جدوى للإستثمار
Jadwa Investment

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Quarterly Oil Market Update

Volatility Returns to Oil Markets

Summary

- Both OPEC and non-OPEC cuts are contributing to a reduction in global oil balances. Latest OPEC data shows that crude oil production from OPEC members averaged 32 million barrels per day (mbpd) in Q1 2017, down 1.6 mbpd from October 2016 levels. Meanwhile, Russia, who also committed to cuts, has reduced oil production too.

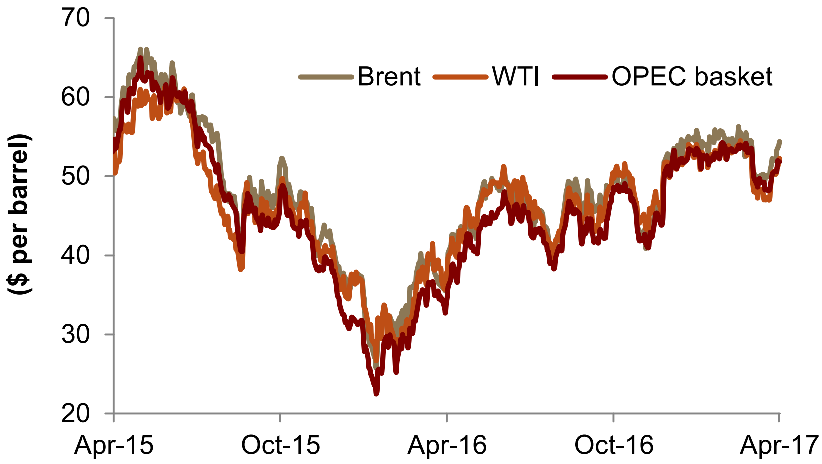
- That said the risk of a faster rebound in US oil production and the lack of sustained decline in record commercial crude stocks saw prices drop by as much as 5 percent in one day in early March. Prices have rebounded since then, partially as a result of a risk premium attached to regional geopolitical developments but also due to talks of an extension to cuts in OPEC production.

- As it stands, there are risks attached to both of the possible outcomes related to the issue of extending OPEC cuts.

- If no extension in cuts is agreed then the risk is that, with no caps on production, OPEC could recommence competition for market share, as was the case prior to the agreement, and push its production much higher than current levels.

- On the other hand, if the cuts are agreed and successfully implemented, oil markets would tighten further which would put upside pressure on prices, thereby encouraging an even steeper rebound in US oil output.

Figure 1: Oil prices more volatile in recent weeks



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Overview

Although oil prices rose 10 percent quarter-on-quarter in Q1 2017...

...volatility levels were up too, especially towards the end of the quarter.

Oil prices rose 10 percent quarter-on-quarter in Q1 2017, but volatility levels were up too, especially towards the end of the quarter (Figure 1). Whilst initial stability in prices was bought about through coordinated action by OPEC (Figure 2) and some non-OPEC members, the risk of a faster rebound in US oil production and the lack of sustained decline in record commercial crude stocks saw prices drop by as much as 5 percent in one day in early March. Prices have rebounded since then though, partially as a result of a risk premium attached to regional geopolitical developments but also due to talks of an extension to cuts in OPEC production. Looking ahead, latest OPEC data points to year-on-year oil demand growth of 1.2 mbpd in Q2 2017, effectively flat on a quarter-on-quarter, and still below the average yearly growth of 1.57 mbpd seen in the last two years. That said, demand is expected to pick up in H2 2017, with yearly growth expected to rise marginally to 1.3 mbpd.

No Major Growth in Demand Ahead

Although Q1 2017 yearly motor gasoline demand dropped by 3.2 percent year-on-year…

...but strong growth in US light truck sales should help gasoline demand turn positive in Q2 2017.

