Daily Note

OIL – FRAGILE REBOUND

Konstantinos Venetis

- **Oil market finding a firmer footing, but this is not 2017**
- **Resumption of global inventory reduction hinges on US supply**
- **Benign global macro scenario to see prices veer back to the $60s**

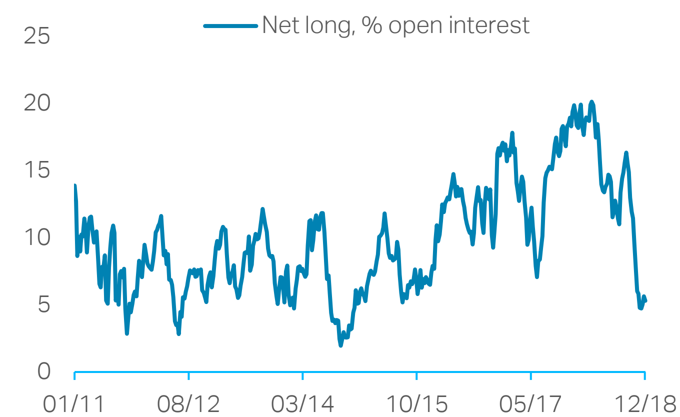
After a rollercoaster year that saw oil prices tumble by 40% in the fourth quarter, the latest rebound was overdue. The question now is whether this rally has more legs, akin to the one that kicked off in June 2017, or not. We think the answer lies somewhere in the middle. Prices are likely to stabilise around current levels and quite possibly drift upwards; but the bar for a sustained advance in 2019 has been raised and volatility is set to remain elevated.

A brief look at the factors behind the winter sell-off is instructive. Oil prices peaked in October as the 'Trump premium' deflated following the US administration's decision to offer waivers on imports of Iranian crude. With global inventories creeping higher and all major producers (Saudi Arabia, Russia and the US) pumping at record rates, fears of a supply glut developing in 2019 dominated the market at a time when consumption had already started to soften. Mounting worries of a global economic slowdown against a backdrop of receding central bank liquidity sparked a broad liquidation of risk assets that intensified the pressure on commodities. In the oil market, the pain was exacerbated by technical selling, the nature of which was not only financial (trading algorithms) but also real (forward hedging). Just as rising precautionary demand from oil buyers propelled prices higher in Q3, accelerated portfolio insurance-type selling by producers is bound to have precipitated a negative feedback loop in Q4.

Signs of a more dovish Fed stance (Powell's remarks on QT) coupled with policy tweaks from Beijing (the cut in banks' required reserve ratio), encouraging news on the US-China trade war front (90-day truce) and a softer dollar have soothed investors' nerves, setting the stage for a rebound in risk assets. This has allowed oil prices to stabilise, not least as speculative length in the futures market is no longer excessive; in fact, the net long 'managed money' position as a share of open interest in Brent crude is now the lowest in four years.

Speculative positioning no longer stretched

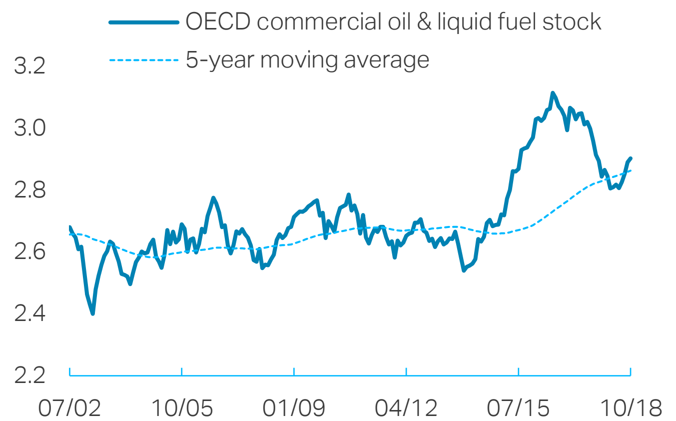
'Managed money' combined positions in Brent*



Source: COT, Bloomberg, TS Lombard *data as of 1/1/19

Global inventories on the rise

Billion barrels



Source: Datastream, TS Lombard

A sustainable advance, however, hinges on positive fundamentals. While it is hard to argue that the recent outsized price swings were caused by shifts in the supply-demand balance, fundamentals ultimately remain the chief driver of the market's direction and risk premia. From the standpoint of supply, the backdrop is gradually turning more supportive. OPEC (led by Saudi Arabia) and its non-OPEC allies (led by Russia) have agreed to reduce output by 1.2mbd. Saudi production ended last year 0.4mbd lower than November's record level (11.1mbd) and is heading to 10.2mbd in January, according to official guidance. The large drop in WTI should also cause growth in US crude output to ease somewhat, even as the rising presence of Big Oil and rekindled M&A activity in the shale sector may have rendered supply somewhat less sensitive to souring market conditions.

However, weaker supply may not be enough to drive prices higher, as – unlike in 2017 – the world economy is now slowing. EM currencies have largely adjusted but the associated cutbacks in domestic consumption will continue to weigh on global GDP growth, limiting the scope for positive surprises in oil demand and hampering inventory reduction. Riyadh is focused on stemming further increases in global crude stockpiles, which rose back above the five-year average in October (latest IEA data), buoyed by higher US output. The recent sharp cuts in exports of Saudi crude to the US should be viewed in this light. Such reductions are aimed (as they have in the past, e.g. H2 2017) at capping the build-up in US inventories – for which data are frequent and accurate – with a view to convincing investors that OPEC is determined to balance the market.

The composition of inventories matters, however, and the problem this time round is that Riyadh's ability to have a material impact on US stockpiles is compromised. The bulk of US inventories is made up of light sweet oil from booming US shale supply, not the heavy sour type of crude imported from Saudi Arabia. On the positive side, the combination of higher US stockpiles and lower prices with infrastructure bottlenecks (availability of pipelines and export terminals catering to Very Large Crude Carrier vessels, known as VLCCs) makes some moderation in US oil production growth more likely over the coming months. The extent of this moderation could dash current bullish market expectations for shale output, especially if the US economy shows further signs of a slowdown.

All this means that while there is reason to think prices can form a base and drift higher from here, the case for a strong, sustained rally looks weak – not least as investor sentiment is likely to stay fragile for as far as the eye can see. We think fears of a Chinese hard landing are overdone, particularly in view of signs that policymakers are gradually shifting to prioritising growth again. Yet a likely export slowdown in Q1– signalled by weak PMIs and consistent with order frontloading in recent months – coupled with the lagged impact from past CNY depreciation points to persistent deflationary impulses. These should keep investors cautious in the near term, or at least until more clarity emerges on Fed policy, Beijing's stimulus tactics and the trade war.

In a benign macro scenario where the Fed pauses, Beijing opts for a mild dose of stimulus and there is de-escalation of the trade conflict, it is plausible to expect oil prices to veer back towards the $60s even as global economic growth shifts lower in 2019. This is broadly where prices traded in the wake of the equity market spasms of Q1 2018, before geopolitical premia started taking root. These are also levels consistent with what Riyadh had originally pegged as an informal target in order to craft its Vienna deal back in 2016 – a good compromise between serving the cartel members' fiscal needs, incentivising capex and allowing US shale operators to balance production growth with financial soundness.

But with the outlook for both supply and demand more uncertain than any time in the last couple of years, the path for oil prices is bound to be volatile. This rebound is still fragile.