Oil markets

Oil markets await verification of OPEC output cuts, but US shale re-emerging

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Highlights

- **Oil prices traded within a narrow range around $55/bbl for Brent and $53/bbl for WTI in Jan, before closing down by 2-3% by January's end.**
- **Volatility was limited as markets await data confirmation of OPEC/non-OPEC production cuts later this month.**
- **But output gains of 487,000 b/d (+6%) from US shale production since July 2016 suggest that prices could come under pressure in 2017.**
- **The IEA has revised up its forecast for global demand growth in 2017 by 100,000 b/d to 1.3 mb/d and expects the market to move into a supply deficit of around -0.7 mb/d in 1H17, thanks to OPEC's output cuts.**

Prices range-bound in January as markets await verification of OPEC's production cuts

January saw oil prices range-bound, with international benchmark Brent crude and US marker West Texas Intermediate (WTI) trading within a narrow band of $55-56 per barrel (bbl) and $52-53/bbl, respectively. By the end of the month, both markers did, in fact, close down slightly compared to December—Brent by -2.0% to $55.7/bbl and WTI by -2.7% to $52.8/bbl. (Chart 1.)

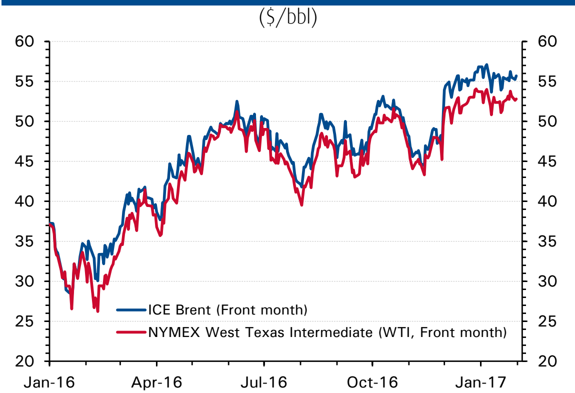
This was crude's first month-on-month decline since October, and came despite the noticeably limited volatility observed during January while markets awaited the first set of OPEC crude production figures to verify the members' compliance with the 30 November agreement.

That data should be available by mid-February, and should confirm that OPEC has made significant headway in bringing aggregate production down to its target level of 32.5 million barrels per day (mb/d). (Chart 2.)

Indeed, judging by the various ministerial comments and announcements coming out of the OPEC camp, notably from Kuwait, Saudi Arabia and the UAE, there is every possibility that OPEC could overshoot its target altogether.

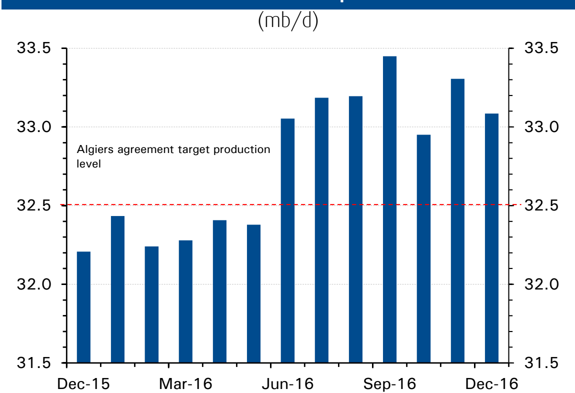
Saudi Arabia's Energy Minister, Khaled Al-Falih, remarked last month that the kingdom had gone beyond its obligations and reduced output to less than 10 mb/d; Saudi Arabia's target production level is 10.058 mb/d. The minister also followed up by suggesting that OPEC might not need to extend the 6-month deal beyond June, as global supply would be sufficiently in tune with global demand. Prices would then have, presumably, stabilized around a new equilibrium that would be acceptable to the oil exporters.

Chart 1: Crude oil prices
($/bbl)



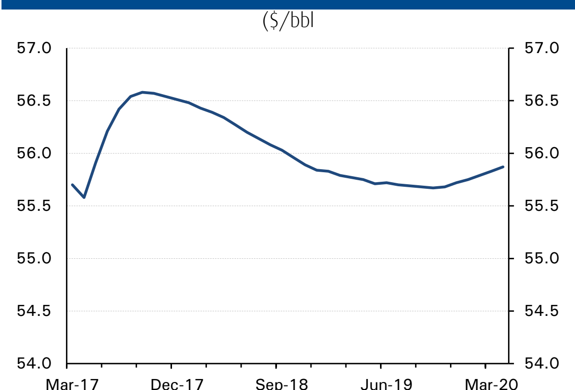
Source: Thomson Reuters Datastream

Chart 2: OPEC crude production
(mb/d)



