Fundamentals and Geopolitics: a Volatile Mix for Oil

Earl Sweet, Head, Economic Risk • earl.sweet@bmo.com • 416-359-4407

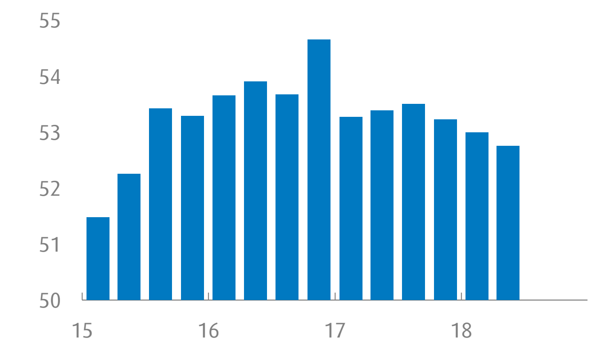
The global oil market is being impacted by fundamental drivers of supply and demand that are influencing medium- and longer-term price expectations, as well as by geopolitics, which are playing an important role in near-term pricing and in fanning volatility. The agreement in late 2016 among OPEC, Russia, and several other exporters (OPEC+) to curtail production (*Chart 1*) in order to eliminate a glut at that time, combined with surging global demand for petroleum products fuelled by low prices and strengthening global growth, succeeded in rebalancing the market. International Energy Agency (IEA) data show that OECD inventories (a proxy for global stocks) declined from 14% above their five-year average at the beginning of 2016 to a little under that benchmark in the first quarter of 2018 (*Chart 2*). Taking into consideration rising consumption during that period, inventories, as measured by the number of days of forward demand, have fallen 3.5% below their five-year average. Concurrent with the correction in inventories, oil prices have risen sharply from their lows of a couple of years ago (*Chart 3*). U.S. benchmark West Texas Intermediate (WTI) reached US$74/barrel in early July (and European benchmark, Brent, close to US$79), before retreating to $69 (Brent, $73) toward the end of the month as escalating trade tensions between the United States and China raised fears of a global economic slowdown.

While fundamentals have played a role in this recovery, geopolitics are clearly exerting a heavy hand. OPEC+ production has actually been running well below what the original agreement had specified, reflecting collapsing output in Venezuela (due to political turmoil and a failing economy), insurgency-related on-again/off-again disruptions in Nigeria and Libya, and downward trending output in Mexico, Azerbaijan, and Angola. And now, following the departure of the United States from the Iran nuclear deal, renewed U.S. sanctions on Iran could reduce its oil exports by up to 1.0mmb/d, raising supply risk in investors' minds. Prices also received a lift from a late-June power outage at Syncrude's oilsands complex in western Canada (capacity of 0.36mmb/d) that is not expected to get back to full production until the first half of September.

Wishing to avoid an unruly price spike in oil that could lead to another boom/bust, OPEC+ decided on June 23rd to raise the group's output by up to 1.0mmb/d starting in July, despite opposition from Iran and a few other participants. The intent was to eliminate unintended over-compliance with the original agreement and to prevent further market tightening. However, country-specific quotas were not announced and the actual increase is likely to be less than

Chart 1
OPEC+ Oil Production*

(million barrels per day)



* Includes oil produced in OPEC, the Former Soviet Union (capturing output in Russia, Kazakhstan, and Azerbaijan), Brazil, Mexico, Oman, and Malaysia
Source: BMO Economics

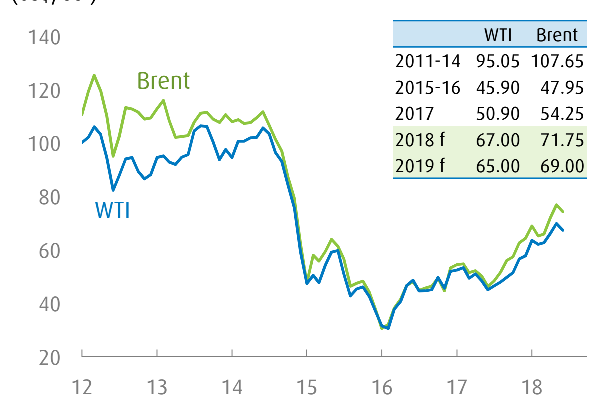
Chart 2
OECD Commercial Oil Inventories

(% deviation from 5-year average)

