جدوى للإستثمار
Jadwa Investment

April 2018

Quarterly Oil Market Update

Volatility is back

Summary

- Rising optimism around global economic growth, continued OPEC compliance to output targets and rising geopolitical tensions all contributed to pushing Brent oil prices to an average of $67 per barrel (pb) in Q1 2018, up 8 percent quarter-on-quarter.

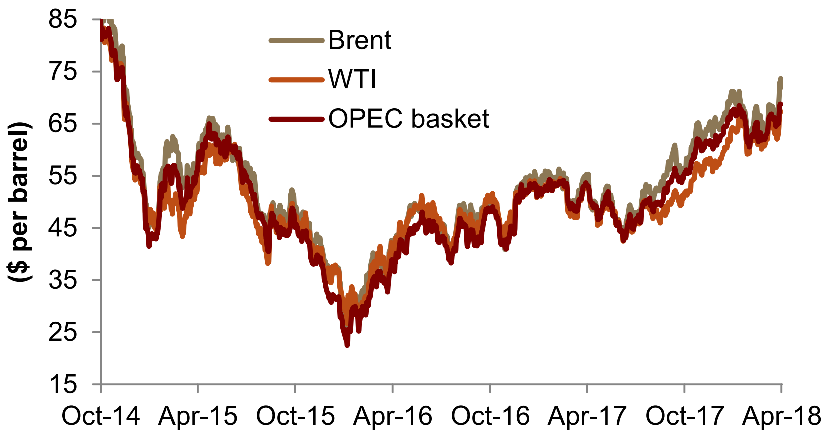
- Although oil prices were pressured somewhat at the start of April, due to trade tensions between China and US, they have since rebounded, as regional geopolitical tensions have become more predominant. In fact, in the last few days, oil prices have surged above $70 pb, to levels not seen since October 2014 (Figure 1).

- Meanwhile, latest available data shows that both OPEC and Russia have been adhering to previously agreed production levels, and their efforts have contributed to bringing commercial crude oil stocks back in line with long term averages.

- More recently, the argument for extending OPEC and non-OPEC cooperation seems to have moved towards incentivizing upstream investment, with talks of a prolonged output agreement likely to feature heavily in the upcoming Joint Ministerial Monitoring Committee.

- Looking ahead, the biggest factor affecting oil prices is related to whether or not sanctions are reapplied on Iran. In May 2018, the US president will decide whether or not to waiver the current nuclear deal, all of which could have a sizable impact on oil output and oil prices.

Figure 1: Oil prices at highs not seen since October 2014



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Despite a sizable expected rise in oil demand in 2018 as whole, at 1.63 mbpd…

...this level of growth still represents a second consecutive yearly decline in global oil demand.

Lingering fears that the US government may institute further protectionist trade measures could put pressure on oil prices.

OPEC data shows that crude oil production from its members averaged 32.1 mbpd in Q1 2018, showing no change quarter-on-quarter.

Oil demand stable:

Three countries are expected to contribute nearly 60 percent of yearly rises in global oil demand in Q2 2018, with China contributing 28 percent, the US 14 percent and India 15 percent. These three countries will also be the main drivers of growth beyond Q2, significantly contributing to OPEC's forecasted yearly global oil demand growth of 1.63 million barrels per day (mbpd) in 2018 as whole. Despite 2018's growth being comfortably higher than the annual average rate seen in the last ten years, two points stand out. Firstly, the latest revision for March 2018 is the eight monthly revision to oil demand since OPEC first published its 2018 forecast back in July 2017 (Figure 2). March 2018's forecast is 370 thousand barrels per day (tbpd) higher than the July 2017 total. Secondly, despite the sizable expected rise in oil demand expected in 2018, this level of growth still represents a second consecutive yearly decline in global oil demand (Figure 3).

Last month, the US government imposed tariffs on Chinese steel and aluminum imports, which was swiftly countered by China imposing higher duties on some US goods. Although oil prices were pressured somewhat towards the end of Q1 2018 (see oil price section below), the fallback was motivated by investor risk-off sentiment, rather then any direct impact on oil demand itself. Currently, the lingering fear is that the US government may institute further protectionist trade measures, leading to heightening trade tensions between the two largest economies, and oil consumers, in the world. Such a fallout would have inevitable negative effects on global growth, and would put significant pressure on the oil prices. As it stands, the rhetoric between China and the US has cooled in recent days, and with it, so has investor's fears over a full blown trade war.

