Commodities Research: Crude Oil

The wind beneath its wings

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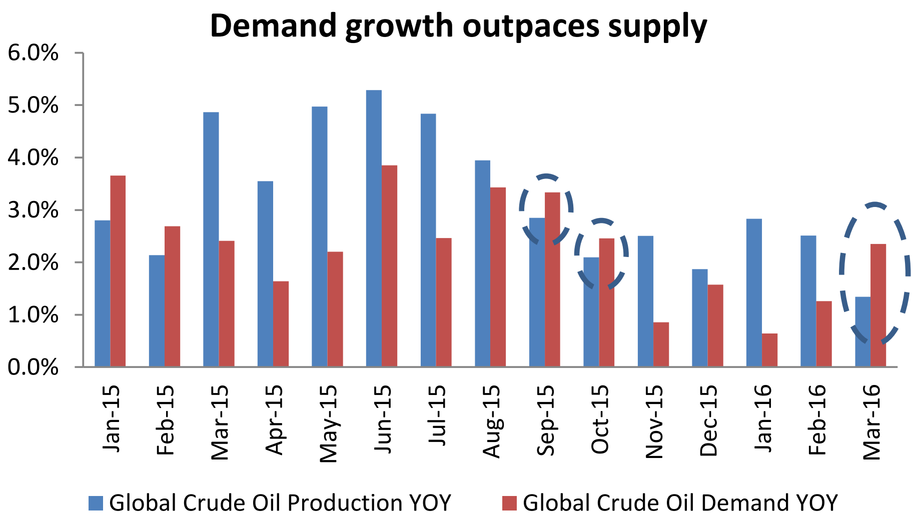
Highlights

- Crude oil rallied even in the absence of a production freeze agreement in April's Doha Talks. A quick investigation shows that the mix of events and improving fundamentals are the key reasons for this phenomenon.
- In the spectrum of things, fundamentals did improve significantly since we started the year: China once again reigns as the top importer of crude oil, although recent upticks in US imports are observed. On the whole, crude oil demand growth had outpaced supply, much to the cheer of oil bulls.
- We stick to our call for both WTI and Brent to touch $50/bbl at year-end with upside risk, where any agreement in the OPEC cartel to freeze/cut production in its June meeting to be a significant contribution to a sharp upward correction in oil prices.

Fundamentals First

Should one compare how demand and supply have shifted since we started the year, it is of no surprise that prices have effectively bottomed in 1Q16. Back then, the chief worry was on the supply glut, and the worsening of it. One could recall the rhetoric by key producers back then: Saudi Arabia was prepared to see crude oil below $40/bbl, while Iran was gearing up to touch its former glory of 4.0 million barrels per day (mbpd) production handle. Coupled with intense growth woes led by China and the lackluster external environment, crude oil prices did suffer greatly.



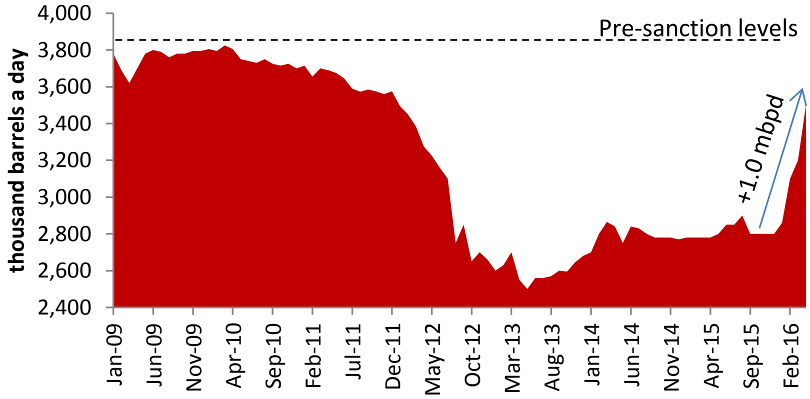
Source: Energy Intelligence Group, OCBC Bank

The contention amongst market-watchers now, is vastly differently. Gone were the days of calling for a bottom, given that prices have rallied past its $45/bbl handle. The question now mainly revolves around the resilience and pace of an oil price recovery. To consider the factors now present will yield the reasons for such a change: global crude oil demand growth outpaced that of supply in the latest print, all thanks to thirstier nations such as US, Europe and most of Asia. China in itself has again out-paced US as the world's top importer of crude oil, even as US approaches its driving season, a period when gasoline consumption escalates. Elsewhere on the production front, US output levels have tapered substantially (-0.785mbpd from June 2015), while imports have came in to balance the fall (+0.61mbpd over the same period). All-in-all, these evidences continue to suggest that the rebalancing of the oil markets is still on track.