Source: BMO Economics

Chart 3
Oil Prices

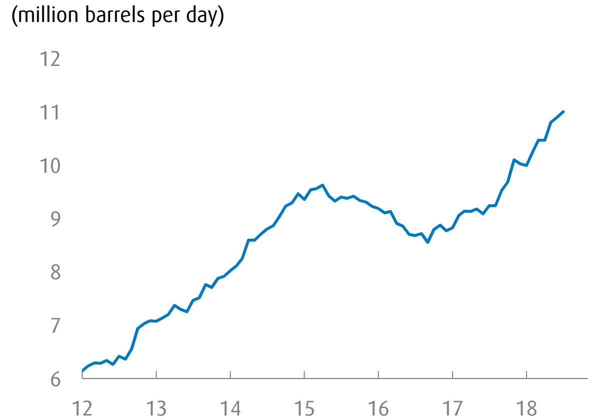
(US$/bbl)



Sources: BMO Economics, Haver Analytics
f = forecast

agreed due to capacity constraints. Only Saudi Arabia, Russia, Kuwait, and the UAE have spare capacity. Most is in Saudi Arabia, which is likely to be cautious in raising output too quickly, lest prices decline sharply in advance of the scheduled 2019 privatization of part of its national oil company. Additionally, Saudi Arabia, embroiled in regional conflicts and requiring substantial revenues to restructure the economy, has a fairly high fiscal breakeven oil price, in the vicinity of US$90/barrel (for Brent). While the planned output increase by OPEC+ is intended to offset anticipated declines in Venezuela and, later this year and in 2019, in Iran, it doesn't seem to have assuaged President Trump's anxiety (and increasingly vigorous warnings to OPEC) about rising gasoline prices in advance of the U.S. mid-term elections. Perhaps in response to concerns about the impact of rising prices on the global economy, Saudi Arabia already had increased output in June by 0.43mmb/d, as did Russia by 0.1mmb/d.

Chart 4
U.S. Crude Oil Production



Source: BMO Economics

Meanwhile, non-OPEC+ supply[1] is growing briskly. The IEA projects average gains this year and next to be concentrated in the United States (1.45mmb/d) and Canada (0.25mmb/d). That should be sufficient to meet global consumption of oil, which is forecast to climb at an average annual pace of 1.4mmb/d through 2019. With the global market remaining roughly balanced, we anticipate that WTI will average US$67/barrel in 2018 (it averaged $65.40 during the first half of the year) and US$65 in 2019. Nevertheless, volatility will likely remain prominent. Given the current global context, risks to this forecast are elevated, both to the upside and downside, though skewed to the former over the next year.

Upside risks include the following:

- a slowdown in growth of U.S. crude oil output—which has now reached 11mmb/d (*Chart 4*)—due to rising costs and production and transportation bottlenecks in the increasingly crowded Permian Basin, from where much of the growth has been emanating;
- larger-than-expected declines in supply from Iran and Venezuela;
- Iran following through on threats to disrupt the flow of oil through the Strait of Hormuz or encouraging proxies in Yemen to attack Saudi oil shipments in the Bab al Mandab Strait, as occurred on July 25th;
- market participants becoming increasingly uneasy about the diminishing buffer of global excess productive capacity available to deal with supply shocks, as Saudi Arabia, the holder of most of that excess capacity, raises production; and,
- expectations of impending supply gaps due to the sharp reduction in global investment in oil industry exploration and development following the collapse of prices in 2014-2015.

Downside risks are also prominent, including:

- slower growth in the demand for oil should trade frictions between the United States, China, and most everywhere else escalate, dampening global economic activity;
- weaker-than-expected compliance with U.S. sanctions on Iran;
- OPEC+ raising production more than intended as participants attempt to reap the benefits of higher prices.

[1] Comprises crude oil, condensates, natural gas liquids (NGLs), and oil from non-conventional sources.