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# OIL MARKET OUTLOOK

## Q3 / 2016

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# Oil Market Outlook

24 June 2016

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## Highlights

- Brent crude oil spot prices breached the $50/barrel (b) mark in June, having averaged $47/b in May, up $5/b from April. The May oil price rise marked the fourth consecutive monthly increase since recording a 12-year low of $31/b in January. Prices have been supported by supply disruptions in Canada (due to wildfires), Nigeria (militant attacks) and Venezuela (economic troubles), and continuing production decline in the US.
- Several major producers are continuing to produce near all-time highs (notably Russia, Saudi Arabia and Iraq), while falling US tight oil production is largely being offset by Iran's increasing production and exports in the wake of sanctions on that country having been lifted in January.
- World liquids production is forecast to increase only marginally (0.2 mb/d) this year and slightly more (0.5 mb/d) next year, but may decline towards the end of the decade as a result of the steep cutbacks in investment spending last year and this year.
- Oil demand is projected to rise by about 1.3 to 1.5 million b/d this year, with about half the increase attributable to consumption growth in China and India.
- The recent oversupply in world oil markets is expected to gradually narrow over the coming year. Global oil inventories are expected to grow by an average of about 0.5 to 1 mb/d in 2016, and grow modestly in the first half of 2017 before contracting in the second half. Hence oil prices are not expected to begin to recover significantly until later in 2017 when supply and demand converge.
- The US EIA has raised its price forecast for Brent crude to $43/b in 2016 and $52/b in 2017, up from the April forecasts of $34 and $40, respectively.
- The major geopolitical risks to oil supplies are the socio-political and economic instability in Venezuela and the attacks by militants in Nigeria, while Iraq's production looks reasonably secure for now as the Islamic State is under sustained attack in its strongholds of northern Iraq and Syria.

## Consumption

The IEA in June projected that global oil demand will grow by 1.3 mb/d in 2016, down from a 1.8 mb/d increase in 2015, as a result of slower global economic growth. The same growth of 1.3 mb/d is foreseen for 2017, spurred by continued low oil prices, which would take global consumption to 97.4 mb/d.

The EIA forecasts that global consumption of petroleum and other liquid fuels will grow by 1.5 mb/d in both 2016 and 2017, mostly driven by growth in non-OECD countries. The EIA anticipates consumption growth of 0.4 mb/d in China in 2016 and 2017, and between 0.3 and 0.4 mb/d in India this year and next. OECD demand is projected to grow marginally, owing to increased consumption in the US and Korea offsetting declines in Europe and Japan. The EIA's demand projections are quite bullish given the muted outlook for global economic growth, and are up substantially from its April forecast.

OPEC is anticipating world oil demand growth of 1.20 mb/d in 2016, driven mainly by growth in India and other emerging Asian countries.

**Oil Demand Growth Forecasts (million barrels per day)**

| Agency | 2016 | 2017 |
|---|---|---|
| International Energy Agency[1] | 1.3 | 1.3 |
| U.S. Energy Information Administration[2] | 1.5 | 1.5 |
| OPEC[3] | 1.2 | |

*Sources:*

1. *IEA Oil Market Report, June 2016.*
2. *EIA Short-Term Energy Outlook, June 2016.*
3. *OPEC Monthly Oil Market Report, June 2016.*

# Production

According to the IEA, global oil supplies fell by almost 0.8 mb/d in May, to 95.4 mb/d – down nearly 0.6 mb/d from a year earlier. A slight decline in OPEC production was compounded by lower output by non-OPEC countries. Non-OPEC supply is expected to decline by 0.9 mb/d in 2016 (led by a 0.5 mb/d fall in US output), with limited growth 0.2 mb/d anticipated in 2017. Iran is expected to add 0.7 mb/d this year.

The EIA expects non-OPEC production to decline by 0.6 mb/d in 2016 and by a further 0.2 million b/d in 2017. The major change will be in US light tight oil production (down 0.5 mb/d), which has short investment horizons and steep production decline curves, which makes it especially sensitive to prices in the short term. Having been the major source of new crude over the past few years, the decline in US tight oil output by about 1 mb/d since its peak in April 2015 has been a significant change, helping somewhat to rebalance the market. However, OPEC crude oil output is forecast to grow by 0.8 mb/d in 2016, led by Iran's increased output. OPEC production is expected by the EIA to increase by a further 0.7 mb/d in 2017.