OPEC compliance continues:

OPEC data shows that crude oil production from its members averaged 32.1 mbpd in Q1 2018, showing no change quarter-on-quarter. Overall, in Q1 2018, OPEC total output equated to 1.5 mbpd less than the organization's October 2016 output, the reference point for the production agreement (Figure 4). Venezuelan production declines continued into Q1 2018, helping the country inadvertently achieve cuts in excess of 400 percent to its agreed level (Figure 5). The Latin American country is still battling an economic crisis,

Figure 2: Annual global oil demand growth forecasts in each monthly OPEC report

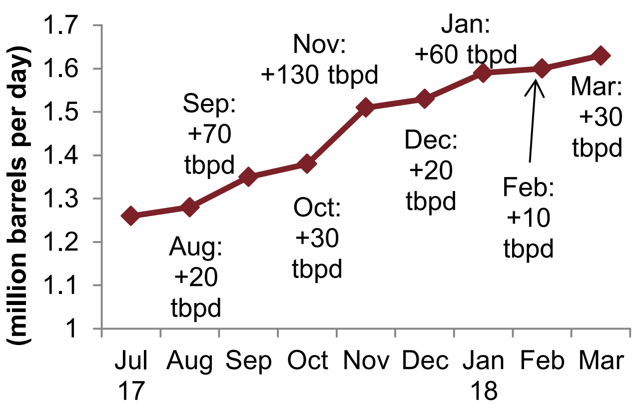
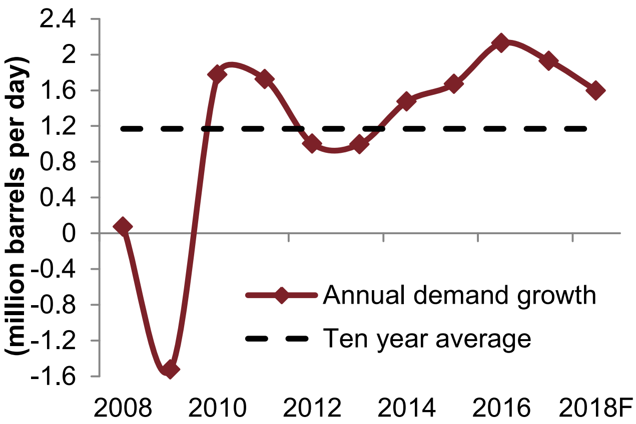


Figure 3: Global oil demand growth and ten year average



Looking ahead, the biggest factor affecting OPEC output in Q2 2018 is likely to be related to whether or not sanctions are reapplied on Iran.

Meanwhile, Russia, another major contributor to the current production agreement, has also kept oil production steady.

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meaning oil revenues will continue to be diverted to government revenue, therefore leaving very little cash for capital expenditure to reverse a decline in oil output.

Looking ahead, the biggest factor affecting OPEC output in Q2 2018 is likely to be related to whether or not sanctions are reapplied on Iran. In May, the US president will decide whether or not to waiver the current nuclear deal, all of which could have a sizable impact on output and oil prices. Any return to sanctions would have the most extensive and immediate impact on oil markets. Previously, combined US and European Union (EU) oil sanctions removed more than 1 mbpd of Iranian oil exports between 2011 to 2015, although it would be less this time around since the EU is not as keen to implement sanctions. That said, European customers may still be forced to scale back purchases of Iranian oil, if US sanctions were reapplied, since this would make financial transactions with Iran more complicated and riskier.

Meanwhile, Russia, another major contributor to the current production agreement, has also kept oil production steady. Data from the Russian Ministry of Energy shows that crude oil production averaged 10.96 mbpd in Q1 2018, with no change from the previous quarter (Figure 6). In the past, some privately owned oil companies had stressed their unease over the production agreement with OPEC, but recently disclosed financial results tell a different story. According to full year 2017 earnings data from five companies, who together account for circa 76 percent of total Russian crude oil production, combined net profits rose by 46 percent, or circa $5 billion, year-on-year. Such a sizable rise in profitability, despite overall Russian oil output declining in 2017, provides a huge incentive for such companies to continue engaging in cuts.

<u>What will be decided in the JMMC?:</u>

In the recent past, the idea of extending OPEC and non-OPEC oil output cooperation into 2019 was aired for possible discussion at the upcoming Joint Ministerial Monitoring Committee (JMMC). The reason for the extension; to lower commercial oil stocks which have been rising since late 2014. However, latest OPEC data shows that OECD commercial crude oil stocks are now trending down towards the five year average, which somewhat weakens the argument for an extension to an output agreement (Figure 7).

