Crude Oil Outlook: Sudden Supply Surplus

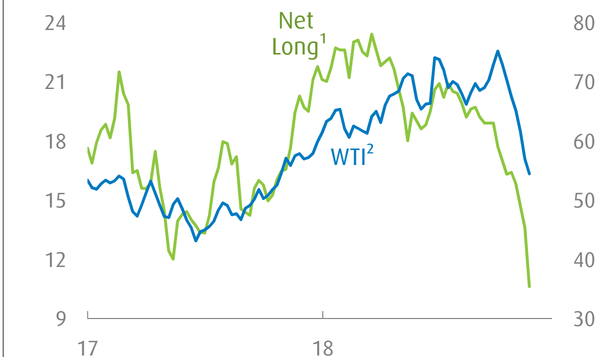
Earl Sweet, Head, Economic Risk • earl.sweet@bmo.com • 416-359-4407

Oil's swift reversal in recent weeks reflects shifting expectations of global demand and supply growth while OPEC and its partners struggle to fine-tune production in order to avoid excessive price swings. Less than two months ago, when West Texas Intermediate (WTI) had shot up to US$76/barrel (*Chart 1*) and Brent to US$86, market commentary centred on the risk of prices spiking to $100 or higher. At the time, OPEC+ production was running notably below quota due to falling output in Venezuela, Mexico, and Iran and there were concerns that production in the latter would plunge by more than 1.0 million barrels per day (mmb/d) once U.S. sanctions on the country fully took hold in early November. Meanwhile, U.S. commercial inventories of crude oil had fallen sharply to below their five-year average after having exceeded it by as much as 38% in mid-2016 (*Chart 2*). Speculative activity also contributed to the earlier rise in crude prices as the market focused on inventory normalization in the United States and overseas, the slimming buffer of global excess productive capacity (mostly located in Saudi Arabia), and the impending sanctions on Iran.

That positivity on oil ended abruptly in early October when it became clear that Saudi Arabia and Russia had agreed to raise oil production by up to 500,000 barrels/day from September levels in order to offset anticipated declines from Iran and to avoid a further destabilizing upward surge in pricing. Market bearishness was also fuelled by surprisingly large increases in U.S. production of shale oil in November (*Chart 3*) and significant inventory builds, the latter augmented by seasonal retooling and reduced throughput at refineries. The negativity associated with these developments accelerated the unwinding of long speculative positions, adding further downward pressure on pricing. Between October 3rd and November 23rd, WTI plunged $25 to $51 – with a particularly sharp drop on the 23rd as investors soured on most risk assets – and it will **likely remain under pressure as the market ponders the next move by OPEC+ at its December 6th meeting in Vienna**. Given the importance of oil to their overall economies and fiscal revenues, neither Russia nor Saudi Arabia, nor other members of OPEC+, would want to see a further reduction in prices. Ahead of the meeting, Saudi Arabia has indicated it could reduce output by as much as 0.5mmb/d in December and Russia has already begun to make small production cuts.

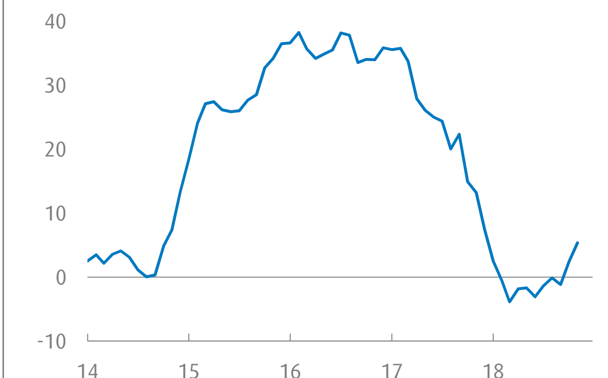
The decision that OPEC+ makes in December will be influenced by its expectation of the global oil market balance over the next year. **Global oil demand is projected to continue to grow at a healthy pace in 2019, in the vicinity of 1.4 mmb/d.** However, downside

Chart 1
West Texas Intermediate and Net Long Position on the Nymex



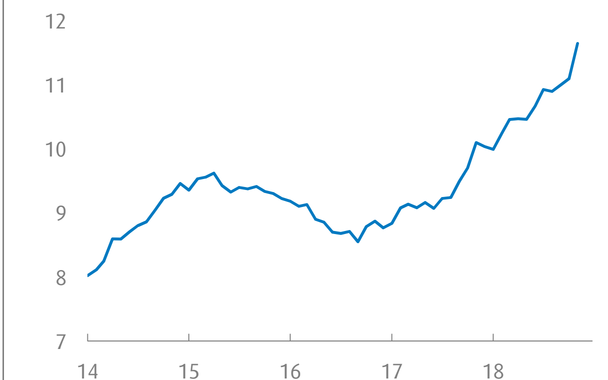
[1] (lhs : % open interest) [2] (rhs : US$/bbl)
Sources: BMO Economics, Haver Analytics

