QNB Economics
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Tightening physical market to exert upward pressure on oil prices

Brent crude oil prices have been particularly volatile in recent quarters, ranging between USD 86/b-USD 50/b late last year and USD 74/b-USD 59/b so far in 2019. This article aims to discuss the background behind these price movements and present an outlook for the coming quarters.

In 2018, Brent crude prices averaged USD 72/b, up from USD 55/b in 2017. Years of oversupply caused OECD commercial inventories to balloon well above their five-year average. Then between Q2 2017 and Q1 2018 tighter supply depleted global inventories, leading to a recovery in prices.

On the demand side, global synchronized growth had generated strong demand expansion, especially in the US, China, and other Asian countries.

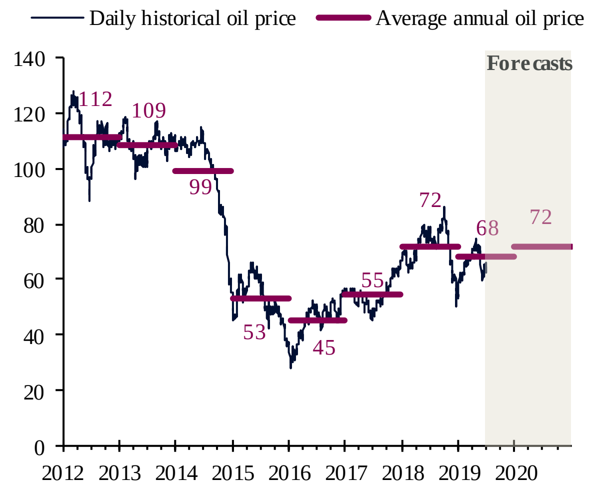
On the supply side, two elements had restrained crude production growth despite continued upside surprises in US shale production. First, major oil exporters delivered coordinated output cuts to balance markets under the so-called OPEC+ agreement, intentionally taking around 1.2 million barrels per day (Mn b/d) from the market. Second, idiosyncratic factors and geopolitical shocks reduced supply from Venezuela and Iran, taking a further 2.0 Mn b/d from global supply. This led to a supply deficit with a drawdown of OECD commercial inventories. Such re-balancing led to a recovery in oil prices which peaked at USD 86/b in October 2018.

In Q4 2018, the backdrop changed significantly. On the demand side, a gloomier outlook for growth resulted from fears of an escalation in the US-China trade dispute and tightening financial conditions due to a then hawkish US Federal Reserve (Fed). On the supply side, both OPEC and Russia ramped up production to record levels to cushion expectations of significant supply disruptions caused by the re-imposition of US sanctions on Iran. But the market was flooded with crude and Brent prices plummeted to a bottom of USD 50/b in late December 2018 as the US surprised the market with 180-day waivers to several importers of the Iranian crude.

The Brent crude prices partially recovered from the late 2018 lows to average USD 66/b in the first half of 2019 on the back of the December 2018 OPEC+ agreement to cut output by 1.2 Mn b/d. Prices were also supported by Saudi Arabia over-delivering on production cuts and harder than expected US sanctions on disrupted exporters (Venezuela and Iran). This was amplified by an improvement in market sentiment as global financial conditions loosened in response to a more dovish Fed.

Our view is that oil prices are likely going to tick up slightly over the coming quarters, even if volatility is expected to remain high due to geopolitical tensions and sudden changes in market sentiment.

Brent crude oil price
(USD/b)



Sources: Haver, Financial Times (FT), QNB analysis

On the demand side, global growth is expected to slow despite a recent US-Fed driven loosening of global financial conditions and positive early responses from fiscal and monetary stimulus in China.

On the supply side, the dynamics will be dominated by booming US shale, distressed exporters (Venezuela and Iran) and OPEC+ arrangements. In the US, infrastructure bottlenecks in the key shale oil production region of the Permian Basin in West Texas will likely ease, benefiting producers. Thus, US crude supply is expected to increase by 1.7 Mn in 2019 and 1.3 Mn in 2020. As sanctions and other disruptions could potentially affect around 1.1 Mn b/d of Venezuelan and Iranian oil exports, additional negative supply shocks would lead to an even tighter market, pushing inventories down below their five year average. Official communication from the recent OPEC+ meeting suggests that output cuts are likely to be further extended beyond March 2020. With that in mind, we expect oil prices to tick up.

Other things being equal, i.e., assuming no significant changes in the geopolitical backdrop as well as on market sentiment and growth expectations, the physical market should tighten further into a deficit over the next couple of quarters. This is expected to draw down inventories and modestly push up Brent prices to average USD 68/b in 2019. In 2020, we expect to start the year with a tight physical market that is likely to loosen gradually as additional US shale production comes onstream, placing some downward pressure on prices only towards the end of the year. Therefore, we forecast Brent prices to average USD 72/b in 2020.

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