Daily Note

OIL – REBOUND RUNNING OUT OF ROAD

Konstantinos Venetis

- **Oil rally set to take a breather as ‘financial’ drag evaporates**
- **Inventories, contango capping near-term upside**
- **Crude quality matters: Brent-WTI spread to stay wide**

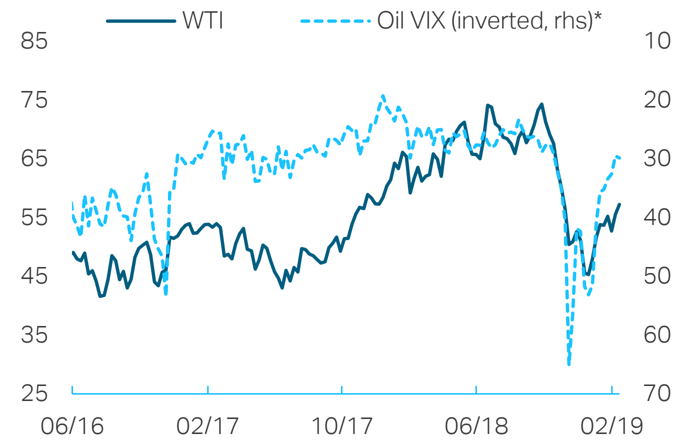
The oil market has come a long way this year. Prices are up by a third from the December lows – attracting Trump’s ire again – and this despite a string of data pointing to slowing global economic growth. Has the market got ahead of itself, or does this rally have further to run?

Back in early January, we fleshed out the reasons why we thought the risks to oil prices were skewed to the upside. The market had spiralled down owing primarily to reasons that had little to do with fundamental shifts. It was Trump’s waivers on Iranian crude imports and a broad-based liquidation of risk assets, after poor Fed communications raised the spectre of a monetary policy error, that caused oil prices to tumble by 40% in Q4. The FOMC’s dovish about-turn in January, coupled with Beijing’s shift to an easier policy mix and fading trade war fears, has since revived investor sentiment, lifting crude along with equities and other risk assets. The ‘financial’ drag on the oil market is largely gone. Still, neither the macro backdrop nor crude’s fundamentals argue for further strong gains in the near term: with Brent and WTI approaching $70 and $60, respectively, the rebound is likely running out of steam.

On the one hand, recovering EM currencies and lower crude prices have alleviated the risk of demand destruction in non-OECD countries – the main source of growth in oil consumption. True to form, the IEA will probably end up revising its estimate for global demand growth (1.4mbd) in 2019 higher over the course of the year. On the other hand, unlike in 2017, the world economy is now ‘resynchronising lower’, with flagging momentum spreading to the US. Both the Fed and the PBoC are playing defence, responding to softening growth, not setting up a Goldilocks scenario. Crucially, we expect the nascent pick-up in Chinese credit growth to be weaker than in the 2015/16 easing cycle – not least as the large commercial banks remain cautious about lending to the private sector against a backdrop of mounting deflationary pressures.