Chart 2
Crude Oil Stocks



Source: BMO Economics

Chart 3
Crude Oil Production



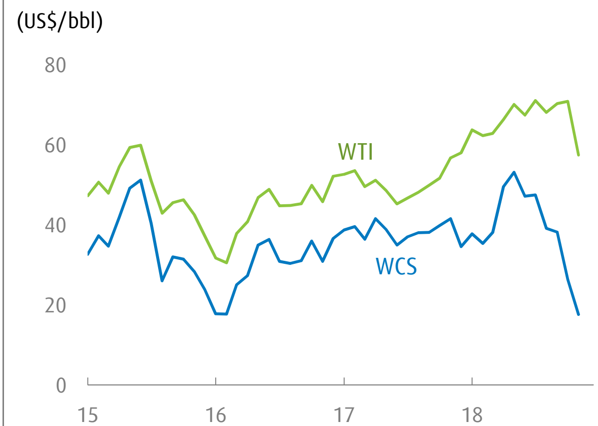
Source: BMO Economics

risks to the global economy and oil demand are prominent, given the potential for an escalating trade war between the United States and China, and rising interest rates. On the supply side, the International Energy Agency (IEA) estimates that non-OPEC oil production has grown 2.4 mmb/d in 2018, mostly in the United States, Russia, and Canada, and **expects it to rise a further 1.9 mmb/d in 2019**. Thus, without an output cut by OPEC+, global inventories would once again swing from a roughly balanced position currently to a significant glut, which would likely cause WTI to fall below $50.

Notwithstanding admonishments from Donald Trump to keep supply high and prices low, we expect that OPEC+ will cut production sufficiently to keep the market balanced in 2019. Even if WTI remains near its current level through the end of this year, it will average $65.25 in 2018. With Saudi Arabia's fiscal break-even price for oil in 2019 estimated by the IMF at US$73 (average of WTI, Brent, and Dubai) and the kingdom embroiled in costly regional conflicts, it is likely that it, supported by some other members of OPEC+, will cut production enough to raise prices moderately from current levels. We also anticipate that once stockpiles built up prior to the imposition of Iran sanctions dwindle, the full impact of the sanctions will be felt in the market. **Thus, we project WTI to rise from its current level to an average of US$62/barrel in 2019.** This is down from our previous outlook in July ($65) due to escalating risks to the global economy and a greater extent of waivers on Iran sanctions granted by the United States.

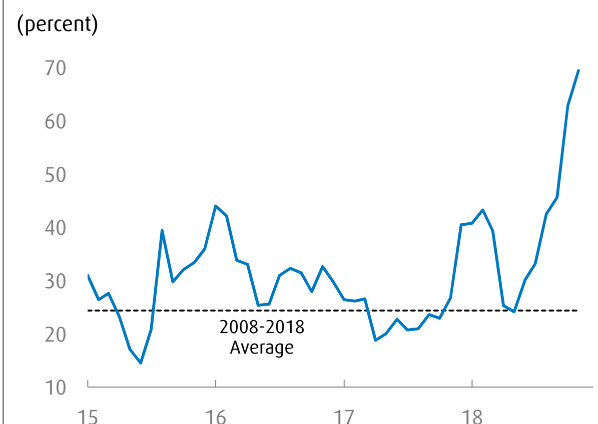
In Canada, producers will continue to be heavily challenged by a very wide discount from global oil prices until transportation capacity out of Alberta is increased. As oil production in Alberta continues to grow, the seemingly interminable delays to projects targeting expanded pipeline capacity to the United States (Keystone XL) and to the Pacific coast (Trans Mountain) have caused local supplies to accumulate. In turn, this has caused the discount on West Canada Select, a benchmark for heavy oil, to blow out to a record-high US$44.40/barrel in October (*Chart 4*). The discount as a per cent of WTI has soared to almost 70% in November (*Chart 5*), far above its 2008-2018 average of 24%. Getting back to a 'normal' discount will require new pipelines to carry Alberta crude oil to the United States or overseas markets. **While the WCS discount will remain elevated in 2019, it is likely to narrow moderately as rail transport is augmented** (*Chart 6*) and Enbridge's project to replace its aging Line 3 pipeline—from Alberta through Saskatchewan, Manitoba, and into the United States—becomes fully operational in the second half of the year.

Chart 4
WTI and WCS



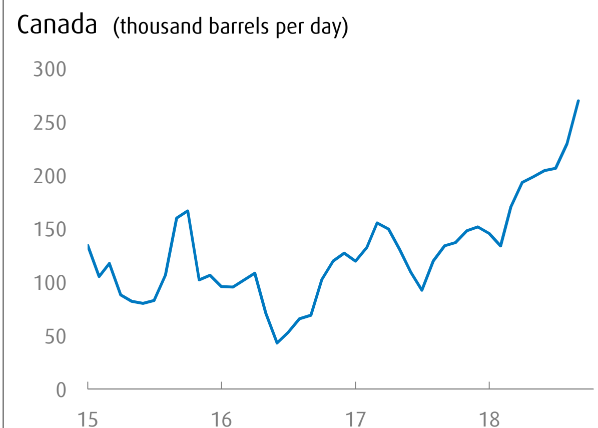
Source: BMO Economics

Chart 5
WCS Discount from WTI



Source: BMO Economics

Chart 6
Rail Shipments of Crude Oil



Sources: BMO Economics, NEB

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