جدوى للإستثمار
Jadwa Investment

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Quarterly Oil Market Update

Oil prices buoyed by geo-political risk

Summary

- Oil prices have moved higher in response to the war between Israel and Hamas (Figure 1). Traders are concerned that the violence could intensify and spread, possibly pulling in state actors and threatening oil supply. We think these fears are overdone, but appreciate that miscalculation or over-reach by one or more of the parties involved could see containment unravel very quickly. If prices were to push durably above $100 per barrel this could tip the global economy into recession.

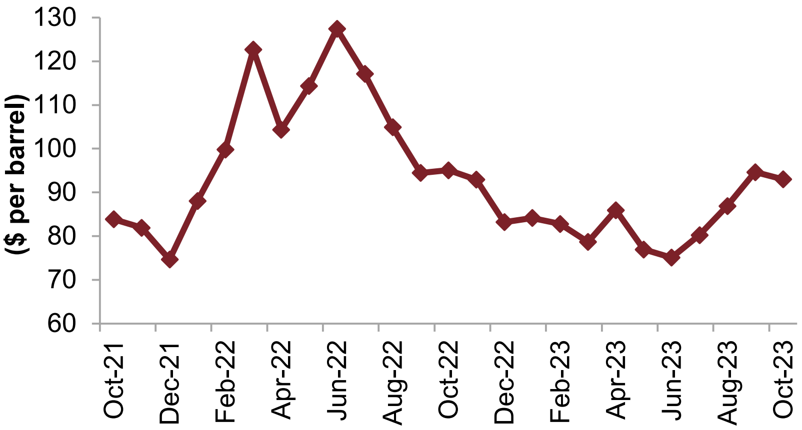
- The latest upturn in prices reverses an earlier downturn caused by the surge in longer-term US Treasuries. This upward shift dulled appetite for risk assets, including oil. Nevertheless, fundamentals remain tight, with demand for products such as diesel especially high. In part, this reflects a long period of underinvestment in refineries.

- Meanwhile, demand has held up well in the US and even in Europe, which is restocking as another winter looms without meaningful Russian energy supply. Demand from China is also brisk, shrugging off the weakness in the country's property sector as services such as transport and tourism gather pace. India's oil product demand is also very strong.

- Resilient demand comes against a backdrop of constrained crude supply, with both Russia and Saudi Arabia rolling over the production cuts they made earlier in the year. Unwinding these will need to be carefully timed given the likelihood of a sharp slowdown in the US. From a Saudi perspective, the best time would be when the US Federal Reserve has moved into rate-cutting mode, which is likely to be in H2 of next year.

- The heightened uncertainty and geo-political risk makes oil price forecasting particularly hazardous, but assuming fundamentals reassert themselves we expect Brent to average $88 pb in 2024, up from an estimated $85 pb this year.

Figure 1: Brent surges as war erupts between Hamas and Israel



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Overview

Oil prices have been volatile, reflecting gyrations in financial markets and violence in Gaza and Israel.

Oil prices have been buffeted by two competing forces in recent weeks. For much of the second half of September and into October prices were pulled lower by a surge in US Treasury yields, which hurt demand for most risk assets including oil. Put simply, higher Treasury yields made risky assets look poor value in comparison, and investors were drawn to the "risk free" asset instead. The impact of this on prices was pronounced, with Dated Brent giving up most of its Q3 gains.

This trend was abruptly halted by the outbreak of war between Israel and Hamas in early October. Although the violence has so far been geographically contained, there are fears that other actors might be drawn in, with implications for oil supply. As such, traders appear to have assigned a large geopolitical risk premium to the oil price, and by late October Dated Brent was just below $90 a barrel (pb).

Despite this volatility, fundamentals remain tight and stocks are falling (Figure 2). Products, especially gasoline and diesel, are in high demand. Yet the outlook remains as hazy as ever, with intensive speculation about how long the US can sustain its good economic momentum, and when OPEC Plus might choose to unwind its production cuts.