Back from the brink

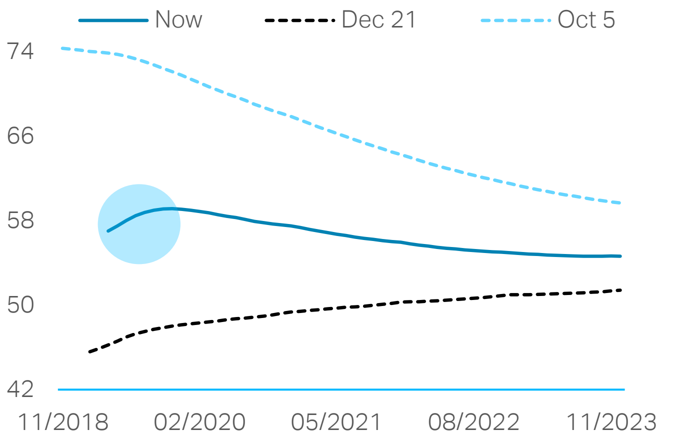
US$/bbl — Index



Source: Bloomberg, TS Lombard *CBOE Crude Oil ETF Volatility Index

Front end still in contango

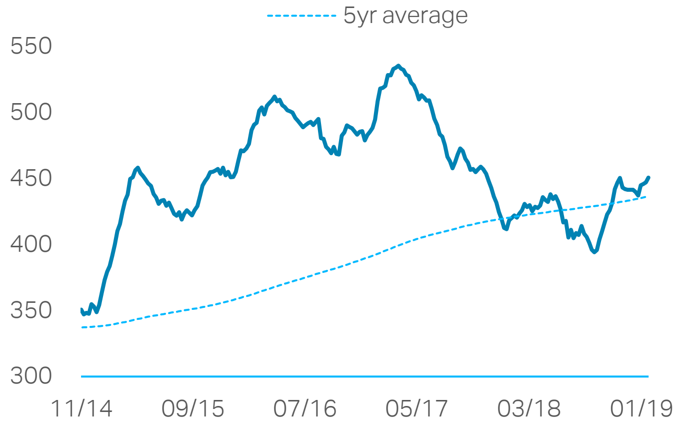
WTI forwards curve, US$/bbl



Source: Bloomberg, TS Lombard

Stock build

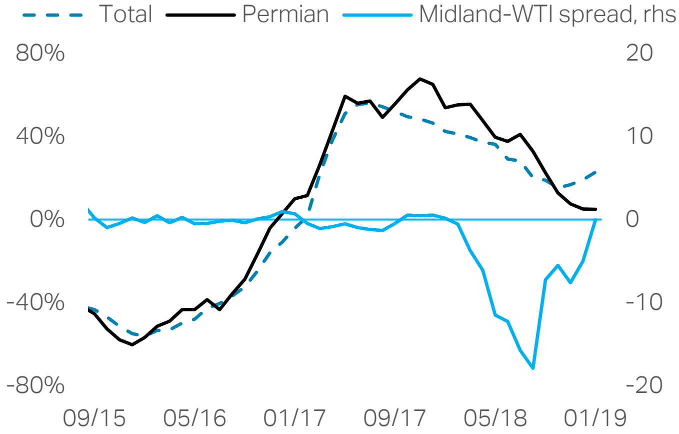
US crude oil inventory (ex SPR), million barrels



Source: Bloomberg, TS Lombard

Permian glut easing

US shale, wells completed (YoY, 3m MA) US$



Source: Bloomberg, TS Lombard

OPEC's latest output cuts have rendered the supply-demand balance more stable. At the same time, US crude production has gathered pace (12mbd), with crude stocks on the rise since the autumn despite a surge in exports (3.6mbd in February). To be sure, the combination of lower prices and rising inventories points to some moderation in US output in the months ahead, consistent with a plateauing rig count. Notably, the rate of well completions in the Permian basin – the prime driver of growth in shale output – has kept slowing, decoupling from the other producing regions (see chart above). This is payback from soaring output in Q2/Q3, which, coupled with infrastructure bottlenecks, created a local supply glut – captured by the differential between oil priced at Texas (WTI Midland) and the benchmark (WTI Cushing). This spread has shrunk back to zero, suggesting that as long as prices hold up and the US economy skirts recession, any moderation in shale supply is unlikely to alter the trend of fast-rising production.

It does not follow, however, that US output strength precludes fundamental upside risks to global oil prices. In its February Oil *Market Report*, the IEA highlighted an important theme that is often overlooked: crude quality matters. US shale oil is of the light sweet variety, an imperfect substitute for the heavy sour crude produced by Saudi Arabia and other OPEC members (including Iran and Venezuela). Importantly, it is the latter type that is better suited to global refiners' preferences, as demand for heavier products (e.g. diesel) is on the rise – unlike for gasoline. There is also a mismatch within the US, where the majority of refineries are configured for the heavier, imported crudes that dominated supply before the shale revolution.

This has far-reaching implications. First, sustaining high rates of growth in US shale output will increasingly depend on rising exports as the US hits a 'refining wall'. Second, even as short-cycle fracking technology makes the US the world's marginal producer, OPEC is still the swing producer. Geopolitical risk premia should therefore remain a significant source of volatility, irrespective of US supply. Third, the Brent-WTI spread can be expected to stay wide. Finally, it underscores the importance of conventional non-OPEC oil production outside the US and Russia (over a third of world supply), the deterioration in which tends to be understated by the IEA.

Near term, however, it is hard to get very bullish on oil prices. The market is still working off the surpluses built in H2 2018, keeping OECD commercial inventories stuck above the five-year average – OPEC's yardstick for market stability. What is more, while the forwards curve has shifted up over the last couple of months, the front end remains in contango (i.e. spot prices are lower than future prices), suggesting the market remains concerned about oversupply. This is also the message from speculative positioning. Investors have turned more constructive in 2019, yet most of the increase in net long positions has come from a reduction in shorts: the longs are still shying away, especially in WTI. Expect a period of consolidation in oil prices.