

Agreeing to what has been agreed

Wednesday, February 17, 2016

Highlights

- Much of the oil rally in the week is due to a hope for a production cut from the world's largest oil producers – Saudi Arabia and Russia. Any cut, even as small as 5%, would effectively shave one million barrels per day off the grid.
- But things sometimes do not go as what is expected. Despite the blatant oil supply glut, four oil producers, including Qatar and Venezuela, had agreed to freeze oil output at January levels, disappointing hopes for a production cut. WTI and Brent prices then immediately plummeted to its previous \$30/bbl and \$34/bbl handles.
- This is not new news, should we compare this announcement to OPEC's agreement to keep production at 31.5mbpd at its Dec 2015 meeting. Thus, merely to 'agree to what has been agreed' clearly isn't enough to rally oil prices. In short, the supply glut continues.

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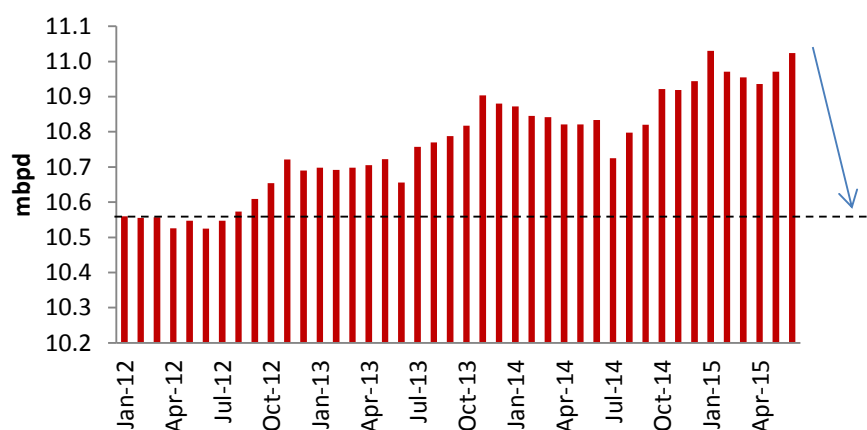
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The giants stood firm

When Alexandar Novak, Russian Energy Minister, placed an arbitrary production cut of 5.0% earlier this month, market-watchers had likely perceived some willingness by the Russians to cut production in hope to buoy oil prices. This move, should it come to pass, is extremely significant to oil production around the world, given that OPEC's clear rhetoric was for a no-cut stance 'until other producers agree to a cut'. A talk in Doha was then scheduled, the talk went underway, and the result clearly disappointed with both giants agreeing to freeze production levels.

Russia crude oil production's 5% cut is equivalent to 500k bpd back to Jan 2012 levels



Source: Bloomberg, OCBC Bank

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It is vital to note that Russia and Saudi Arabia are the two biggest oil producers in the world. In the latest figures, Russia produced just under 11 million barrels per day (mbpd) while Saudi Arabia registered a strong 10.22 mbpd in January 2016. Cumulatively, they account for a whopping 21% of global production. Thus, any cut,

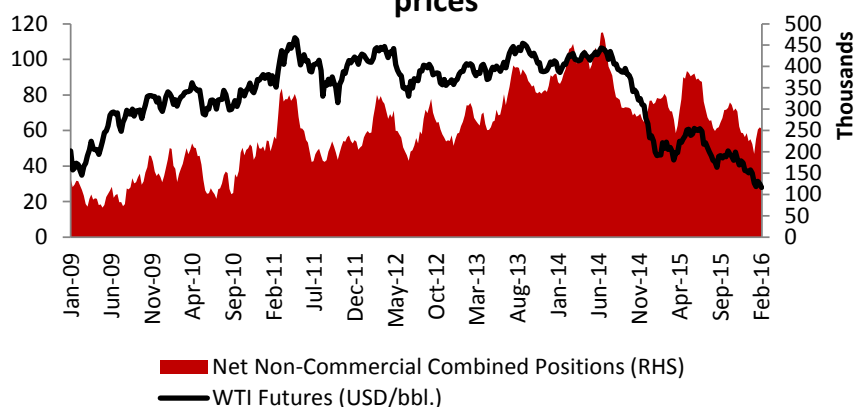
even as small as 5%, will result in a fall in global supplies by a significant 1 mbpd. Should that come to pass, the fall in production will not only offset any production increases by Iran, owing to its newly found freedom to export oil, but also effectively narrow the supply glut.

Still, the production freeze is likely unable to militate further downside in oil prices – the freeze is said to be contingent on other producers joining in. On this, Iran's absence from the Doha talks and its intransigent calls to raise its own production since last year may well undo the very thing the Doha talk aimed to achieve – to stabilize oil prices.