Demand

Fundamentals are tight, with demand stronger than might be expected in key consuming areas.

Demand for oil products remains robust, with diesel and, to a lesser extent gasoline, in high demand. This is a structural issue, reflecting underinvestment in refinery capacity—especially in Europe—over the past decade or so. More immediately, the US economy continues to surprise on the upside, with better-than-expected employment reports continuing to confound long-standing expectations of a sharp downturn in economic activity. US gasoline consumption in Q3 was down year-on-year, but only marginally (-0.7 percent) and overall liquids consumption was up a touch (Figure 3). Early macro-economic data for Q4 suggests that the US economy is far from "stall speed" with the labor market still marking strong monthly gains (labor "hoarding" appears to be playing a significant role here). That said, the full impact of the Federal Reserve's monetary tightening is yet to feed through and a large number of economists think that the US economy could quite suddenly lurch into recession, or something close to it, in the months ahead.

Figure 2: Oil stocks have fallen

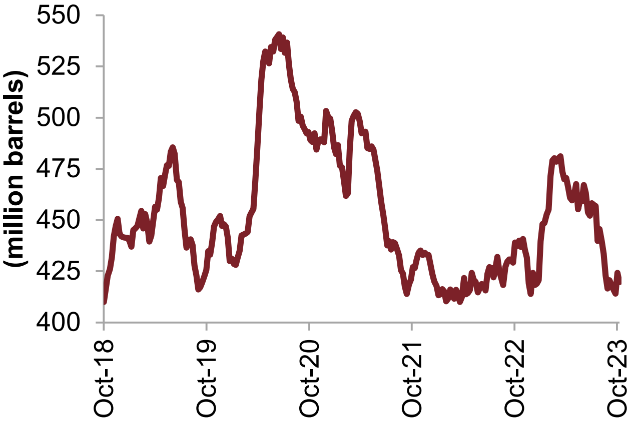


Figure 3: US oil consumption has held up (year-on-year)

India's booming economy is supporting oil product demand…

As well as US resilience, oil is being supported by firm South and East Asian demand growth, especially from India, China and Indonesia. India's manufacturing activity is especially strong, and oil product demand grew by 5.7 percent in September, year-on-year. Despite a slew of negative headlines, China's oil demand is robust: the three month rolling average of crude oil imports grew by 31 percent, year-on-year, in August (Figure 4). While there is an element of restocking here, the more fundamental reason for this growth is the shift in oil demand away from the country's beleaguered property/construction sector towards transport and logistics, which is thriving. Today, transport and logistics accounts for around 70 percent of China's oil demand, up from around 40 percent a decade or so ago. Revived tourism is also boosting demand for aviation fuel, as a backlog in exit visas is addressed.

...while China's demand is also much stronger than some macro data would suggest.

Demand is also drawing strength from the Middle East, with brisk demand from the Gulf helping to offset softness in the Levant and North Africa and lifting overall liquids demand by 2 percent, year-on-year in the third quarter, according to the Energy Information Administration (EIA). Even in Europe, where economies are flagging under the weight of higher interest rates, oil demand is holding up reasonably well with total liquids down by less than 1 percent in Q3, year-on-year. This likely reflects restocking as the continent braces for another winter without meaningful Russian energy supplies.

Yet the surge in US Treasury yields pressurized all risk assets, including oil.

Despite this underlying demand strength, prices were pulled lower by a surge in longer-term US Treasury yields as traders began to realize that the US government's fiscal outlook is weak and, separately, that the private sector will have to absorb a lot of Treasuries as the Federal Reserve unwinds its quantitative easing program (Figure 5). The re-rating of yields made equities and commodities look comparatively poor value against these "risk free" assets and a rapid sell-off ensued. The associated rise in the USD also dulled appetite for oil since most potential oil buyers do not hold the greenback. However, this drag came to an abrupt end with the outbreak of serious violence between Hamas and Israel in early October.

