Oil Market Recovery Under Pressure

Executive Summary

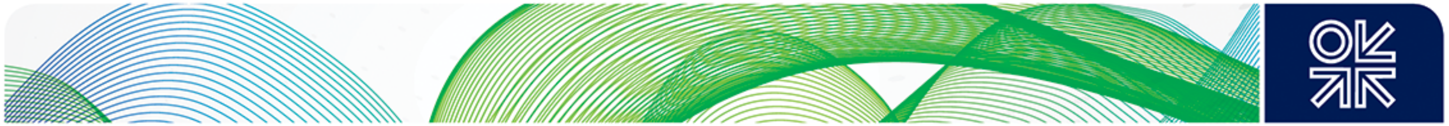
After achieving month-on-month gains in every month between May and August, the Brent price shed some of these gains in September and October. After rebounding by $20.9/b since April, the monthly Brent price fell by $3.8/b between August ($44.3/b) and October ($40.5/b) but held in the $40/b-$45/b range for the fifth consecutive month. In September, our analysis shows that demand factors accounted for nearly the entire $3.2/b m/m decline as weaker than expected oil demand growth contributed to price declines for the first time since April by $0.6/b, while negative speculative demand pressures reflecting demand concerns amid a renewed virus resurgence continued to build on the downside for the third consecutive month, dampening price growth by $5.3/b. Supply-side factors particularly high OPEC+ compliance provided steady support for prices by $3.7/b, albeit the return of Libya production lowered prices by $1/b.

While the main risks facing the oil market are still being dominated by demand factors and the surge of COVID-19 resulting in new lockdown measures particularly in Europe, the risks on the supply side have also been on the rise. On the demand side, two trends are becoming apparent:

- The recovery of oil demand has been slower than expected back in May and June leading to downward revisions in oil demand forecasts for 2020 and 2021. Global oil demand is now expected to take longer to reach its pre-crisis level.
- The pace of demand recovery is highly uneven both in terms of geography and fuels.

The global oil demand data in Q3 2020 and Q4 2020 reflect these two trends. In Q2 2020, oil demand is estimated to have fallen to around 83 mb/d, a year-on-year decline of 16.4 mb/d. In Q3 2020, it is estimated that demand increased to almost 94 mb/d i.e. an 11 mb/d increase quarter-on-quarter but still a year-on-year decline of 7 mb/d. In Q4 2020, oil demand is projected to increase only to 94.9 mb/d, a mere increase of 0.9 mb/d quarter-on-quarter and a year-on-year decline of 6 mb/d. In other words, the global oil demand recovery seems to have almost stalled.

The pace of oil demand recovery has been highly uneven. In terms of geography, Asian demand remains robust led by China and India. China's crude imports have been higher y/y, though imports have slowed in recent months (in October, m/m crude imports fell by around 12%) and China's equilibrating role has eased. However, China' imports are expected to rise driven by higher import quotas for next year. Data from India has been strong across the board. Indian sales of diesel rose by 17% on the month in September while jet-kerosine consumption rose by nearly 30% on the month. But the most spectacular growth has been seen in gasoline sales which rose not only on a month-on-month basis, but also year-on-year (+22,000 b/d). Preliminary data indicate similar robust performance in October. The robustness of Asian demand kept grades destined to Asia such as Russia's medium ESPO and Angolan medium sweet Girassol trading at premiums to their benchmarks. Oil floating in vessels around Asia has also seen big drawdowns. This is in contrast to Europe, where the reimposition of restrictions is already having its toll particularly on gasoline and jet fuel demand which after showing



some signs of recovery this has stalled. Demand in OECD Europe is now expected to fall by 287,000 b/d q/q in Q4 2020, after rebounding by 1.8 mb/d in the previous quarter, which is 1.5 mb/d below a year ago levels. In the US, preliminary data show that September sales were down by 426,000 b/d on a month-on-month basis across all products, with gasoline consumption posting the largest m/m losses by 263,000 b/d. For OECD Americas overall, demand growth in Q4 2020 is downgraded to 248,000 b/d q/q from 543,000 b/d forecasted last month.

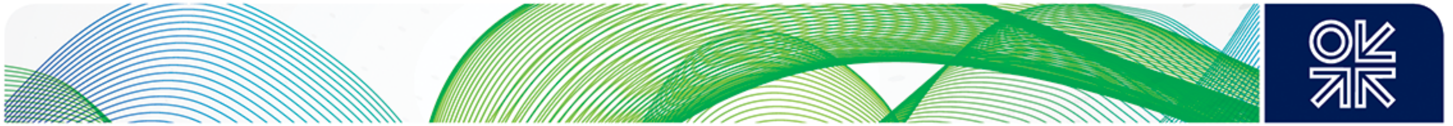
In terms of fuels, jet fuel remains the weakest link by far. In 2019, jet fuel demand stood at around 7.9 mb/d and this is estimated to decline to around 4.3 mb/d in 2020, a decline of around 45%. Diesel consumption has been impacted by the economic contraction, though recently trucking and freight is offering some respite as demand from e-commerce and from companies' re-stocking has been on the rise. This unevenness in demand is causing refineries, particularly in Europe, massive headaches as they are forced to cut runs to reduce the supply of diesel and jet fuel, but by doing so, they are restricting the supply of other fuels such as naphtha and fuel oil, the demand for which has held reasonably well. The US refineries are operating at 78% of operable capacity while those in Europe at 72%. Despite these low refinery runs, the margins for gasoline and diesel, particularly in Europe have been eroding. And any sustained improvement in margins will take time as increase in diesel demand could be met from stocks and increase in refinery runs. This unevenness, alongside the ability to ramp up refinery runs and large product stocks will continue to keep refining margins under pressure, especially that the cost of heavy and medium sour crudes has been relatively strong due to OPEC+ cuts, Iran and Venezuela disruptions and lower Canadian production.