OPEC predicts that non-OPEC oil supply will contract by 0.74 mb/d to average 56.4 mb/d in 2016. The cartel abandoned its official production target or cap of 30 mb/d in December, reflecting the major players' (especially Saudi Arabia's) decision to focus on market share in the face of competition from other suppliers, including tight oil producers.

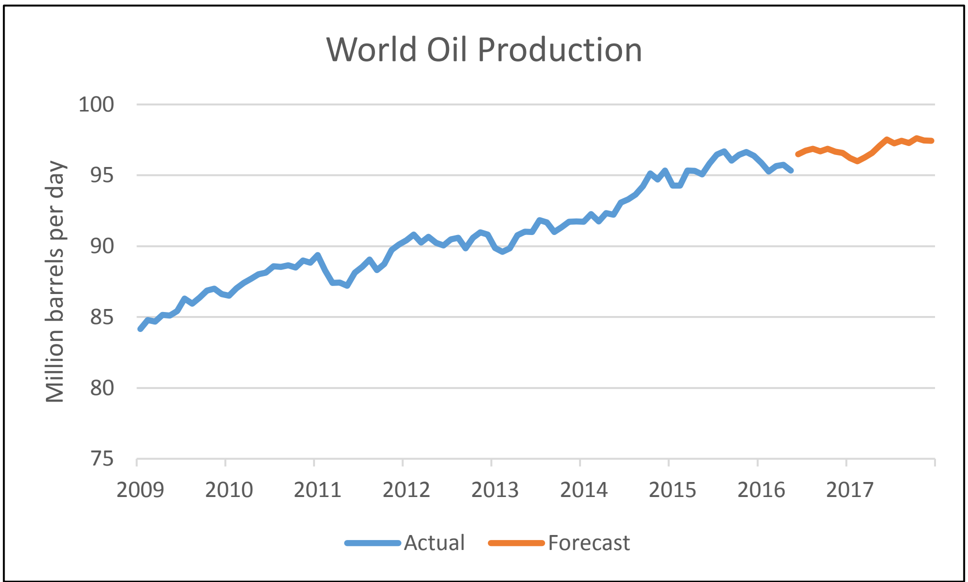
U.S. crude oil production averaged 9.4 million barrels per day (mb/d) in 2015, and is forecast by the EIA to average 8.6 million b/d in 2016 and to fall further to 8.2 million b/d in 2017. May 2016 crude output averaged 8.7 million b/d, down about 1 million b/d from the 9.7 million b/d attained in April 2015. The production decline is largely attributable to a reduction in shale oil output, which is price sensitive even in the short- to medium-term.

**Non-OPEC Oil Supply Change Forecasts (million barrels per day)**

| Agency | 2016 | 2017 |
|---|---|---|
| International Energy Agency[1] | -0.90 | 0.2 |
| U.S. Energy Information Administration[2] | -0.70 | -0.2 |
| OPEC[3] | -0.74 | |

