Daily Note

OIL – THE RESET

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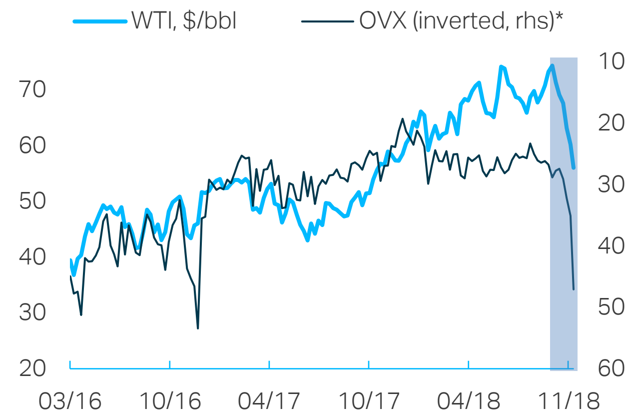
- **Oil resets lower as the market faces its biggest test since June 2017**
- **The easy gains for both prices and OPEC's tactics are behind us**
- **This is neither 2007/08 nor 2014/15, but could turn out to be like 2006**

It was only a month ago that the oil market was gripped by speculation of a swift rise to $100/bbl. We urged investors at the time not to get carried away. Momentum has since turned and oil prices have dropped significantly, with both Brent and WTI falling through key psychological levels ($70 and $60, respectively). What changed? And what is in store for 2019?

Uncertainty over US sanctions against Iran had made the market fixated with supply. Investors saw oil price risk as largely one-way, fuelling worries about the margin of safety in OPEC's spare capacity. The US administration's decision to offer waivers on imports of Iranian crude deflated the 'Trump premium' on prices. It also led investors to shift their focus away from geopolitics to the broader fundamental outlook. The reality is that consumption is slowing at the same time as crude production is rising. It was not excessive demand but fear of inadequate supply that briefly drove Brent above $85/bbl. This is not news. The softer restrictions on Iran have changed the arithmetic, however, raising the possibility of a supply glut developing in 2019.

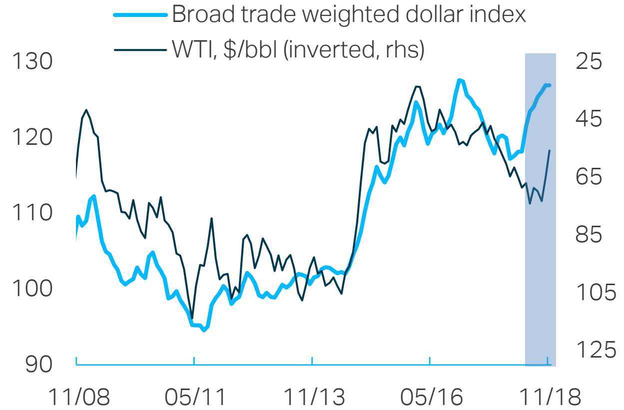
Just like positive demand surprises underpinned the oil price rally, intensifying risks to world growth constitute a drag. Both OPEC and the IEA have trimmed their consumption estimates for this year and next, with the cartel now expecting the call on its crude in 2019 to be 1.4mbd lower than October's output of 32.9mbd. US shale production is gathering pace as operators have taken advantage of elevated prices to increase well completions. Global inventories are creeping higher again, reflecting softer demand for oil products: OECD commercial stocks recorded their largest quarterly gain since 2015 in the third quarter. Coupled with tighter global dollar liquidity and souring financial market sentiment, this is a bearish combination for oil prices. Not least as, unlike in 2008 and 2016, the scope for large-scale Chinese stimulus that would shore up EMs – the main source of growth in oil demand – is limited.

Recoupling 1: volatility



Source: Bloomberg, TS Lombard *Oil ETF VIX Index

Recoupling 2: dollar



Source: Bloomberg, TS Lombard

Looking to OPEC+ for reassurance worked well in the past 18 months, propping up prices. The difference this time is that, with the demand outlook deteriorating, output tweaks on their own cannot 'fix' things. Investors' conviction has been shaken and the market is facing its biggest test since June 2017. A lot of air fizzled out of the market this week, catalysing a recoupling of prices with volatility and the dollar. Financial players showed signs of capitulation, presumably amplified by heavy technical selling as the front end of the curve flipped into contango. Prices are resetting lower after the sentiment pendulum swung violently from one extreme to the other in a short period of time: front-month crude has fallen by over 25% in a little over a month.