Crude stocks remain high and remain elevated well above the 2010-2014 average. In terms of products stocks, despite the decline in jet fuel demand, jet fuel stocks have been under control. For instance, in the US, jet fuel stocks have been below the 2010-14 average. Alongside weaker diesel demand, refineries have been diverting jet fuel output to the diesel pool contributing to a massive surplus in diesel/middle distillates. For instance, in the US, the middle distillates surplus to the 2010-2014 average currently stands at above 31.3 mbbls after having reached a peak of 43.4 mbbls back in June. A similar picture is emerging in Asia where middle distillates have also risen.

The slow and uneven pace of oil demand recovery remains the main headwind facing the oil market but the downside risks from the supply side have also been on the rise. To start with, there has been the return of Libyan barrels to the market. Libya's crude production is now expected to rise above 1 mb/d by year end. The Alberta government has announced that it will stop setting monthly oil production limits for producers by December 2020 allowing producers to use available pipeline capacity. At the start of the pandemic, more than 20% of the Alberta's oil production went off-line. Some of the shut-in production has already made its way back to the market since then, and in August, Alberta's production stood at 3.1 million b/d compared to a curtailment limit of 3.81 mb/d. Also, there is a belief that with Biden now winning the election, the US will return to the Joint Comprehensive Plan of Action (JCPOA) fairly quickly and this implies around 1.2-1.5 million b/d could hit the market as soon as 2021 (Iran's exports have risen considerably both in September and October defying US sanctions). This scenario is being increasingly incorporated into the 2021 and 2022 balances.

In the US, the latest EIA production data suggest that all of the shut-in production may have returned in August. However, low activity and base declines are expected to take a toll on the US supply outlook, though tapping into a backlog of drilled but uncompleted wells (DUCs) can boost output temporarily. After bottoming at a staggering 172 active rigs in the week August 14, at a 15-year low level last seen back in 2005, US oil rigs began to rise in October and reached 221 units but remain down by 475 rigs relative to a year ago. Low activity, barriers to external finance and cash flow pressures are expected to suppress US shale production well into 2021 and by the end of next year is expected to only rebound close to 8 mb/d, which is still 1.1 mb/d below December 2019 levels. On this basis, the US shale outlook remains supportive for global balances and price in the short run. Despite the sharp reductions in US production and the bleak outlook, US crude exports continue to hold relatively steady competing strongly in Asia and Europe.

As the OPEC+ meeting approaches, the Group finds itself in an uncertain and harsh environment with the balance of risks tilted to the downside. In addition to the size of the cut and the high compliance, another key feature of the OPEC+ deal is that the agreement extends all the way to end of April 2022. This gives OPEC+ the potential to 'tweak' the deal to changing demand conditions and the potential



return of disrupted supplies. This requires a proactive and flexible approach and keeping compliance high under the different scenarios.

Our results show that by extending the current cut, OPEC+ will be able to keep oil prices well supported in the $40/b-$45/b price range in H1 2021, lifting the Brent price by nearly $4/b on average compared to our base case of no extension and by $2/b for 2021 overall. If OPEC+ decides to deepen the cut by 1.9 mb/d and essentially returning to the first phase of the agreement, the price would break the $50/b mark and average $52.9/b in Q1 2021 assuming that demand does not suffer from a new virus-induced shock. But ultimately the effectiveness of OPEC+ response will be shaped by demand conditions (outside the control of OPEC+) and compliance (under the control of OPEC+). If demand falters the annual price in 2021 can undershoot by as much as $9/b and the oil market could flip back to surpluses. Also, if compliance deteriorates the oil prices in 2021 could lose as much as $7/b on annual terms, compared to our scenario of full compliance. On the other hand, if vaccine becomes available and demand recovers quicker than expected, the oil price is projected to increase moderately up to $4/b annually as it will be capped by the existing buffers.

Our short run outlook suggests that downside risks are significant with demand risks related to the renewed pressures on global growth prospects elevated in both the remainder of 2020 and the whole of 2021 by -$7/b and -$8.2/b, respectively, but begin to ease significantly in 2022. In addition, downside risks appear to build gradually on the supply side and amplify as we progress further towards 2022, from -$2.3/b in 2020 to -$9.4/b in 2022, pertaining to OPEC+ compliance risks and the ease of geopolitical supply disruptions. The upside price potential remains capped close but not beyond 2019 levels. Despite the recent weakness in recent months, market deficits persist throughout our outlook but a renewed virus-induced hit on global demand could flip the market back to surplus in the near term. For now, we still project a 2.2 mb/d surplus in 2020 and the market to flip into a 2.2 mb/d deficit in 2021. The stubbornness of the stock clearance in Q3 2020 however, suggests that surplus stocks are projected to draw slower than previously expected. Our modelled projections show stocks not returning to pre-shock levels before at least 2022, underscoring a difficult and lengthy oil recovery ahead.