<u>Supply</u>

Views about supply have been dominated by the violence in Israel and Gaza.

This conflict is clearly dominating views about oil supply. Traders are concerned that the violence within Israel and Palestine might spread to include other regional actors, with the potential that supply from the Gulf could be squeezed or even stopped. According to this

Figure 4: China's oil demand is strong despite macro weakness

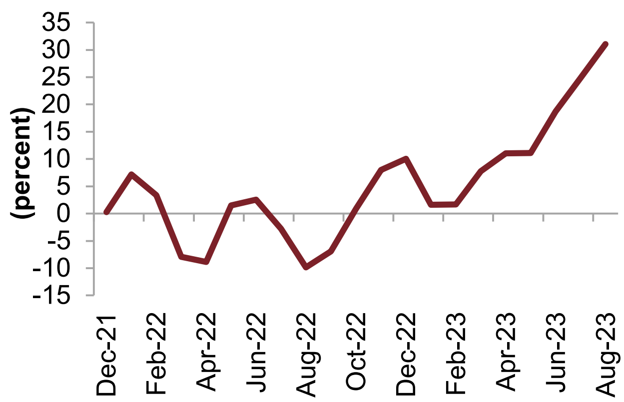
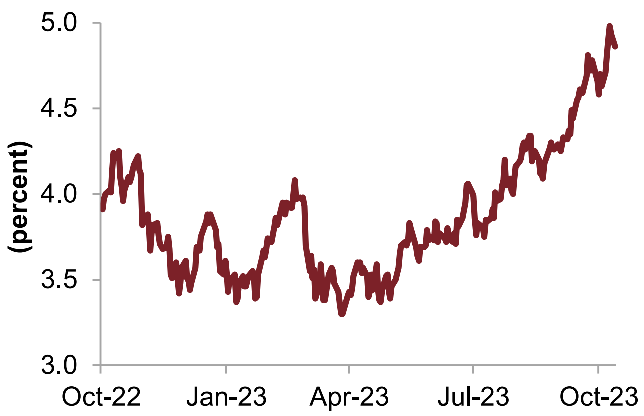


Figure 5: The yield on the Ten Year Treasury has shifted up



We think the situation will be contained and there is no material threat to oil supply. However, the risk of an escalation cannot be dismissed.

narrative, there are two ways that this might happen. One would be if Iran became sufficiently aggressive that it might disrupt the flow of oil exports, such as by launching attacks against shipping through the Straits of Hormuz or GCC oil facilities. The second—and less alarming—scenario involves the US squeezing Iran's exports by enforcing existing sanctions more rigorously (Figure 6).

We do not give much credence to either scenario. Prior to the violence in Israel and Gaza, Iran was edging its way back towards some kind of accommodation with the US. It seems unlikely that it would invite a military confrontation with the US—which has after all moved an aircraft carrier strike group to the Mediterranean—when it can influence events in the region through its proxy militias, and with considerably less jeopardy. The rapprochement between Iran and Saudi Arabia should also help to keep a lid on inter-Gulf tensions.

It also seems unlikely that the US would a) be able, or b) even want to restrict Iran's supply. Iran's main market is small refineries in China, which are eager to suck up heavily-discounted Iranian crude and have no interest in abiding by Western sanctions. Iran's exports are not priced in US dollars and involve a host of small trading firms that also appear indifferent to the sanctions regime. Nor is enhanced enforcement in the Biden administration's political interest, given the impact this might have on US gasoline prices.

Of course, it would be unwise to dismiss rising MENA tensions as "noise". There is a meaningful risk of miscalculation or over-reach by any one of the actors, which could lead to a rapid escalation, conceivably involving inter-state violence. Yet we still see this very much as a tail risk (high impact, low probability) and that the political risk premium in the oil price is too high.

Meanwhile, traders are calculating when Saudi and Russian production cuts might be unwound.