Figure 4: OPEC crude oil production remains constrained

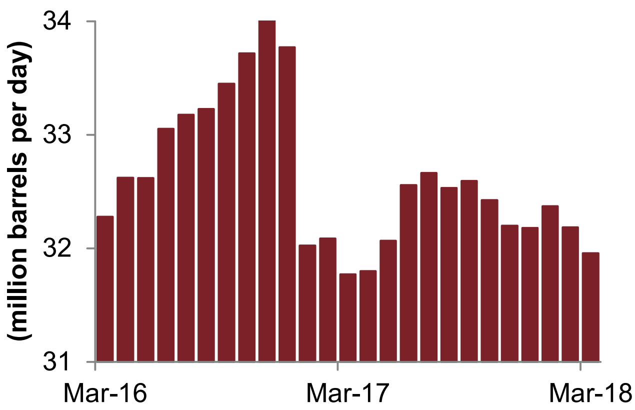
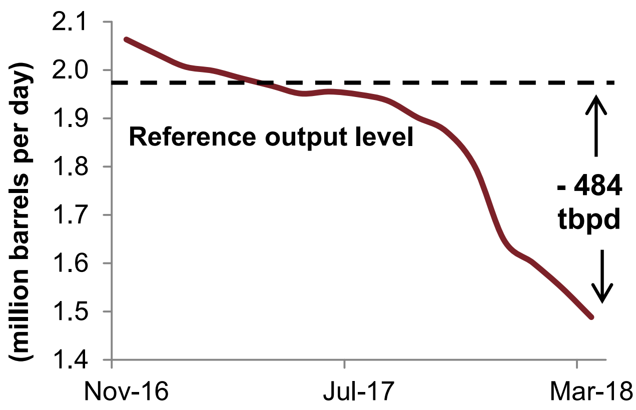


Figure 5: Current Venezuelan oil production is 484 tbpd less than the agreed reference level



According to the International Energy Agency (IEA), the global oil industry needs to replace around 3 mbpd of oil every year, in order to avoid a price spike.

As a result, the upcoming JMMC may see some participants pushing for continued cooperation in order to encourages upstream capital expenditure.

The latest Short Term Energy Outlook by the EIA shows that total US crude oil production averaged 10.2 mbpd in Q1 2018, up 13 percent year-on-year.

The combination of a widening WTI-Brent oil price differential and the recent rebound in US crude oil production is resulting in record levels of oil exports coming out of the US…

...with a rise of around 800 tbpd still possible in the months ahead.

More recently, the argument for extending OPEC and non-OPEC cooperation seems to have moved towards incentivizing upstream investment. According to the International Energy Agency (IEA), at current oil demand growth rates, and factoring in oil field depletion rates, the global oil industry needs to replace around 3 mbpd of oil every year, for the foreseeable future, in order to avoid a price spike. The main concern is that the current levels of upstream capital expenditure, after dropping significantly in recent years, may not be sufficient to avoid price volatility in the next few years (Figure 8). As a result, the upcoming JMMC may see some participants pushing for continued cooperation in order to maintain oil prices at a level which encourages a rebound in upstream capital expenditure and, in turn, provides security against future price cycle volatility.

Shale oil helping US oil exports:

The latest Short Term Energy Outlook by the US Energy Information Administration (EIA) shows that total US crude oil production averaged 10.2 mbpd in Q1 2018, up 13 percent year-on-year. The EIA also revised its forecasts for 2018 and 2019 upwards again, with oil production now expected to average 10.7 mbpd during 2018, up 15 percent year-on-year, and 7 percent in 2019, at an average of 11.4 mbpd (Figure 9).

The combination of a widening WTI-Brent oil price differential and the recent rebound in US crude oil production is resulting in record level of oil exports coming out of the US. Latest EIA data shows that US exports in March 2018 averaged 1.7 mbpd, close to record highs of around 1.8 mbpd seen back in October 2017. According to the Oxford Institute for Energy Studies (OIES), the US has a theoretical export capacity of 3.2 mbpd, but current infrastructure constraints put capacity closer to 2.5 mbpd. Accordingly, a rise of around 800 tbpd is still possible in the months ahead, especially as US crude oil output hits record highs towards the end of 2018 and again in 2019. If exports do rise in the near future, both OPEC and Russia would likely see increased competition in their traditional markets, especially so if these same countries agree to extend their production cooperation, and, with it, continue to curtail supply to customers.