Source: OPEC secondary sources

Chart 3: Brent forward curve
($/bbl



Source: Thomson Reuters Datastream

Futures markets are pricing in lower supply during 1H17 and crude stock draws/higher supply in 2H17

Brent futures are currently pricing in such an eventuality, but the spread between the spot and mid-year futures price was, as of 31 January, less than a dollar at $56.5/bbl. After this peak the futures curve moves from contango into backwardation, with longer-dated futures priced lower than nearer-term futures—at least until 2020. (Chart 3.) Lower prices in the second half of this year could be a sign that the market is expecting sizeable stock draws—or that it believes that the OPEC/non-OPEC agreement will not be extended and non-OPEC supply, especially US light tight oil production (LTO), or shale, as it is commonly known, will re-emerge strongly.

US shale production creeping up, filling some of the OPEC supply void

Indeed, according to weekly US production data provided by the US Energy Information Administration (EIA), US crude output, with shale at the forefront, is recovering well. Since its 2016 low of 8.43 mb/d in July, US production has surged by 6%, or 487,000 b/d to 8.92 mb/d as of 27 January. (Chart 4.) 30% of that gain has come in the last 4 weeks, when prices have been at their highest in 18 months. Also, US rig counts were back up to 712 last week as drillers brought back 78% more of the rigs that they had idled during the oil price downturn, at the rate of about 9 rigs a week, since May's rig count low of 404.

In recognition of the robustness of US LTO production and the efficiency with which US drillers have managed to eke out additional output, the International Energy Agency (IEA) has revised its estimate for US production growth this year by 110,000 b/d and in 2018 by 300,000 b/d. The agency now expects a "significant" boost in US shale output in a higher oil price environment.

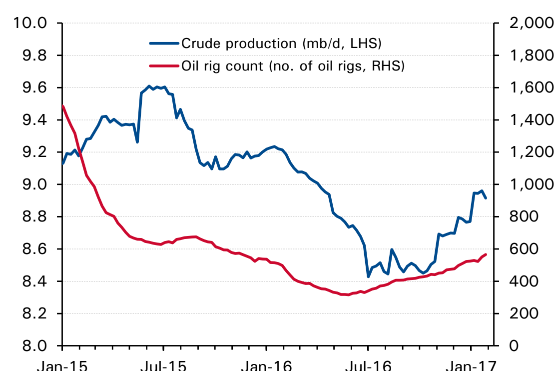
Moreover, the expectation of higher oil prices in 2017-18 appears to be spurring oil majors to get back into the game. Capital spending by oil companies is projected to rise this year, by 3%, to $450 billion after two consecutive years of declines, according to a report by Wood Mackenzie. Rystad Energy, another consultancy, has estimated that 15 billion barrels of oil equivalent (boe) in new offshore production capacity will be sanctioned in 2017, compared to only 6 billion boe last year.

With demand growth outpacing supply growth in 1H17, the market is expected to move into a supply deficit of 0.7 mb/d

On the demand side, the IEA has just revised up its global oil demand forecast for 2016 and 2017. The agency now estimates that growth will come in 120,000 b/d higher at 1.4 mb/d in 2016 and 100,000 b/d higher at 1.3 mb/d this year thanks to better-than-expected US crude demand and revisions to Russian and Chinese crude data. (Chart 5.)

Taken together, still-relatively buoyant crude demand growth and curtailing OPEC/non-OPEC supply should see the balance of supply and demand swing into deficit of around 0.7 mb/d during 1Q and 2Q of this year. That should bode well for oil prices over the next 6 months. It is the longer-term outlook that is far from certain.

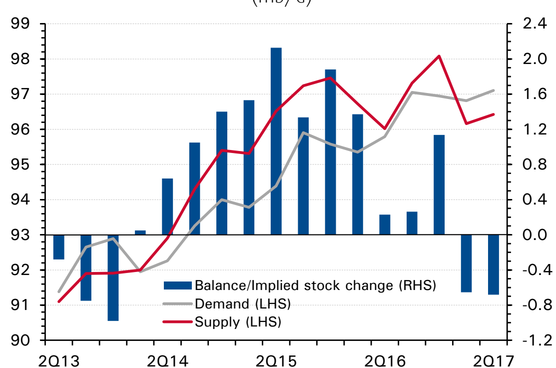
Chart 4: US crude oil production and oil rig counts



Source: US Energy Information Administration (EIA)

Chart 5: Balance of global supply and demand

(mb/d)



Source: IEA; assumes OPEC/non-OPEC cuts implemented as announced

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