

# OIL MARKET OUTLOOK

Q2 / 2016

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# Oil Market Outlook

March 2016

Compiled by Dr Jeremy Wakeford

## Highlights

- Oil prices have remained very weak in recent months, with the Brent benchmark averaging \$31/bbl in January and \$32/bbl in February – prices not seen since early 2004. This is a result of continued high levels of production, by both non-OPEC and OPEC countries, amid tepid global demand. Prices recovered slightly to around \$40/bbl in mid-March, buoyed by talks between Russia and several members of OPEC about a possible production ‘freeze’.
- Several major producers are continuing to produce at or near all-time highs (notably Russia, Saudi Arabia and Iraq), while falling US tight oil production is being partially offset by Iran’s increasing production and exports in the wake of sanctions on that country having been lifted in January 2016. Iran has said it will not cap its production, and thus the talks of an output freeze are unlikely to have a major impact on prices in the near future.
- World liquids production is forecast to remain virtually flat for the next two years, but may decline thereafter as a result of the steep cutbacks in investment spending last year.
- Oil demand is projected to rise by about 1.2 million b/d this year after dipping significantly in the last quarter of 2015, although downside risks remain as a result of weaknesses in the global economy, and especially the Chinese economy.
- The recent oversupply in world oil markets is expected to persist over the coming year. Global oil inventories are expected to grow by an average of between 1 and 1.6 million b/d in 2016. Hence oil prices are not expected to begin to recover significantly until 2017 when the gap between supply and demand narrows.
- The US EIA currently forecasts that Brent crude will average \$34/bbl in 2016 and \$40/bbl in 2017, a marked fall compared to its December forecast of \$56/bbl for 2016.
- On the geopolitical front, the recent attenuation of conflict in Syria has somewhat reduced the immediate threat to oil production in the region. Nevertheless, continued conflict and instability in several major oil exporters (e.g. Iraq, Nigeria and Venezuela) presents an ongoing supply-side risk.

## Consumption

The continuing slow-down in the rate of global economic growth is contributing to somewhat weaker oil demand, especially in the last few months. Another contributing factor has been the relatively mild winter in the northern hemisphere, which has reduced demand for heating oil. Chinese oil demand is expected to grow modestly this year, by about 300-400 kb/d.

The IEA in March projected that global oil demand will grow by 1.2 mb/d in 2016, down from a 1.8 mb/d increase in 2015, as a result of slower global economic growth.

Similarly, the EIA forecasts that global consumption of petroleum and other liquids will grow by 1.1 million b/d in 2016, which is lower than its previous estimate due to reduced expectations for global economic growth.

OPEC is slightly more bullish, anticipating world oil demand growth of 1.25 mb/d in 2016.

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

Agency	2016
International Energy Agency <sup>1</sup>	1.2
U.S. Energy Information Administration <sup>2</sup>	1.1
OPEC <sup>3</sup>	1.25

1. Source: IEA Oil Market Report, March 2016.
2. Source: EIA Short-Term Energy Outlook, March 2016.
3. Source: OPEC Monthly Oil Market Report, March 2016.

## Production

According to the IEA, global oil supplies fell by 180 kb/d in February, to 96.5 mb/d. Production stood 1.8 mb/d above a year earlier, as a slight decline in non-OPEC was more than offset by OPEC gains. Non-OPEC production is forecast to decline by 750 kb/d in 2016, to 57.0 mb/d.