Returning to the fundamentals, changes in the flow of oil are currently being governed by OPEC Plus—specifically the timing of any unwinding of the 1.5 million barrels a day (mbpd) of combined cuts made by Saudi Arabia and Russia earlier in the year. Our view is that Saudi Arabia will remain cautious. The chances of the US slipping into recession remain quite high (above 50 percent) and even if a recession is avoided most analysts expect a sharp slowdown as the weight of interest rate increases bears down on firms and households. The shift up in Treasury yields is also unlikely to be temporary given the US's fiscal outlook. Meanwhile, the first quarter tends to be a time of higher oil stocks, and the Kingdom will not want to add to these by unwinding its production cuts. We therefore think that these cuts will not be reversed before H2 of next year (see below).

Figure 6: Iran's oil exports have been helped by significant discounting

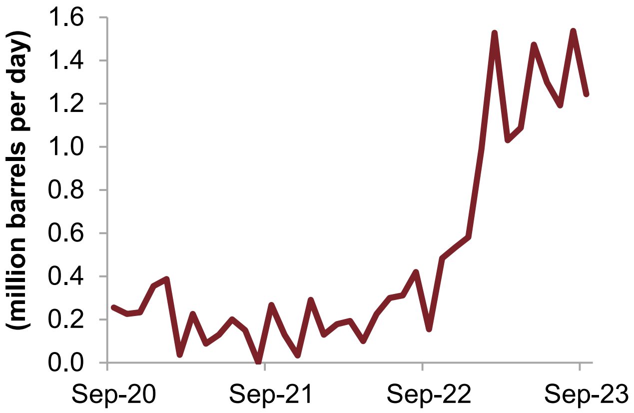
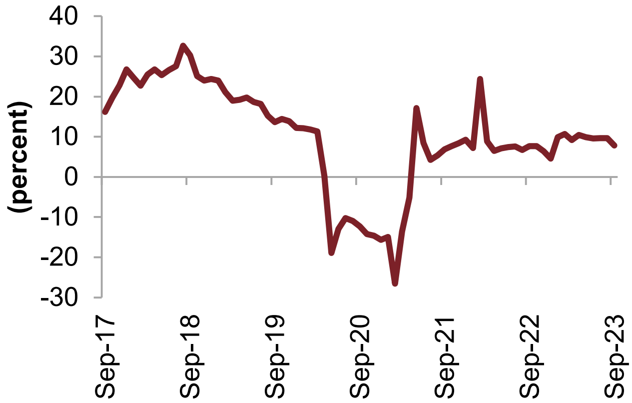


Figure 7: US shale output growth is solid, but beginning to plateau (year-on-year)



There could also be some moderate gains in output from other OPEC members next year.

There is potential for some additional OPEC supply increases, with the UAE likely to make use of its higher quota next year (adding perhaps 200,000 bpd to the country's output). Iraq's exports could also be boosted if it can reach an agreement with Turkey over suspended flows through the northern pipeline. The pipeline is ready to restart, though Baghdad is awaiting the final "sign off" from Ankara. This might add 250,000 bpd when (or if) these flows restart. The US has recently eased sanctions on Venezuelan exports, but years of underinvestment suggests that upside here is limited.

Elsewhere, the risks are largely to the downside (from a production perspective) with Libya probably at its current sustainable peak and Nigeria and Angola struggling to keep supply stable.

Recent M&A activity might boost well productivity in the Permian, but not necessarily overall output.

Non-OPEC output is dominated by the US, and in particular its tight ("shale") output (Figure 7). Here the picture is mixed, with the best acreage in the prolific Permian basin seemingly already exploited, and well productivity in danger of plateauing. Exxon Mobil's takeover of Pioneer Resources and Chevron's capture of Hess are in part meant to remedy this, with both majors confident that they can improve efficiency quite substantially. Yet more cost-effective output does not necessarily mean more output. Meanwhile, smaller producers are finding it easier to raise capital, but these funds are not typically being used to increase drilling. All in all, it seem that US shale output will continue to increase in the next year or two, but at a slowing rate. Beyond 2025, many believe that shale producers will be "drilling to stand still" given heavy decline rates.

