Jadwa Investment

July 2018

Quarterly Oil Market Update

Trade tensions pose downside risk for oil

Summary

- Brent oil prices averaged $75 per barrel (pb) in Q2 2018, up a sizable 12 percent quarter-on-quarter. Concerns over OPEC output, in light of declines from certain countries, and anticipation over Iranian sanctions lifted Brent oil prices to $81 pb at one point in the second quarter.

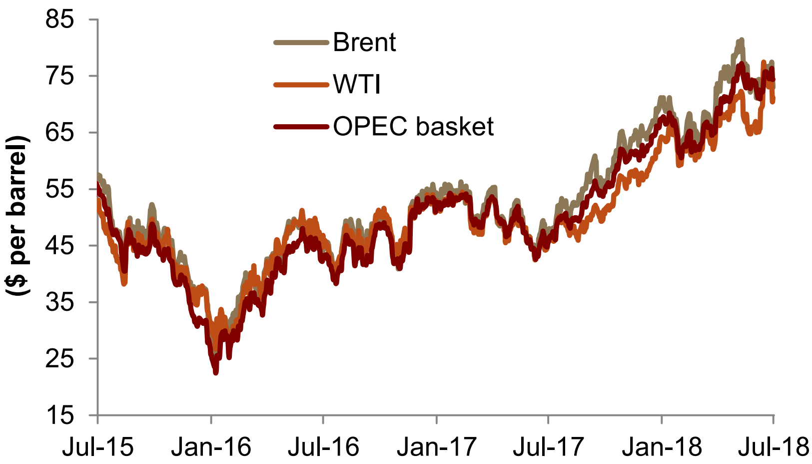
- Oil prices have been pressured somewhat at the start of Q3 2018 due to the combination of renewed trade tensions between the US and China and rising oil output from OPEC/non-OPEC and the US.

- On the demand side, the fear is that the Chinese government may retaliate to US's recent tariff measures, leading to a tit for tat dispute, which could negatively effect global oil demand. At the same time, OPEC and certain non-OPEC countries have seen rising output following a recent meeting which allowed for higher quotas for oil production.

- Additionally, despite US oil output showing strong growth, the US Administration recently suggested the release of up to 30 million barrels of oil before November, in order to tackle the rise in gasoline prices at home.

- Overall, with Brent oil prices currently trading around $72 pb and with the year-to-date average at around $71 pb, we have maintained our recently revised Brent oil price forecast of $68 pb for 2018.

Figure 1: Brent oil prices trading around $72 pb



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OPEC's forecasted yearly global oil demand growth is 1.66 mbpd in 2018…

Oil demand steady, so far:

According to the latest OPEC monthly report, US, China and India remain the main contributors to yearly oil demand growth during 2018. Out of OPEC's forecasted yearly global oil demand growth of 1.66 million barrels per day (mbpd) in 2018, the above three countries are expected to contribute 57 percent of this rise. OPEC also expects lower oil demand growth in 2019, at around 1.45 mpbd, which is still higher than the ten year average (Figure 2). Again, the above three countries, are expected to make up a bulk of demand growth, but at a slightly lesser total of 54 percent in 2019. Earlier this month, the US introduced a second round of tariffs on Chinese products, but the latest OPEC forecasts do not assume further significant rises in trade tariffs, and indeed assume the current trade dispute will be resolved. Thus any further escalation in the trade tensions between China and US could have a dramatic effect on OPEC demand forecasts (see Oil price outlook below).

…with lower oil demand growth in 2019, at around 1.45 mpbd.

The latest EIA short term outlook report shows US oil consumption remains robust…

The latest EIA short term outlook report shows US oil consumption remains robust. So far in 2018, gasoline consumption, which constitutes roughly half of all US liquid consumption, is flat on a year-on-year basis, but in line with recent highs. According to the American Automobile Association, a record number of Americans, 46.9 million, took to the roads for the July 4 holiday, underlining strong demand for gasoline and crude oil. In fact, commercial crude oil stocks, which have been declining since early 2017, reached 417 million in early July, a level not seen since March 2015. Strong demand and depleting oil stocks have, in turn, pressured pump prices. In June 2018, gasoline prices rose to $2.97 per gallon, the highest in four years. In fact, the US Administration recently suggested that it could release up to 30 millions barrels of oil, from the US Strategic Petroleum Reserve (SPR) oil stockpile, in order to tackle the rise in gasoline prices. That said, according to current forecasts, the EIA is still expecting gasoline demand to remain strong in Q3 and Q4 2018, with record highs being reached in 2019 (Figure 3).