In the **US** (21 percent of global oil demand), provisional Q1 2017 data shows that yearly motor gasoline demand dropped by 3.2 percent year-on-year. The decline is most probably a result of abnormally high consumption during last year when pump and oil prices dropped to multi-year lows. According to US Energy Information Administration's (EIA) forecasts, Q2 2017 year-on-year gasoline demand will pick up marginally, with a similar trend in growth throughout H2 2017. Gasoline demand will be helped along by the strong growth in US light truck sales. Latest data from the US Bureau of Economic Analysis shows that light trucks, which consume more gasoline per kilometer compared to a regular car, made up 60 percent of total US vehicle sales in March, compared to only 50 percent two years earlier (Figure 3). If light truck sales continue to make up a larger proportion of total vehicle sales going forward, this could present an upside to US gasoline and total energy consumption.

A weaker euro and higher yearly oil prices are affecting demand in Europe…

European oil demand (15 percent of global oil demand) was down by 2 percent in Q1 2017 year-on-year. Continued structural factors, such as fuel substitution, tepid economic growth in combination with a weaker euro and higher year-on-year oil prices negatively

Figure 2: Strong OPEC compliance to cuts in Q1 2017 (secondary sources)

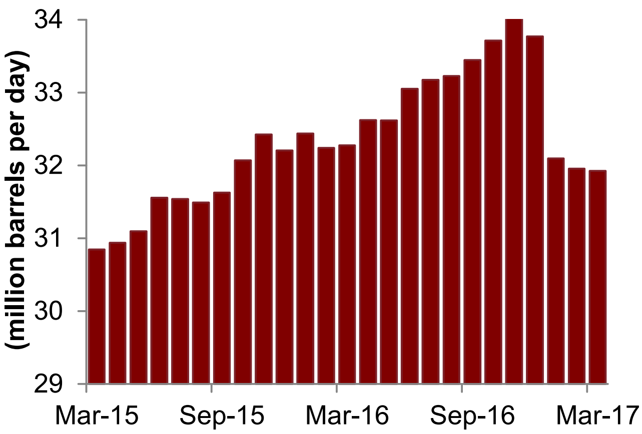
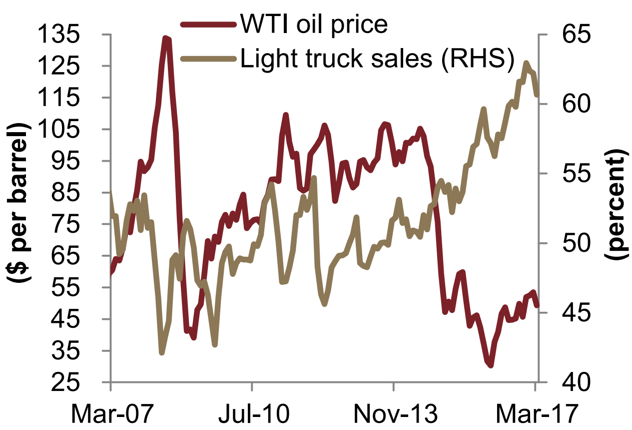


Figure 3: WTI prices and US light truck sales as a percentage of total vehicles sales



...in addition to structural factors.

impacted demand. Looking ahead, following the UK's recent announcement to begin its formal exit from the European Union, the risks of weakening political cohesion between the remaining members of the Euro zone, and the repercussions on the economy, and therefore oil demand, are high. As it stands, Q2 2017 should see some growth in oil demand, but the above factors will ensure that growth will be kept to a minimum for the rest of the year, with risks to downside if political factors have detrimental economic knock-on effects.

Chinese crude imports were up 15 percent year-on-year in Q1 2017…

...at highs of 8.2 mbpd.

Data for Q1 2017 shows that **China** (12 percent of global oil demand) imported record levels of crude oil, at 8.2 mbpd, up 15 percent year-on-year. This rise in imports was, in part, driven by independent oil refiners' additional purchases of oil after receiving fresh import quotas in January. Oil import growth is expected to remain strong during the year since the Chinese National Petroleum Company (CNPC) is expecting China to import an average of 7.95 mbpd in 2017. Aside from higher demand from independent refineries, Chinese crude imports remain supported by lower retail pump prices, rising vehicle sales, and ongoing efforts to boost strategic and commercial crude oil stocks (Figure 4).

Indian oil imports were flat year-on-year…

...as measures to ban high denomination currency bills disrupted the Indian economy.