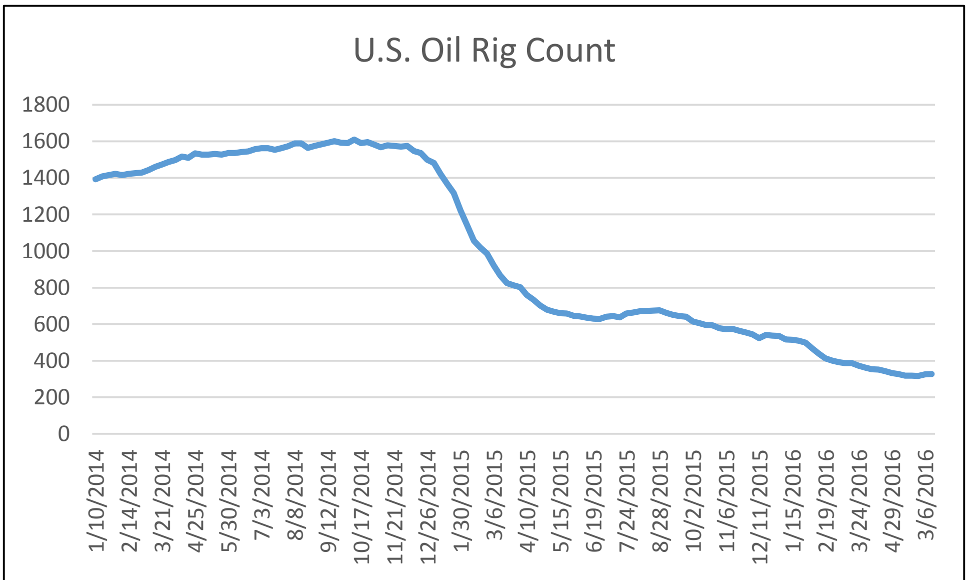
*Sources:*

1. *IEA Oil Market Report, June 2016.*
2. *EIA Short-Term Energy Outlook, June 2016.*
3. *OPEC Monthly Oil Market Report, June 2016.*




*Source: U.S. EIA*

The US oil rig count has finally stopped its seemingly relentless decline, climbing by nine units in the first week of June and a further 3 in the second week, as (mainly shale oil) drillers reacted to the rise in oil prices towards the $50 per barrel level, together with buyers' market conditions for oil production services and oil field workers. The US oil rig count reached 328 units in the second week of June, down from 1,600 active rigs in October 2014 and 386 rigs in mid-March. The decline in US shale oil production is unlikely to turn around soon given the overall decline in drilling and the time lags (up to around 6 months) between drilling and production.



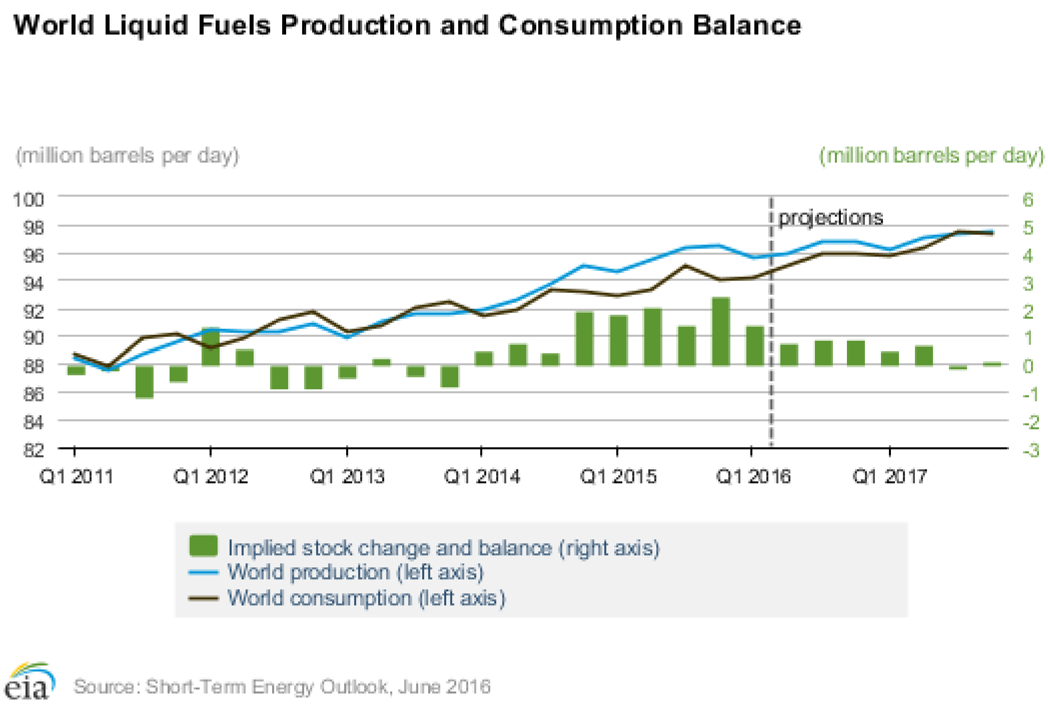

*Source: Baker Hughes*

# Market Balance and Inventories

Whereas earlier in the year the IEA had expected excess supply of 1.5 mb/d in the first half of 2016, the actual stock build has been about 0.8 mb/d. This is because oil demand growth has been more robust than anticipated (1.6 mb/d), combined with the supply outages mentioned earlier. In the absence of shocks, the Agency expects the oil market to be roughly balanced in 2016H2, with a small stock draw in the 3rd quarter offset by a small inventory build in Q4. Next year, the IEA foresees global oil stocks building slightly in 1H17 before falling slightly more in 2H17.