...with strong demand and depleting oil stocks pressuring gasoline prices.

China crude oil imports grew to record levels in Q1 2018, averaging 8.8 mbpd during the quarter…

China's crude oil imports grew to record levels in Q1 2018, averaging 8.8 mbpd during the quarter, up 6 percent year-on-year. The rise is likely related to higher demand from a fleet of independent refiners. Back in December 2017, China's Ministry of Commerce gave independent 'teapot' refiners crude import quotas

Figure 2: Global oil demand growth and ten year average

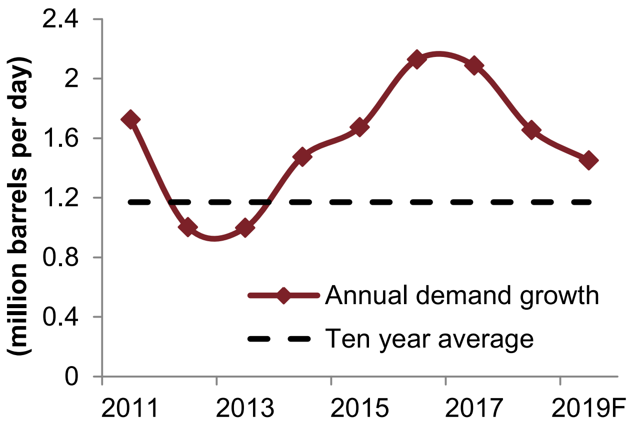
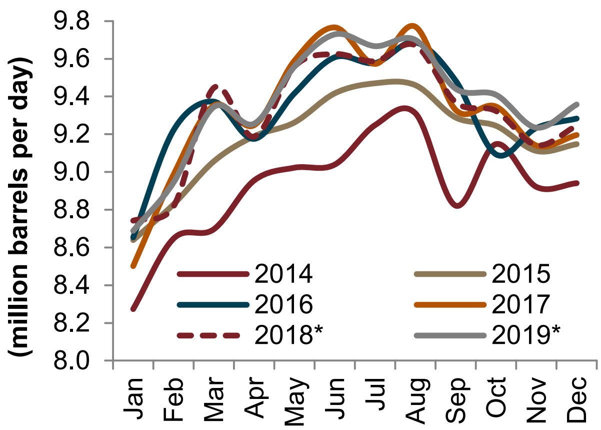


Figure 3: US gasoline demand remains robust



*EIA forecasts from July 2018 onwards

...with rises expected ahead on the back of higher refinery intake.

for the first half of 2018, allowing them to import 660 million barrels in total, which was double the volume allocated in first half of 2017. Looking ahead into Q3 & Q4 2018, continued rises are expected on the back of higher refinery intake, with independent refiners recently being allocated quotas for second half of 2018, roughly 56 percent higher than last year. Looking out into 2019, according to OPEC forecasts, Chinese oil demand is expected to grow by 3 percent, due to demand from transportation and industrial sectors and rising passenger car sales.

India is expected to see continued rise in imports during Q3 & Q4 2018, with overall oil consumption rising by 3.4 percent year-on-year in 2018.

Indian oil imports were up by 383 thousand barrels per day (tbpd) or 8 percent year-on-year in Q2 2018. This growth was seen as a result of a rise in refined product consumption, especially LPGs, which was driven by increased residential consumption. India is expected to see continued rise in imports during Q3 & Q4 2018, with overall oil consumption rising by 3.4 percent year-on-year in 2018 with OPEC expecting oil demand growth to be at similar levels in 2019.

OPEC data shows that crude oil production from its members averaged 32.2 mbpd in Q2 2018, exhibiting no change on quarter-on-quarter basis.