Measures taken by the Indian government to ban high denomination currency bills at the end of last year resulted in disruptions to the **Indian** economy (5 percent of global oil demand) in Q1 2017. As a consequence, crude oil imports were flat during the first quarter of 2017, year-on-year, in contrast to 15 percent growth seen in the previous quarter. A breakdown of Q1 2017 imports shows that Saudi Arabia remains the largest supplier of crude oil to India, at 19 percent of total imports. Other significant suppliers include Iraq at 16 percent of total imports. Iran's market share has increased in the last year. Just prior to the lifting of most international sanctions, Iran's crude oil export market share stood at 4 percent, but has since risen to 15 percent (Figure 5). However, a dispute over the development of an off-shore gas field between the two countries could see India cutting Iranian oil imports up to 20 percent. Looking ahead, in Q2 2017 and beyond, strong economic growth with industrial expansion and rising car sales will help boost overall India crude oil consumption by 5 percent in 2017 as a whole, despite flat growth seen in the first few months of the year.

Figure 4: China's crude oil imports

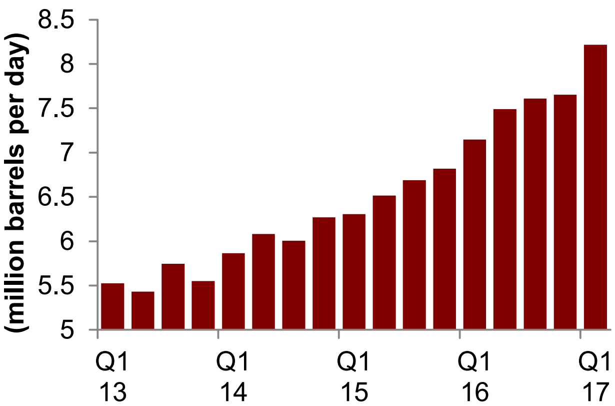
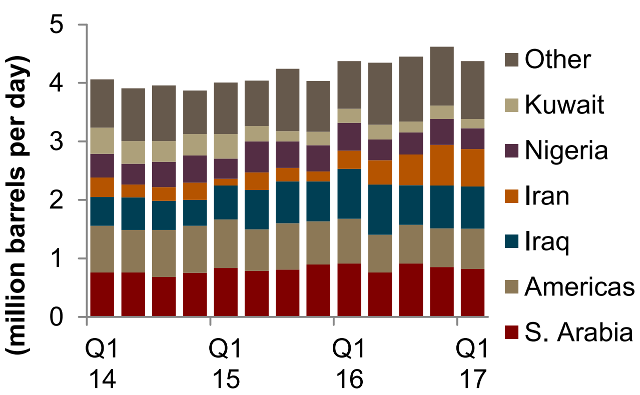


Figure 5: Indian crude oil imports by country



Japanese oil demand will remain in the negative territory in Q2 2017 and year-on-year in 2017.

Japanese (3 percent of global oil demand) crude oil imports have been declining consistently, year-on-year, in the last two years due to slower economic growth, rising fuel efficiency, and cuts in refining capacity. Accordingly, Q1 2017 oil imports were down by 3 percent, year-on-year. The Japanese economy is not expected to improve massively and further closure of refinery capacity will keep crude oil demand in the negative territory in both Q2 2017 and 2017 as a whole, with further downward pressure on demand if more nuclear reactors are restarted.

Preliminary data shows Saudi Arabia's domestic consumption was down a sizable 15 percent year-on-year in Q1 2017...

Latest data available, for January 2017, shows **Saudi Arabia's** domestic consumption (3 percent of global oil demand) being down by a sizable 15 percent year-on-year. A fall in consumption was seen across almost all energy types. Most notably, a combination of improved energy efficiency, higher gas usage, and subdued economic activity led to the lowest consumption in crude oil (for generating electricity) in the Kingdom in almost eight years (Figure 6). Lower demand was also seen across all refined products, except liquid petroleum gas (LPG), on a year-on-year basis.

...as a result of slower economic growth, rising energy efficiency, and larger gas supplies.