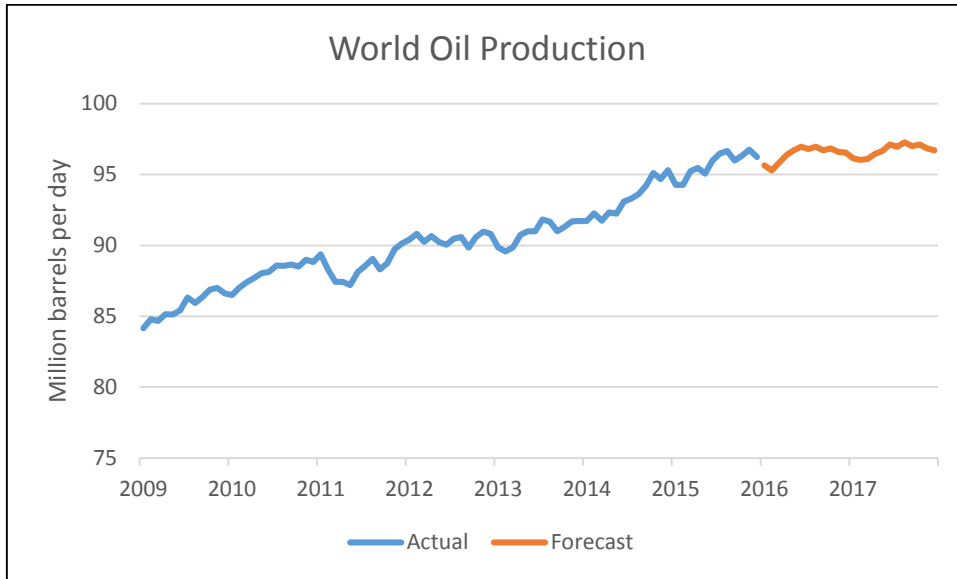
The EIA expects non-OPEC production to decline by 0.4 mbpd in 2016 and a further 0.5 mbpd in 2017, led by falls in US output. OPEC crude oil production is forecast to increase by 0.7 mbpd in 2016 and by 0.4 mbpd in 2017, with Iran responsible for most of the increase as it ramps up production following the lifting of US and EU sanctions. World liquids production is forecast by the EIA to remain virtually flat for the next two years.

OPEC predicts that non-OPEC oil supply will contract by 0.70 mb/d to average 56.39 mb/d in 2016. At this stage the cartel is not planning to increase their official production target, although Iran has said they will not limit their output.

#### Oil Supply Change Forecasts (million barrels per day)

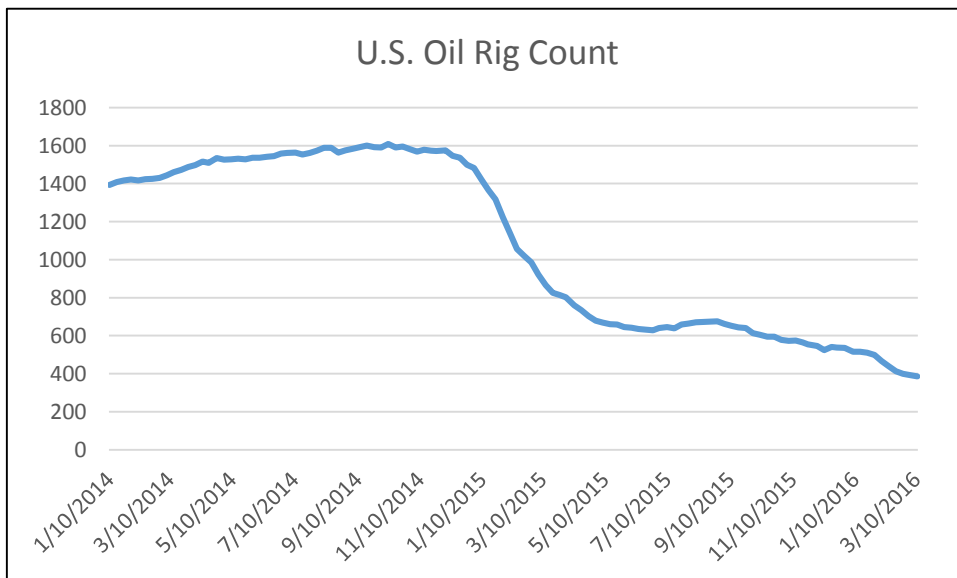
Agency	2016
International Energy Agency <sup>1</sup>	-0.75
U.S. Energy Information Administration <sup>2</sup>	0.30
OPEC <sup>3</sup>	-0.70

1. Source: IEA Oil Market Report, March 2016.
2. Source: EIA Short-Term Energy Outlook, March 2016.
3. Source: OPEC Monthly Oil Market Report, March 2016.