<u>Oil output rising, but is it enough?:</u>

OPEC data shows that crude oil production from its members averaged 32.2 mbpd in Q2 2018, exhibiting no change quarter-on-quarter basis. That said, there were number of changes between members. Thus, continued outages from Libya, Nigeria and declines in output from Angola and Venezuela, led to a combined drop of 460 tbpd. On the flip side, rises from Saudi Arabia and the admission of Congo into OPEC, saw combined output rises of 491 tbpd (Figure 4).

Looking ahead, we expect a rise in OPEC output following a recent OPEC non-OPEC Joint Market Monitoring Committee meeting.

Looking ahead, we expect a rise in OPEC output following a recent OPEC non-OPEC Joint Market Monitoring Committee meeting. The conclusion of the meeting back in late June resulted in OPEC and certain non-OPEC members allowing for higher quotas for production, at a total of 1 mbpd. Due to continued oil outages from OPEC members, such as Nigeria and Venezuela, we expect Saudi Arabia to make up a large portion of the agreed rise in output. In fact, Saudi output rose by 400 tbpd month-on-month in June, and despite Saudi Arabia's crude oil output averaging 10 mbpd in the year-to-June, we now expect it to average 10.3 mbpd over the course of the year (for more on this please refer to our recently published *Macroeconomic* update).

As oil outages continue from OPEC members, we expect Saudi Arabia to make up a large portion of the agreed rise in output.

That said, with the US recently reapplying sanctions on Iranian oil,

Figure 4: Q2 2018 OPEC oil production (quarter-on-quarter change)

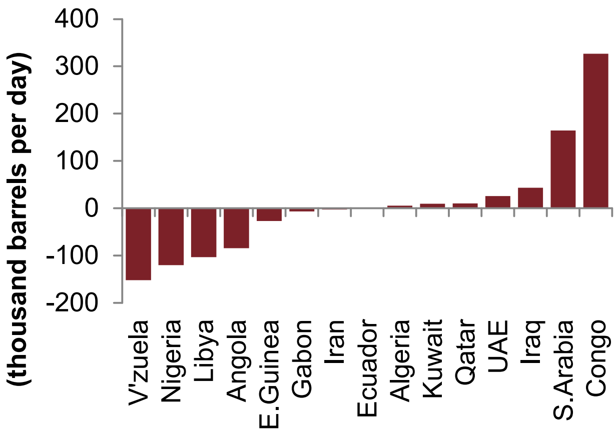
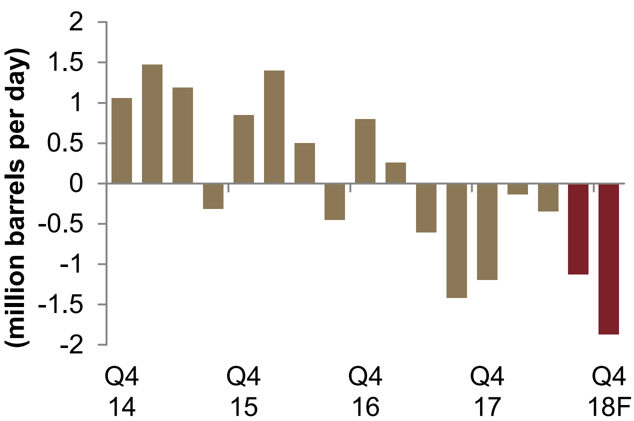


Figure 5: Global oil balances expected to be in deficit in H2 2018



Despite this, assuming the US is successful in reducing the above countries Iranian oil exports significantly…

...and, when holding OPEC output constant at Q2 2018 levels, we would expect to see oil markets in deficit by 1.9 mbpd come Q4 2018.

and aggressively pushing Europe, Japan and South Korea to reduce oil imports from Iran by the November 4th sanctions deadline, there is a possibility that OPEC/non-OPEC’s 1 mbpd of additional oil may not be sufficient to balance markets. Of Iran’s circa 2.1 mbpd of current oil exports, around a third, or 700 tbpd is exported to Europe, Japan and South Korea. Indeed, the National Iranian Oil Company (NOIC) has estimated that its crude oil exports could drop by as much as 500 tbpd when sanctions come into effect. Therefore, assuming there is no major escalation in trade tension, if Iranian oil exports declined significantly and OPEC production remained unchanged at Q2 2018 levels, oil markets would be in deficit by 1.9 mbpd come Q4 2018 (Figure 5).