Going forward, slower growth in the economy and the continued effects of higher year-on-year gas output should keep oil consumption rises to a minimum in Q2 2017, even as demand picks due to hotter weather. Looking further ahead into H2 2017, oil demand will be negatively affected after the government links household electricity prices to a yet to be determined reference price from mid-2017 onwards. Despite this, six power plants are scheduled to come on-line during the year, and both Sadara and Petro Rabigh II petrochemical complexes will reach full capacity, which should push Saudi consumption back up. Overall, due to the above factors we see Saudi consumption remaining flat, at around 2.9 mbpd year-on-year in 2017.

OPEC Cuts Holding

Latest OPEC data shows that crude oil production from OPEC members averaged 32 mbpd in Q1 2017.

Latest OPEC data shows that crude oil production from OPEC members averaged 32 mbpd in Q1 2017. This output equates to 1.6 mpbd less than the organization's October 2016 output, the reference point for agreed cuts. That said, if we exclude Indonesia's oil production from OPEC's October 2016 total, since the country's

Figure 6: Saudi crude oil consumption (for electricity generation) lowest in eight years

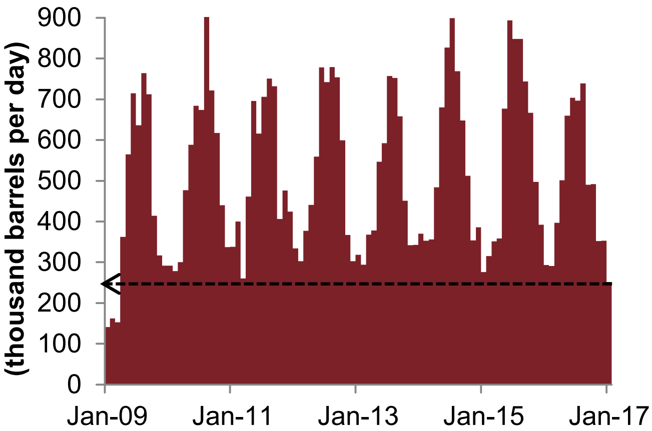
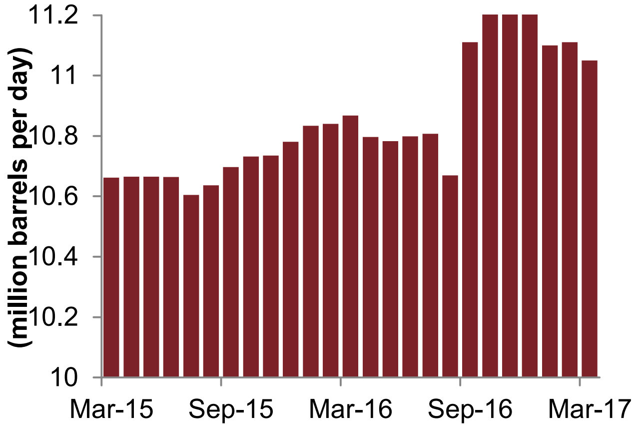


Figure 7: Russian crude oil production declining slowly



Russian oil output was 200 tbpd lower than October 2016 levels…

membership was suspended at the end of 2016, the cut amounts to 900 tbpd in Q1 2017. Although this is lower than the 1.2 mbpd agreed upon by the group, it still represents a high degree of compliance.

...but less than the agreed 300 tbpd cut…

...although the Russian government has stated it expects to reach 100 percent compliance by April.

Russian oil output averaged 11.05 mbpd in March 2017, which equates to a 200 tbpd reduction to October 2016 levels, and less than the agreed 300 tbpd cut (Figure 7). Whilst larger oil producers have met their production cuts, the problem lies with getting smaller operators to comply. The higher proportional impact of cuts on smaller companies is the main reason why they have been reluctance to comply, to date. That said, the Russian government has stated it expects to reach 100 percent compliance by April. If this were not to occur, then the risk of non-compliance from other non-OPEC producers who together agreed to contribute a further of 258 tbpd cut, is also likely to increase.

Global commercial oil inventories remain at record highs…

...paving the way for potential extension in OPEC cuts.