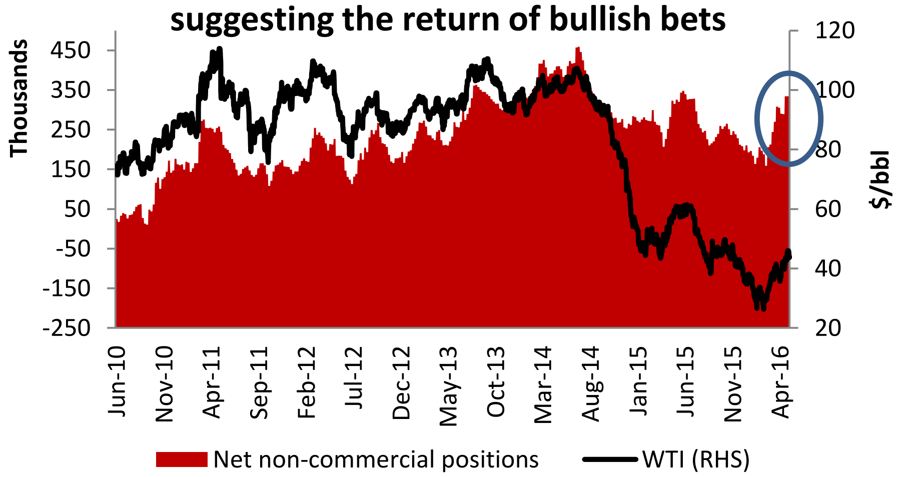
The wind beneath oil's wing

Given the production cues seen in the Middle East, we expect future concerns over Iran's rise in oil production to gradually cease one simple reason: Iran's oil production have increased substantially over the last few months to 3.5 mbpd in April. Given its pre-sanction production level of 4.0mbpd, a simple arithmetic calculation suggests that the upside to production is only but a mere 500kbpd. This is a fraction of what it promises to increase compared to the beginning of 2016. The good news is that, even with the uptick in Iranian oil production of late, markets see the improved demand environment as a credible fillip to stronger oil prices.

The upside in Iranian's oil production is merely 500k barrels a day



WTI speculative demand picked up considerably, suggesting the return of bullish bets

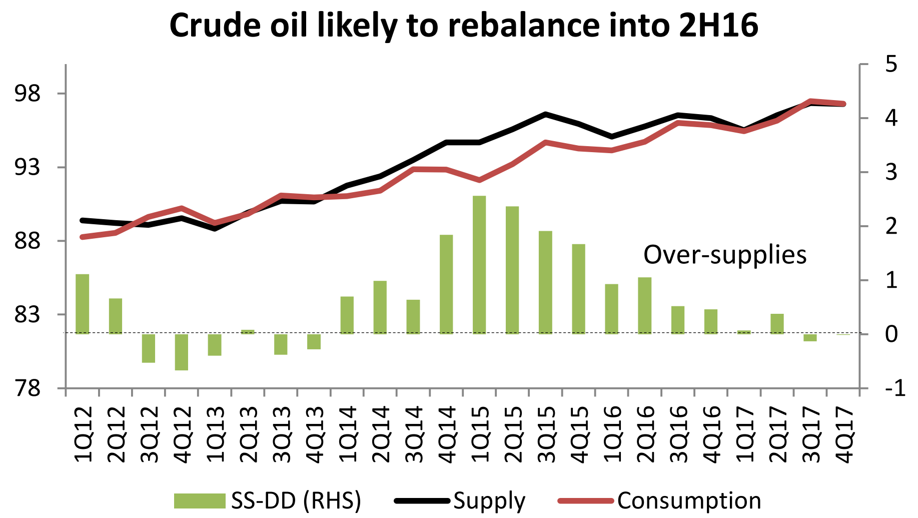


Source: CFTC, Bloomberg, OCBC Bank

Elsewhere, telltale signs of higher oil prices may be seen from the improving CFTC net-long speculative positions and steeper forward curves seen in the future markets. Technically, the higher net-long positions indicate that the bullish bets are returning, suggesting that market-watchers are indeed looking for further recovery in oil prices. The uplift in oil prices would also take cues from the recent events seen in Canada (fire accidents in its oil sands which disrupted oil production in Alberta) and Libya (sustained fighting in which the country's oil production may fall by another 120kbpd).

Look out for June

With the Doha talks come and gone, the next key event to watch for would be the 169th OPEC meeting in June. Although the oil freeze agreement had been left unconcluded, there is still a chance for it to resurface especially if oil prices stay weak. On this, we see a good chance for Iran to finally agree to a production freeze, given that it has successfully increased in oil production to near its pre-sanction levels in such a short time.



Source: EIA, OCBC Bank

Still, we note that even in the absence of an oil agreement, the rebalancing scenario that is already been observed is a persuasive force to lift oil prices. With the fall in US oil production and lack of production growth in OPEC (ex-Iran), the International Energy Agency's call for a narrowing of the supply glut into 2H16 sounds realistic. To this end, we stick to our call for both WTI and Brent to touch $50/bbl at year-end with upside risk, where any agreement in the OPEC cartel to freeze/cut production in its June meeting to be a significant contribution to a sharp upward correction in oil prices.