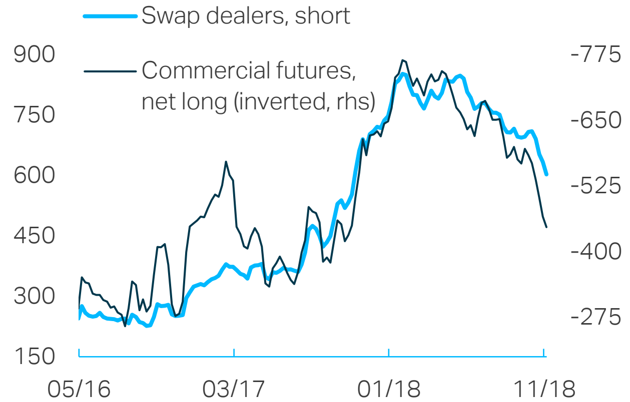
The dust has not settled yet. The risk now is that reflexivity sets in, with investors taking the sharp drop in oil as a signal of weaker global economic growth, sending prices into a downward spiral. But just as today's global macro environment is different from 2007/08, when oil rallied to the mid $100s, it also has little resemblance to 2014/15, when prices nosedived to the low $30s. Four years ago, a massive supply glut was building in the oil market; fears of a deflationary slide into global recession were rampant; and the dollar's appreciation from undervalued levels was still in its early days. Now, the dollar is near its highs; the world economy is growing around trend; and while oil demand is cooling it is still expected to top 100mbd in 2019.

What now? OECD oil inventories are on course to rise above their five-year average – OPEC's yardstick for market stability – next month for the first time since March. So the cartel can be counted on to announce a gradual reversal of its recent output increases at December's meeting, especially as we are entering a period of seasonal weakness in demand (refinery maintenance). Russia, whose fiscal breakeven oil price is substantially lower than Saudi Arabia's, will continue cooperating. Meanwhile, Riyadh has other ways of sending hawkish signals to the market, e.g. via lowering November production and exports to raise 'over-compliance' with the existing cuts. But, as demand turns from tailwind to headwind for the oil market, this also exposes the limitations of Riyadh's strategy. While OPEC's objective is market stability, it runs the risk of injecting volatility by over-responding to price fluctuations. What is more, cohesion within OPEC+ will become progressively harder to maintain as the pie shrinks and pressure on members' market share intensifies.

Finally, a point that is often overlooked is that all this assumes the data is 'right'. Historically, the IEA has tended to underestimate demand and overestimate supply. In 2006, the IEA's inaccurate forecasts prompted OPEC to cut production, precipitating a sharp inventory drawdown in 2007. This time round, years of deficient upstream capex – a key reason why the back end of the forwards curve has come out of this sell-off relatively unscathed – could mean that the IEA's current estimate of a 0.6mbd increase in non-OPEC supply outside the US in 2019 will prove too optimistic, raising the call on OPEC capacity and forcing investors back to the drawing board.

Mean-reversion 1: hedging

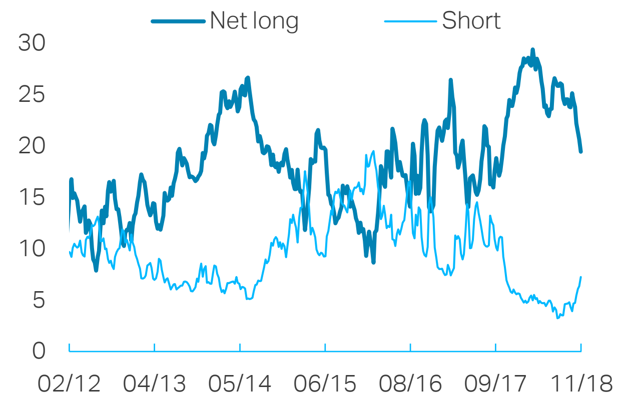
CFTC Nymex crude oil contracts ('000s)*



Source: Bloomberg, TS Lombard *Data as of Nov 6

Mean reversion 2: speculation

Non-commercial WTI futures, % op int.*



Source: Bloomberg, TS Lombard *Data as of Nov 6