Source: U.S. EIA

Some high-cost sources of oil supply are beginning to be cut back in response to the low prices, notably US shale oil which has shorter development timelines compared to conventional projects. The US oil rig count has continued its decline, reaching a low of 386 units in the second week of March, down from 1,600 active rigs in October 2014.



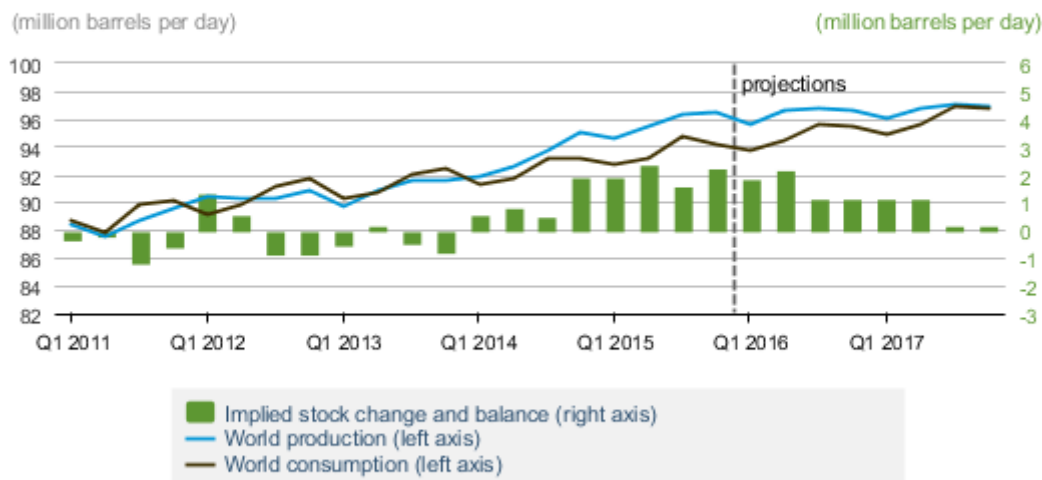
Source: Baker Hughes

## Market Balance and Inventories

The EIA expects global oil inventories to grow by an average of 1.6 million b/d in 2016 and by 0.6 million b/d in 2017, i.e. the oil glut is projected to continue until the third quarter of 2017. Hence oil prices are not expected to begin to rebound until later in 2017.

In the IEA's view, excess supply will remain high for the first half of 2016, at 1.9 mb/d in 1Q and 1.5 mb/d in 2Q, but will decline to 0.2 mb/d in both 3Q and 4Q.

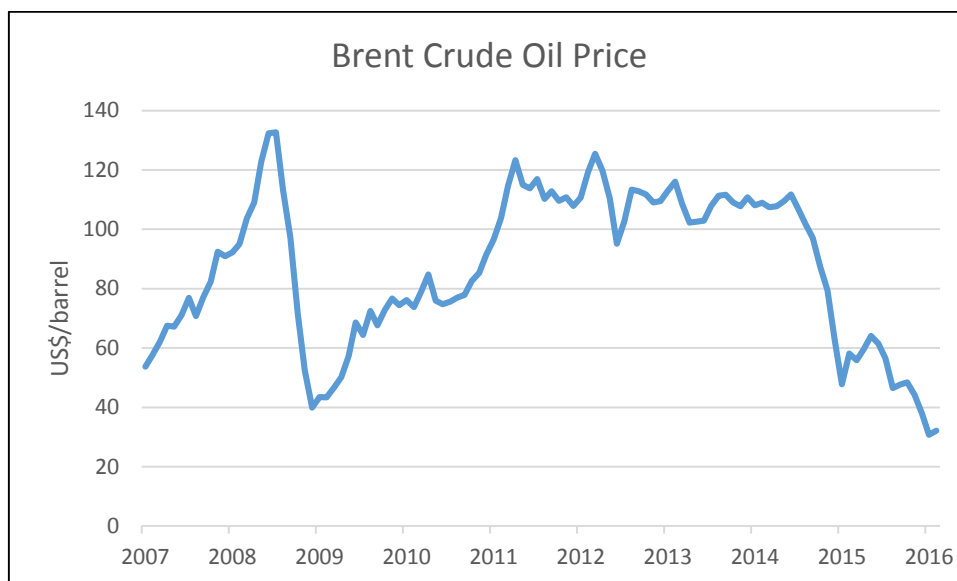
### World Liquid Fuels Production and Consumption Balance