The EIA anticipates that global oil inventories will grow by an average 0.8 million b/d during 2016Q2 and 2016Q3, while draw-downs are expected to begin in 2017Q3. Inventory accumulation is expected to average 1 mb/d in 2016 and 0.3 mb/d in 2017. Accordingly, a sustained price recovery is unlikely before the latter part of next year.

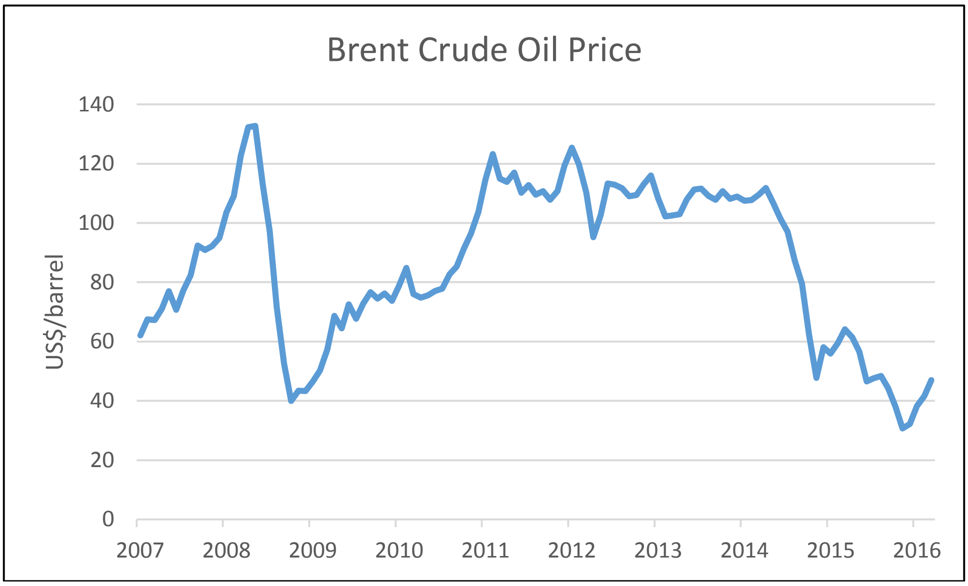
OPEC projects that demand for the group's crude in 2016 will average 31.5 mb/d, some 1.8 mb/d higher than last year. In May, OPEC was pumping 32.36 mb/d. However, the organisation sees an easing of global excess supply in the second half of 2016.




# Prices

Brent crude oil spot prices averaged $47/b in May, rising $5/b from April and marking the fourth consecutive monthly increase since recording a 12-year low of $31/b in January.

Oil prices have been supported in recent weeks by supply disruptions in several countries. Wildfires in Canada led to about 1 mbpd of tar sand production being taken offline, and it will take several weeks for output to be fully restored. Militant attacks on oil infrastructure in Nigeria's delta region has reduced production volumes to 1.4 mbpd in May (the lowest level since the 1980s) from over 2 mbpd in 2015. Venezuela's production has also slipped, and the country is said to be on the verge of social and economic collapse as a result of a combination of factors, including economic mismanagement, a lack of foreign exchange and drought-inflicted electricity shortages. US crude oil production continues to decline slowly as tight oil producers react to low prices. Somewhat improved sentiment in the commodity markets could have contributed to the recent rise in oil prices.




*Source: U.S. EIA*

The US EIA's latest forecast is that Brent crude will average $43/b in 2016 and $52/b in 2017. As a result of growing draws on oil inventories in the latter part of 2017, the EIA expects the price of Brent crude to rise to $58/b in 2017Q4.

The historically large stockpiles of oil, built up over three years of approximately 1mb/d of excess supply, are likely to weigh on prices over the next year and a half or more.