Although both OPEC and non-OPEC cuts are contributing to a reduction in global oil balances (Figure 8), global commercial oil inventories nevertheless remain high. According to OPEC data, OECD commercial oil inventories were unchanged in Q1 2017, quarter-on-quarter, remaining around record levels (Figure 9). As a result, a number of OPEC countries recently agreed to review the possibility of extending OPEC cuts for another six months. So far, Kuwait, UAE, Angola, Saudi Arabia, and Iraq have reportedly signaled interest towards extending production cuts for another six months, until the end of 2017 (Box 1).

As it stands, there are two outcomes:

i) OPEC decides not to extend cuts beyond June…

Box 1: Extension in OPEC cuts

As it stands, there are two outcomes related to the issue of extending OPEC cuts:

i) OPEC decides not to extend cuts beyond June:
Currently, total inventories are partially inflated due to planned refinery outages, as maintenance is carried out, as is usually observed around March/April time. Hence, even without an extension in cuts, markets are expected to tighten from May onwards, as global refineries come back on-line and summer demand picks up. Using OPEC demand and supply forecasts, and

Figure 8: OPEC cuts could help re-balance oil markets more quickly (year-on-year change)

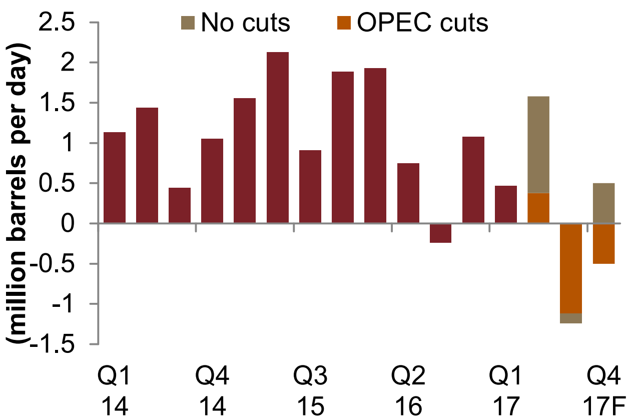
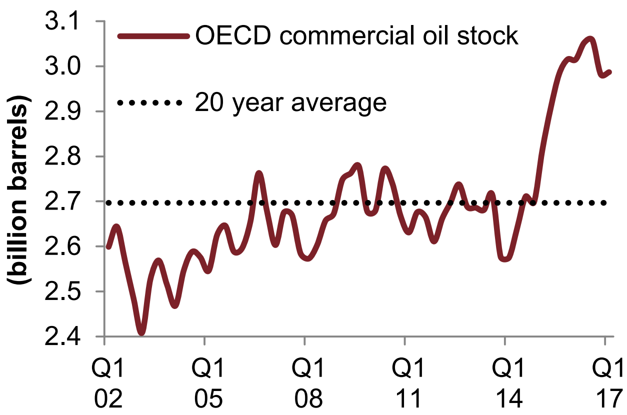


Figure 9: Global oil stocks remain around record highs



...which could result in all-out competition for market share amongst OPEC members again…

assuming OPEC reverts to pre-cut production of 33 mbpd, we can see that global oil balances would be in surplus by an average of just 200 tbpd in H2 2017 (Figure 8). The risk is that, with no caps on production, OPEC could recommence competition for market share with even more intensity and push its production beyond 33 mbpd. This coupled with forecasted rises in US production, especially as US producers are protecting themselves against a drop in prices with a record number of short positions against WTI prices, could result in markets being significantly oversupplied again.

...or ii) OPEC decides to extend cuts beyond June…

ii) OPEC decides to extend cuts beyond June:
If OPEC extends the deal, there are two major risks with this option. Firstly, if after agreeing to cuts there is a lack of follow through by OPEC members, this could lead to a situation similar to one described above, i.e. recommencement of competition for market share. Secondly, if the cuts are successfully implemented, and tighter oil markets do occur, this would put upside pressure on prices and could encourage an even steeper rebound in US oil output.

...which encourages US producers to raise production even further.

Forecasts for US oil production have already been revised upwards in the last six months, and with the US government's pro-oil agenda still be fully implemented *(see our report previous Quarterly Oil Market Update: All eyes on OPEC and the US for more details)*, extended OPEC cuts could encourage US producers to raise production even further.

N.B The decision to cut will be made at the next OPEC meeting on May 25th, 2017.