Source: Short-Term Energy Outlook, March 2016

## Prices

Oil prices have remained very weak in recent months, with the Brent benchmark averaging \$31/bbl in January and \$32/bbl in February – prices not seen since early 2004. Prices recovered slightly to around \$40/bbl in mid-March. The main factors behind this uptick include the discussions about a possible output freeze by OPEC and Russia; supply disruptions in Iraq, Nigeria and the UAE (whose combined output fell by 350 kb/d in February); indications that non-OPEC production is falling (led by reduced output in the US and the North Sea); and recent weakness of the US dollar.



Source: U.S. EIA

The US EIA forecasts that Brent crude will average \$53/bbl in 2015 and \$56/bbl in 2016.

#### Forecasts of Brent Crude Oil Price (US\$/bbl)

Agency	2015	2016	2017	2018
International Energy Agency <sup>1</sup>	55	62	67	70
U.S. Energy Information Administration <sup>2</sup>	52.9	55.8		

1. Source: IEA Medium-Term Oil Market Report 2015. These are “assumptions” rather than “forecasts”, according to the IEA.
2. Source: EIA Short-Term Energy Outlook, March 2016.

## Analysis

The recent behaviour of oil markets has surprised many analysts in several ways:

- Prices have plumbed depths not experienced for more than a decade, before the Chinese-led commodity boom in the mid-2000s.
- Supply has proved to be more resilient to low prices than anticipated (i.e. more price inelastic). This is partly because of lags between investments in new oil fields and when production comes online. Many new projects were commissioned between 2011-2014 when prices were in triple digits, and some of these have come on stream just as prices collapsed. In many cases producers cannot simply shut the valves when prices drop, but have to keep producing to maintain well integrity and meet debt obligations. Shale oil companies have found ways to cut costs, but have reduced drilling drastically and are producing from an inventory of previously drilled wells in order to meet debt obligations. However, exploration spending has been severely curtailed since the price collapse began in mid-2014 (Wood McKenzie estimates that about \$380bn worth of projects have been delayed or cancelled); this sets the stage for a possible spike in oil prices in a few years’ time as a consequence of sharply reduced supply.

- Oil demand has similarly been surprisingly unresponsive to the huge drop in prices (i.e. price inelastic). Usually, a price fall of this magnitude would have given a fillip to the world economy, but this impact has apparently been outweighed by negative consumer and investor sentiment and the slow-down in the Chinese economy as it restructures.

The collapse in oil prices is having serious impacts on the finances of oil exporting countries. Many of these countries rely on oil revenues for between 50-90 percent of their government revenue. Thus the drop in prices has forced many governments to curtail spending and increase borrowing. Cuts in social spending is in turn putting increasing political strain on some of these countries (e.g. Saudi Arabia and Venezuela) and thus adding to risks to future oil output in these producers.

Up until the last year or two, an “oil crisis” was synonymous with a price spike (as in the spike to \$147/bbl in 2008). Now, however, really low prices are seen by many as a crisis. This reflects the fragile state of the global economy, where deflation is seen as one of the biggest threats to economic and financial system health. Furthermore, the global oil and gas industry’s debts almost tripled between 2006 and 2014, from about \$1.1tn to \$3tn. These companies are now struggling to repay their debts as revenues have shrunk drastically. Some commentators say this is the latest financial bubble (following the 2007 housing bubble and the 2000 dot.com bubble), which is in danger of bursting if oil price do not recover soon. Over 50 smaller US oil and gas companies have entered bankruptcy since the beginning of 2015.

A potentially important factor for the oil market in the medium to longer term (the 2020s and beyond) is the continuing improvement in battery electric and hybrid vehicle technology, and falling costs of these alternative vehicles. Battery prices fell by 35% in 2015, and according to analysis by Bloomberg New Energy Finance, unsubsidized electric vehicles could be price competitive with petrol cars within six years. Combined with pressures to reduce air pollution and carbon emissions, these developments could reach a tipping point after which the new technology rapidly displaces the century-old internal combustion engine.

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