Crude Oil

Moving on from geopolitics

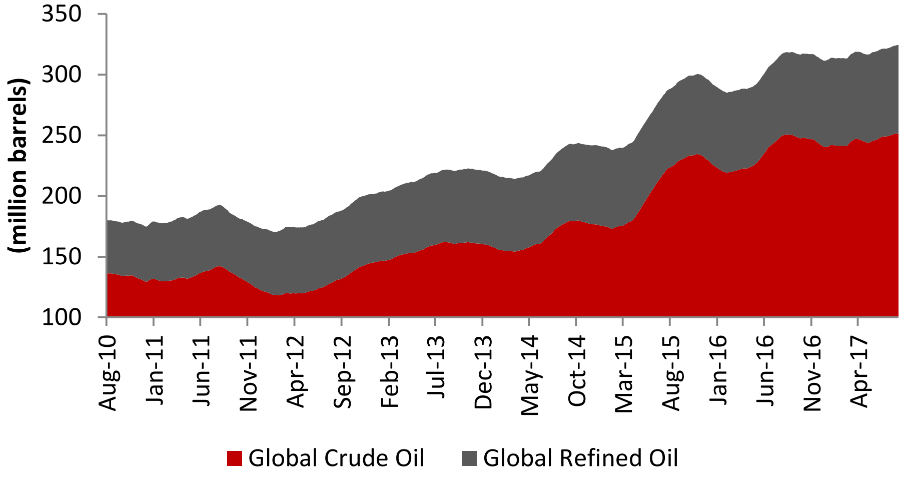
Friday, August 25, 2017

Geopolitical tensions clearly took a backseat to optimism over the last week. Although seemingly range-bound, both WTI and Brent remained supported above its $47/bbl and $50/bbl levels, respectively. With tightened US sanctions against Chinese and Russian firms and individuals in hopes for diplomatic resolution rather than a military one, market-watchers likely view the relatively calmness as a sign that war is still a far-fetched probability.

With tapering geopolitical concerns, market-watchers naturally shifted back to monitoring oil fundamentals in determining how prices might trend into the week ahead. Top of the recent happenings include Libya's shutdown of its largest oilfield which account a third of the country's total oil production, as well as sustained falls in US oil rig counts. Moreover, US crude oil and gasoline stocks have been falling rapidly (crude oil stocks fell to its lowest since January 2016 to 446.5 million barrels) despite the rise in oil production over the same period, suggesting that the rise in oil refinery rates was a reaction to satisfy the pickup in oil demand.

Regardless, the argument on whether the crude oil market has rebalanced has taken on another form. Despite empirical evidence indicating that supply and demand on a volume perspective has rebalanced as early as April this year, prices have failed to rally in response. Importantly, despite the fall in US oil inventories of late, it remains to be elevated versus historical levels (current: 466.5 million barrels, 5-year average: 411.1 million barrels). More starkly perhaps, is the sustained inventory overhang seen in floating tankers across the globe, which has risen substantially since 2011. Needless to say, there are key implications for oil prices given the large inventory overhang.

Crude and refined oil stored in floating tankers



Source: Bloomberg, OCBC Bank

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(1) **The inventory overhang will likely undermine OPEC's efforts to lift oil prices.** To a large extent, OPEC has remained compliant on their promise to reduce production to 32.5 million barrels per day (bpd), effective 1st January 2017. As of July 2017, OPEC's compliance has risen to 73.1%, up from February's 58.0%, according to our calculations. Across the members, Saudi Arabia, Qatar, Angola and Kuwait have shouldered more cuts than they had promised in hopes to lift oil prices. Still, the other members remained "less-than-compliant", seen especially from Iraq and Iran (both collectively account for 25% of total OPEC production) where recent production cuts failed to meet the targeted production levels. Despite the members' painful efforts to bring market fundamentals to an equilibrium spot, there still remains little headway for oil prices to rally substantially given the massive accumulation of inventories over the last few years.

(2) **"A rebalanced market" may not be enough.** For market-players and oil analysts perhaps, the narrowing of the oil supply glut to its current rebalanced state is likely viewed to be a game-changer. In actual fact, much of the rebalancing seen in the last months were a result of stronger oil demand, led by stronger import from Europe and Asia. Elsewhere, US crude oil implied demand has also risen from 16.0 million bpd in March '17 to its all-time high of 18.9 million bpd in August 2017. As such, it is factual that oil demand across the globe has strengthened substantially while supply growth remained tame. Still, demand has to strengthen further in order to soak up the excess inventories in the years to come.

(3) **Oil prices are likely to stay "low for longer".** Historically, the inventory build-up lasted for over five years, back when oil prices were over $100/bbl in 2012. Then, the rise in oil stocks were chiefly driven by the widening production glut especially seen from the US and Middle East. Importantly, even as demand rose substantially over the last twelve months, the pace of consumption appears only adequate to cover the production pace over the same period. As such, this provides little impetus for global oil stocks to see a quick adjustment back to 2012 levels. In a nutshell, on condition for global growth and energy demand to stay buoyant over the next five years, the gradual depletion of global stocks would only mean a slow and painful recovery of oil prices beyond its $60/bbl handle.

All-in-all, we continue to pencil WTI and Brent at $55/bbl and $57/bbl, respectively at year-end. Much of our bullish call is underpinned by a rosy global growth economic outlook, which consequently should lift overall oil demand into the year-end. On this, we are comforted to see the quick recovery in European oil demand, while Asian oil demand is likely to stay strong on the positive external environment seen thus far. However, given the strong inventory overhang seen to-date, the recovery in prices would likely be a slow and gradual process towards its $80/bbl into 2020.

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