Other non-OPEC gains could come from Brazil, which is finally beginning to fulfill its promise thanks to a government that is deploying incentives for offshore production, rather than penalizing it (Figure 8). Guyana too has considerable growth potential, albeit from a low base.

<u>Outlook</u>

Prices should ease back in the near term, assuming hostilities in the Levant are contained.

The near-term oil price outlook remains governed by events in the Levant, and possibly the wider MENA region. An escalation in hostilities that drew in other militant groups or even Iran directly would clearly see oil prices surge, most likely beyond $100 pb. But despite the potential oil revenue windfall, we doubt that Iran wants head-on conflict with Israel or indeed the US. As such, we expect hostilities to be contained and prices to fall back towards $85 pb in the weeks ahead.

Figure 8: Brazilian output is beginning to fulfill its potential

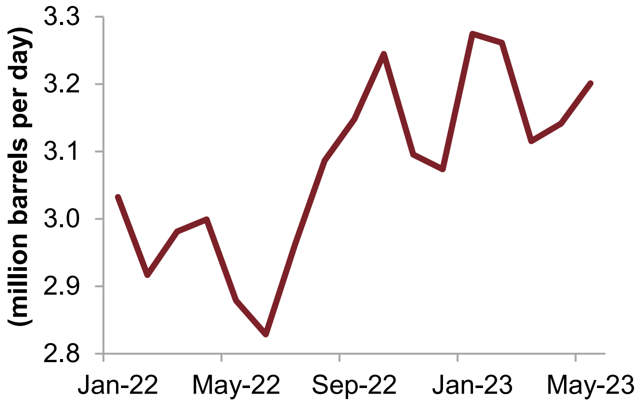
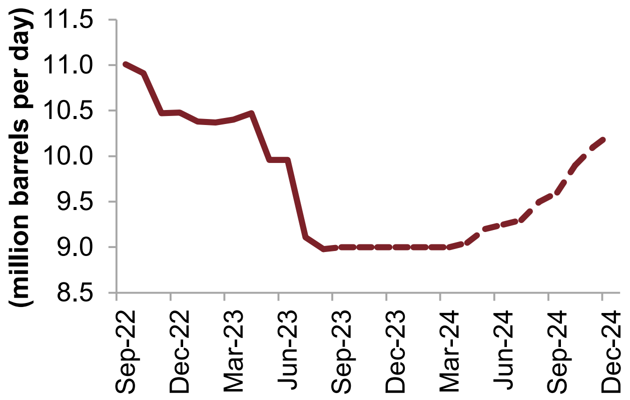


Figure 9: We see Saudi output rising quite sharply in H2-24



We expect Saudi and Russian production cuts to be unwound in H2 -24 as the Fed begins to cut interest rates.

Looking further out, the key influences are likely to be the strength of the US economy and the unwinding of OPEC Plus production cuts. We assume a sharp slowdown in the US, which will become evident in H1-24. This should prompt a Fed rate-cutting cycle, with positive spillovers for global economic activity. This, and the likelihood of a weaker USD should lend support to oil prices. It will also provide a helpful environment for Saudi Arabia and Russia to begin reversing their production cuts, and we see Saudi crude production rising to 10.3 mbpd by the end of next year, around 1.3 mbpd higher than current levels (Figure 9). Note, however, that average output in 2024 is still likely to be slightly down on 2023 (by around 1 percent) given comparatively strong production in the early part of this year.

Brent should average $88/barrel next year.

On balance, we see average prices rising next year, though not by much given the additional output that will need to be absorbed. We expect Brent to average $88 pb in 2024, up from an estimated $85 pb in 2023. The price should be around $90 pb by end-2024 assuming global economic activity gathers pace in H2.