Crude Oil

An Arduous Climb

24th August 2016

Highlights

- A confluence of factors, chiefly driven by the hype over a potential oil deal in the upcoming informal OPEC meeting (26 – 28 Sept) has fueled bullish calls.
- Though we remain skeptical of any concrete action, history be of reference, the informal meeting should still serve as a platform to build participants and market-watchers expectations to an eventual re-implementation of a production quota in OPEC's Nov meeting.
- The rebalancing of the oil market has been delayed, no doubt, as US oil rig count and overall production have increased of late. This phenomenon illustrates a distinct fact: The US oil industry has the capability and capacity to lift production with oil prices as low as $42/bbl.

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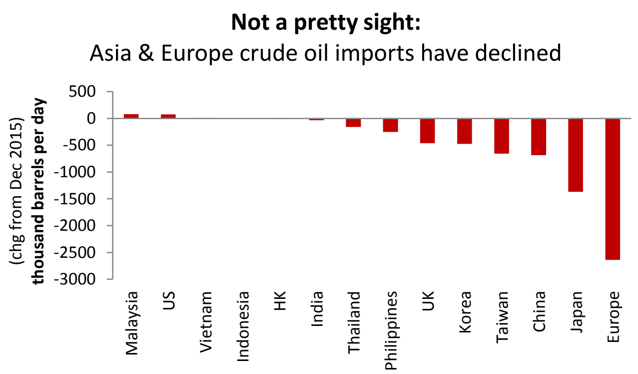
Don't celebrate just yet

Market-watchers of the energy industry seem to be in high spirits of late: crude oil prices have risen 21.7% from its August's trough while net-long speculative positions have risen substantially for the week ended 16 Aug. In regards to the said rally, one can easily point to three key attributing factors: (1) the relatively muted aftermath of the Brexit vote, (2) the consequential rise of global oil demand from 97.7 million barrels per day (mbpd) back in Dec 2015 to July's 98.6 mbpd led by OECD countries, but most importantly (3) the hype over the upcoming informal OPEC meeting in September on a possible oil deal to arrest low oil prices.

However, the expectation for oil prices to rise further into the year may perhaps be rather myopic. The truth is, the global oil environment is still in over-supply territories. Empirically, OPEC oil supply in the month of July has touched historical high of 33.2mbpd according to Bloomberg estimates, led by higher production in Iran (+0.7mbpd) and Saudi Arabia (+0.2 mbpd) in the first six months of 2016. On the other hand, imports across most of Asia and Europe over the same period have weakened considerably.



Source: Bloomberg, OCBC Bank

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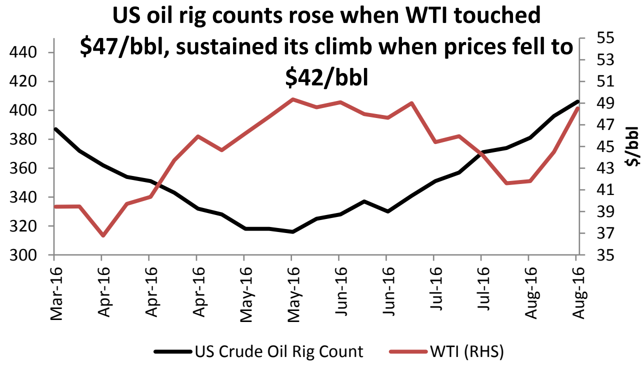
The resilience and importance of US production data

Another key observation is seen from the rising importance of US oil-centric data. We have long been emphasizing that the US crude oil (including those of shale oil) has been, due to the prolonged low oil prices, forced to turn competitive and tune its production cost lower. Crucially, the US oil industry back in 2014 has transformed vastly to date: production was unable to sustain its 9.6mbpd production once seen in 2015 when prices finally dip below $60/bbl. In contrast, given technology advances and increasing expertise in their field, US oil rig counts managed to print higher when crude oil was at $47/bbl, while overall oil production in the US rose when prices were as low as $42/bbl.



Source: Bloomberg, Baker Hughes, OCBC Bank

Expect a strong resistance at $50/bbl

The quick rise in oil prices and stronger net-long speculative positions, alongside clear evidences that fundamentals are not supporting higher oil prices, sends a clear warning to signal to us. We opine that the higher oil prices of late are merely due to an unsubstantiated hype over a possible oil deal in the coming informal OPEC meeting. Importantly, should OPEC disappoint again without any concrete moves, oil prices would almost certainly stage a quick correction back to below $50/bbl. On this, we perceive little room for OPEC to decide on any concrete moves, especially with Iran's call (back in June) to return to individual producer output quota first, before agreeing on a collective quota.

Despite the possibility for another inaction conclusion in the coming month, we believe that the meeting should serve as a platform to return to both individual and collective quota by the next official OPEC meeting in November 2016. For the year ahead, the rebalancing should continue into 2017, albeit at a slower pace given the higher production blip seen in the last few months while demand declined. Given the resilience of the US oil industry, we observe that any upside to $50/bbl would certainly be met with higher production, hence our call for oil prices to see a strong resistance at $50/bbl for the year.

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