**Forecasts of Brent Crude Oil Price (US$ per barrel)**

| Agency | 2016 | 2017 |
|---|---|---|
| U.S. Energy Information Administration | 43 | 52 |

*Source: EIA Short-Term Energy Outlook, 7 June 2016.*

## Analysis

At its biannual meeting in Vienna in early June, **OPEC** once again failed to reach any agreement on limiting oil output. On the contrary, the cartel agreed to Iran's demand that it be allowed to raise its production to pre-sanction levels. This follows the failure of special talks held in April between OPEC and several major non-OPEC producers, including Russia and Mexico, to reach an agreement to cap oil production. Saudi Arabia's oil policy continues to target market share rather than influencing global prices, while Iran continues to ramp up production following the easing of US and EU sanctions. Saudi Arabia's new energy minister, Khalid Al-Falih, announced that the Kingdom will no longer play the role of the world's "swing producer", attempting to influence global oil prices through raising or lowering its oil output.

If the Saudis and OPEC continue with their current policy of not voluntarily restricting output, it implies that the global oil market is back to **marginal cost pricing** – meaning that the price of oil is closely tied to the cost of producing the 'marginal barrel', i.e the last, most costly-to-produce oil required to meet global demand. For the next couple of years, assuming no major change to the gradual upward trend in demand, this could in theory impose a floor under the oil price of roughly $25-30 per barrel (the marginal costs of easier-to-access conventional oil in the Middle East and Russia) when cyclical demand is relatively weak, and a ceiling of perhaps $50-60 per barrel when cyclical demand is relatively high. At prices above about $60, it is likely that more of the higher cost sources of supply like shale oil could come back on-stream, although production costs for new deep-water oil and Canadian tar sands projects are likely considerably higher.

However, there is an ongoing wave of **bankruptcies** among mostly smaller US oil and gas companies that have been unable to service their large debts amid low oil and gas prices. These bankruptcies have had a knock-on effect on bank profits in the US, but as yet not enough to cause another financial crisis, as some analysts fear might happen. It remains to be seen whether the industry can quickly boost production levels if or when oil prices stabilise around $50-60/b, as the appetite for renewed lending by banks may be muted.

The **short-term outlook for oil prices** over the next quarter is clouded somewhat by a number of factors. On the **supply side**, it is likely that the Canadian tar sand production taken offline as a result of the wildfires will be back on stream within a couple of months, although there is a threat of new fires. The prospects of Libyan and Nigerian conflict-driven supply outages being eased is less certain. Presently, at least 1.5 mb/d of production capacity is offline in these two countries. The deteriorating situation in Venezuela could conceivably lead to a dramatic loss of production from that country, which is currently pumping about 2.5 mb/d.

On the **demand side**, the UK referendum outcome to leave the European Union, so-called “Brexit”, immediately triggered a 6 percent decline in the dollar price of oil as the dollar strengthened and concerns about future global economic growth grew more pessimistic. There could be further volatility in the immediate aftermath of the referendum. In the medium term, the UK’s exit from the EU could have further negative ripple effects on confidence in the global economy and in political and economic stability in the EU, possibly weakening demand. More generally, the World Bank recently downgraded its global economic growth projections for 2016, highlighting weaknesses in several large consumers, such as China, Japan, and the Eurozone.

An important trend for the **medium term** (3-5 years) is the impact of recent low oil prices on upstream investment in the oil sector and consequently on the rate of new oil **discoveries**. Over the last few years, new conventional oil discoveries outside of North America have fallen precipitously to just 2.8 billion barrels in 2015, according to data compiled by IHS. This is the lowest level of discoveries since 1952. Total global discoveries amounted to just 12 billion barrels of new reserves last year, slightly more than one third of annual global consumption of approximately 35 billion barrels. This declining trend of discoveries began when prices were over $100/barrel and companies had every incentive to invest in exploration, but since the price collapse, the rate of investment spending has fallen dramatically. Aside from US tight oil, these cut-backs are unlikely to affect production volumes through 2017 because of the time lags involved. However, the decline in discoveries and new oil field development projects suggests that a substantial fall in oil supply could occur in about 3-5 years’ time, giving a strong boost to oil prices.

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