

April 2019



THE OXFORD
INSTITUTE
FOR ENERGY
STUDIES

An Overview of the Crude Oil Market 2019

Executive Summary

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In the second half of 2018, the oil market exhibited high volatility not only in terms of price levels but also time spreads and quality spreads. After reaching highs of \$81/b and \$71/b in October, monthly Brent and WTI prices ended the year in December at \$57/b and \$49/b respectively. At the same time, time spreads switched from backwardation to contango, as inventories rose above their 5-year average and the prospects for global demand worsened amid supplies increasing. The spreads between light sweet-medium sour crude also exhibited wide volatility, with the Brent-Dubai and WTI-Dubai spreads collapsing signaling a shortage of heavier sour crude globally.

Brent and WTI prices have gained significantly since December 2018, ending-March 2019 near \$67/b and \$60/b respectively (about \$10/b higher), and time spreads are once again in backwardation. That said, while the Brent price in the front of the curve has increased sharply since the last quarter, the back end of the forward curve remains relatively sticky at around \$60/b, suggestive of the fact that the dominant narrative remains relatively bearish. This presentation provides an overview of the oil market and price dynamics in early 2019, discussing the key challenges in the year ahead and examining possible outcomes.

The OPEC policy reversal in the second half of 2018 and the resulting sharp increases in OPEC and non-OPEC production that followed, aggravated by the strongest year on record of US shale supply growth accompanied by weaker demand growth, have led to a large build up in stocks driving the market out of balance. So far in 2019, however, these bearish factors have been fading. Saudi Arabia has been sending strong signals about balancing the market, and the unique circumstances which prompted multiple U-turns in Saudi oil policy last year will not necessarily be repeated in 2019. The renewed OPEC+ cutback deal of December 2018 is in full force and three months into the agreement Saudi Arabia has already cut more than pledged and announced that deeper cuts are planned for April.

President Trump has already this year sent out two of his infamous 'oil tweets' asking OPEC (and indirectly the Kingdom) to relax its output cuts, however this time around Saudi Arabia will be far more cautious in reversing its output policy. The ambiguous signals from the US regarding its Iranian waiver policy back in November 2018 have made Saudi Arabia very wary regarding its output policy, with domestic factors pertaining to balancing state finances and maintaining a large cushion of reserve assets also shaping its oil policy. However, the US holds most of the 'wildcards' that could shape market outcomes in 2019 (e.g. US-China trade tensions, Iranian and Venezuelan oil sanctions) which taken together are expected to complicate OPEC output policy looking forward.

US shale growth is expected to slow down in 2019, albeit yearly average growth will remain high. The Permian, which is the primary driver of US shale growth, is facing productivity challenges and capacity constraints which are expected to be resolved in the second half of the year, while the lower oil price environment means that companies operating within cash flow will find it difficult to increase



drilling activity and expenditure without sharp price increases in the near future. On the upside, the increased presence of oil majors in the Permian is expected to boost growth in the medium-term.

Against this background, geopolitical risks will continue to weigh on the oil market outlook in 2019. The latest round of US sanctions targeting Venezuela's oil sector amid the deepening political and economic crisis besetting the country, have accelerated production declines and pose significant challenges for the recovery of the oil industry both in the short- and medium-term. Similarly, the re-imposition of US sanctions has effectively blocked recovery of Iran's oil sector and is already inflicting pain on the country's oil production and exports. The US policy of uncertainty regarding the extension of oil waivers past their expiration in May looms large, with the likelihood of further losses of Iranian barrels in 2019 remaining high. Supply prospects from Libya and Nigeria also remain uncertain. Despite the recovery of Libya's output in 2018, stability in the country remains crucial for the recovery of its oil production to pre-crisis levels. Nigeria's oil sector will continue its declining trend in oil production and investors' uncertainty will persist unless there is an end to the militant violence in the Niger Delta and the country can decisively implement the long-standing transformation of its oil sector.

OPEC output cuts, geopolitical supply disruptions, and another year of strong growth in US shale production are aggravating the sweet-sour imbalance and causing the spreads to narrow. The IMO2020 ruling is expected to have the opposite effect, widening the spreads as refineries seek low sulphur grades. But a further supply shortage of heavy sour barrels in 2019 (e.g. due to the extension of OPEC cuts or increased geopolitical disruptions) may keep the sweet-sour differentials narrow affecting refinery margins.

Despite the supply outlook in 2019 suggesting a tight market, the biggest uncertainty remains the prospects of the global economy and oil demand. Global expansion has slowed and the growth outlook for 2019 has been revised downwards, with the balance of risks to growth prospects tilting further on the downside. The OECD economies losing their momentum, while in China the ongoing trade tensions with the US, and a recent decline in the growth of exports amid deleveraging, are all bearish factors. It is yet to be seen whether the Chinese government's efforts to stimulate the economy through monetary and fiscal policy will have the desired effects, albeit these stimulus measures could run against much needed deleveraging. On the other hand, oil demand has yet to show any strong signs of deceleration and growth in 2019 is expected to remain robust at 1.4 mb/d, with most of the growth is expected to come from emerging economies.

Our reference forecast suggests that the oil market in 2019 is set to return to a balanced mode, with the Brent price expected to recover to \$68/b on an annual basis. However the underlying supply/demand forces driving the expected price recovery will remain volatile. In fact, the Brent prospect that considers over twenty combinations of forecast scenarios reflecting near-term market risks and derives the conditional price outcome highlights that our reference price is mostly sensitive to downside risks pertaining to weaker demand, higher non-OPEC supplies and another US foreign policy reversal (i.e. renewal of waivers); all of which can push the reference price lower to \$63/b annually. These results are consistent with the back end of the forward curve that has rarely moved above \$60/b, reasserting the fact that the narrative around strong US shale growth, lower oil demand growth, and uncertainty about OPEC behaviour is still dominant.