Figure 6: Russian crude oil production steady

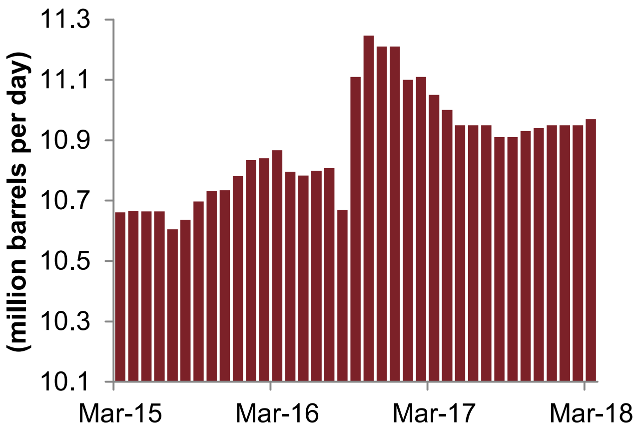
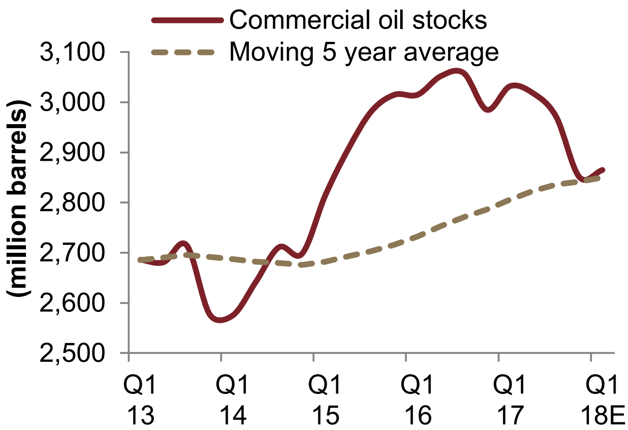


Figure 7: OECD commercial oil stocks vs. five year average



Brent oil prices averaged $67 pb in Q1 2018, up 8 percent quarter-on-quarter.

Looking ahead into the remainder of Q2 2018, as we highlighted above, the biggest factor affecting oil prices in Q2 2018 is likely to be related to whether or not sanctions are reapplied on Iran.

<u>Quarterly oil price outlook:</u>

Brent oil prices averaged $67 pb in Q1 2018, up 8 percent quarter-on-quarter. Rising optimism around global economic growth, continued OPEC compliance to output targets and rising geopolitical tensions all contributed to pushing prices to levels not seen since Q4 2014.

Although oil prices were pressured somewhat at the start of April, due to trade tensions between China and US, they have since rebounded, as regional geopolitical tensions have become more predominant. Looking ahead into the remainder of Q2 2018, as we highlighted above, the biggest factor affecting oil prices is likely to be related to whether or not sanctions are reapplied on Iran. In fact, according to officials from the National Iranian Oil Company (NIOC), if sanctions were reapplied, and circa 400- 500 tbpd of Iranian oil was removed from the market, oil prices could jump to $80 pb or more.

With year-to-date Brent oil prices averaging $67 pb and likely to remain elevated in the near term due to continued regional geopolitical tensions, there is a sizable upside potential to our current Brent oil price forecast of $60 pb. That said, we have decided against reviewing our forecast until the key developments surrounding US's decision on Iranian sanctions in May, and the outcome of the JMMC later this month, are known.

Figure 8: Global upstream oil & gas capex

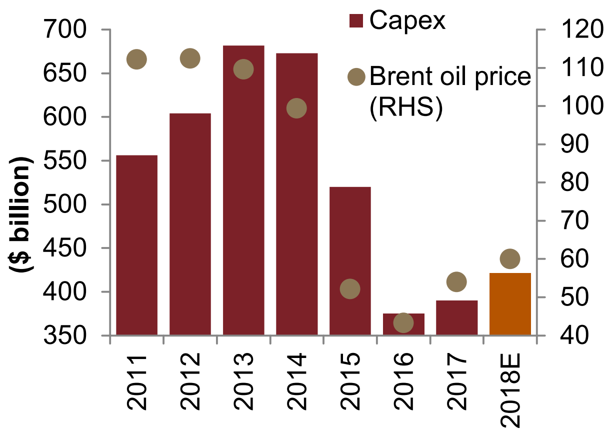
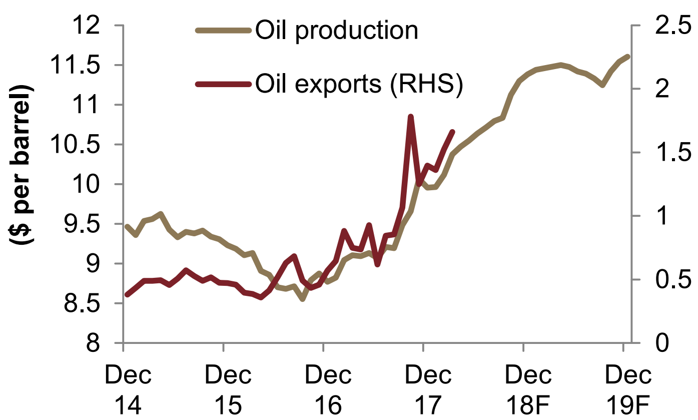


Figure 9: US crude oil production and exports
(million barrels per day)



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