Oil prices are just poised to rise

It is undeniable that oil prices are extremely reactive to any possibility for a production cut. Empirically, oil prices have rallied about 20% over the last three days, a move that reflected market expectation for a production cut. The reactivity in oil prices, even on production cut rumors, suggest that market-watchers are looking for reasons to take bullish positions once again.

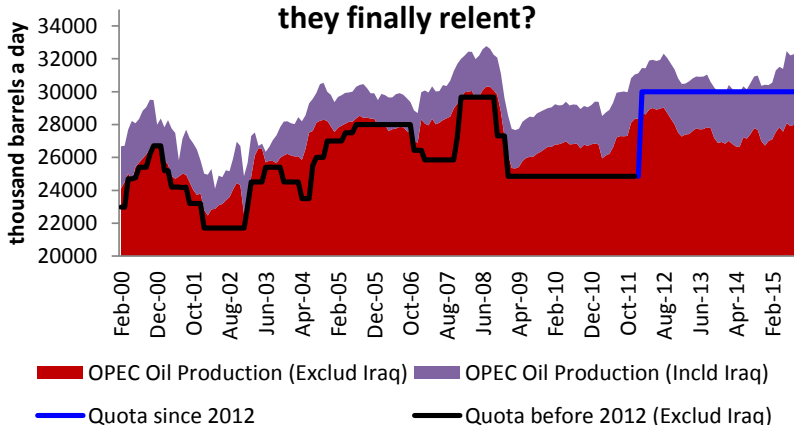
Speculative positions rose despite lower oil prices



Source: CFTC, Bloomberg, OCBC Bank

In this, we note that some green-shoot signs of some upside risk to oil prices: (1) the uptick in CFTC net-long speculative positions since the start of 2016 and (2) the steeper upward sloping futures curve compared a month ago. Both indicators suggest the increase in buying interest (and expectations for oil prices to rally), an unsurprising conviction given how low oil prices are at current juncture.

OPEC's production is adding to the glut. Will they finally relent?

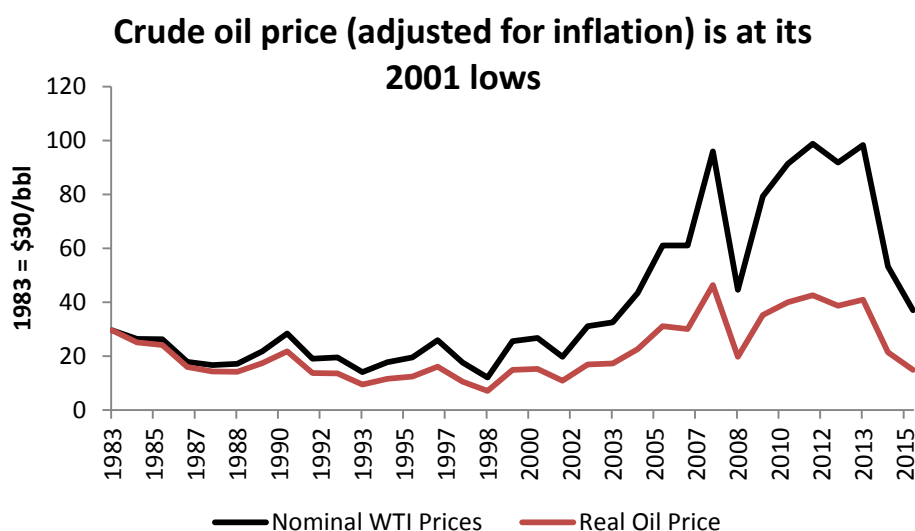


Source: Bloomberg, OCBC Bank

Ostensibly, the increasing bullish calls heard in the market are obviously insufficient to rally oil prices. The determining factor is obviously a move by OPEC (and non-OPEC for that matter) to implement a coordinated production cut either in an emergency OPEC meeting or the scheduled OPEC meeting in June. In our opinion, a production cut is a 'sooner or later' act, given the supply glut present whilst demand growth is to see more downside risk following recent downgrades by the US Energy Information Administration (EIA) to 1.2 mbpd from a previous 1.4mbpd.

Watch out for June (or anything sooner)

For now, we have nothing to do but to wait, either for another call for an emergency OPEC meeting or till June when the official OPEC meeting commences. Should there be an emergency meeting, it may well be likely to be as early as March, especially with the tightly squeezed profit margins observed by many oil producers globally. Also, tell-tale signs that Saudi Arabia may be nearing the end of its 'low-price, high production' strategy is seen from its calls to freeze wages & bonus, as well as rumors to implement income taxes.



Source: Bloomberg, OCBC Bank

But more importantly, we continue to stay bullish on oil prices, especially as oil prices are largely perceived to be undervalued at below \$30/bbl. We think that a production cut in the major oil producers will happen in 2016. This event, coupled with demand growth to stay positive, would rally both WTI and Brent to our year end forecast of \$50/bbl.

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