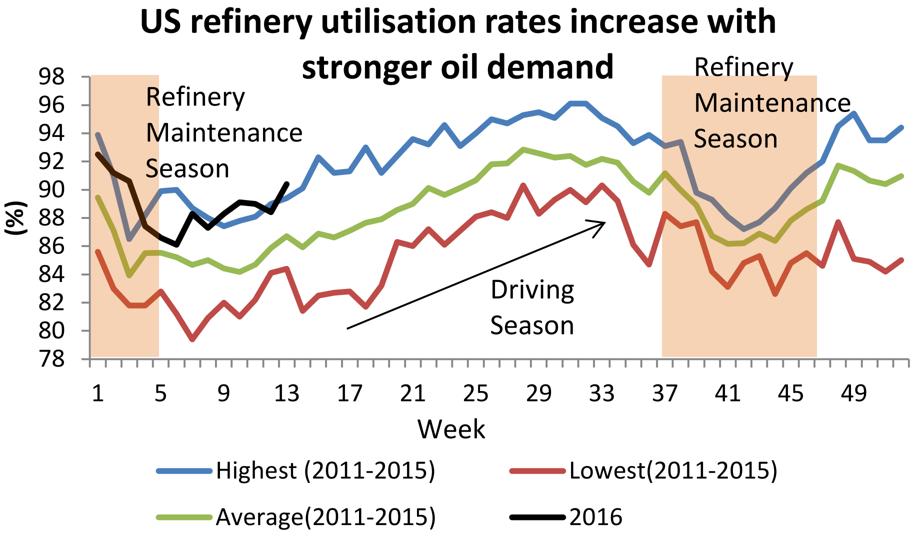
Source: OPEC, US EIA, OCBC Bank

Crude oil likely to rebalance into 2H16



Source: Bloomberg, EIA, OCBC Bank

The rebalancing however, cannot possibly occur without an improvement from the demand side of the equation. Encouragingly, growing demand for crude oil and its distillates have been seen in major economies including the US, China, India and Europe, thanks to the improving economic fundamentals and cheaper oil. Oil demand into 2H16 should continue to stay robust on three counts: the strong Chinese demand into 2016 would likely be the most compelling one. China as a whole saw a strong 8.8% growth in oil imports in 2015, and have sustained in positive growth in the first two months of 2016. Much of the argument for a sustained strong thirst by Chinese importers is the possible stock-piling comportment likely even if growth continues to taper to our call for 6.7% this year. Elsewhere, the economic recovery in Europe seen from the recent positive manufacturing print is already playing out in the uptick in oil import. Last but not least, the US driving season into May to September this year is around the corner, and would inject further uptick in oil demand then.



Source: US EIA, Bloomberg, OCBC Bank

We need higher oil prices

The almost tangible call by both oil producers and market-watchers for higher oil prices have been sounding for some time now. Oil producers have been losing a bulk of their revenue given low oil prices, business outlook turned increasingly bleak as asset sales and capital expenditure cuts come to pass. Elsewhere, crude oil prices as a barometer for global growth have brought concerns over future performance, especially as the low prices had brought about lackluster trade data and pallid manufacturing prints.

But just by focusing on the oil producers at this juncture, owing to the upcoming Doha talks this Sunday, much attention will be paid to the rhetoric and eventual decision to freeze production. On the surface, a production freeze may come to some as an impractical move to prop oil prices higher. However, it will still give hope to market-watchers simply because the fear of supplies to widen the oversupply glut is doused should a decision be reached.

It does appear anemic, we agree, given the low oil prices. The need however to see in long run paradigm, is crucial to recognise the reality of the ongoing rebalancing phenomenon. Our bullish call for WTI and Brent to touch $50/bbl at year end, is very much underpinned by this occurrence, and in it, a hope for higher oil prices to eventually lift global economic performance to greater heights.