Meanwhile, Russian output is expected to continue rising in the following months, and could hit recent highs of 11.25 mbpd seen in late 2016 in July.

Meanwhile, preliminary data for June shows Russian crude oil production is expected to have risen by 100 tbpd month-on-month. Russian output is expected to continue rising in the following months, and could hit recent highs of 11.25 mbpd seen two years ago (Figure 6). Looking to 2019, according to OPEC’s monthly report, Russian oil companies have the potential to increase production even further, through green field development in East-Siberian, amongst other places.

Additionally, the EIA also revised its forecasts for 2018 and 2019 upwards again, with oil production now expected to average 10.8 mbpd during 2018.

Meanwhile, the latest EIA monthly report shows that total US crude oil production averaged 10.71 mbpd in Q2 2018, up by 17 percent year-on-year. The EIA also revised its forecasts for 2018 and 2019 upwards again, with oil production now expected to average 10.8 mbpd during 2018, up 15 percent year-on-year, and 9 percent in 2019, at an average of 11.8 mbpd (Figure 7).

Trade tensions weigh-in on oil price outlook:

Brent oil prices averaged $75 pb in Q2 2018, up a sizable 12 percent quarter-on-quarter…

Brent oil prices averaged $75 pb in Q2 2018, up a sizable 12 percent quarter-on-quarter. Concerns over OPEC output, in light of declines from certain countries, and anticipation over Iranian sanctions lifted Brent oil prices to $81 pb at one point.

...but concern is now that the Chinese government may retaliate to US’s tariff measures…

Earlier this month, the US introduced a second round of tariffs covering more than 250 Chinese products. Previously tariffs on Chinese goods had included boats, aircraft engines, nuclear reactors and other industrial and agricultural machinery, as part of a wide-ranging list of 818 types of product. Oil prices have been pressured at the start of Q3 2018, with fallback motivated by investor risk-off

Figure 6: Russian crude oil production rising

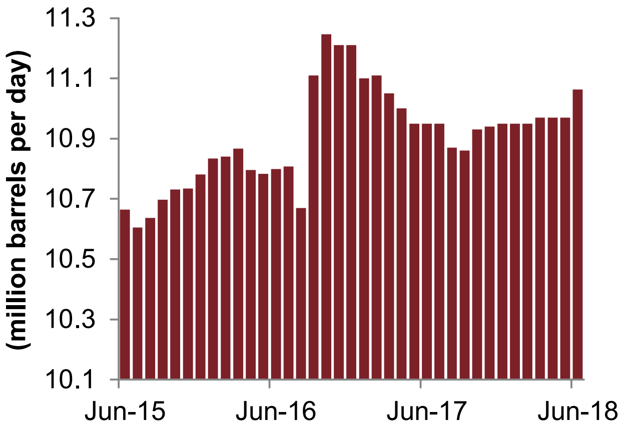
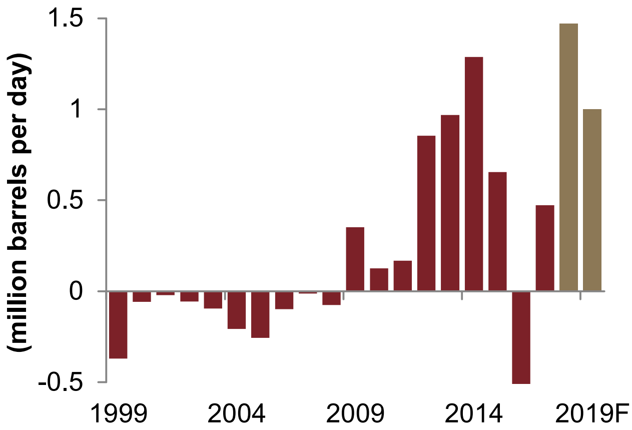


Figure 7: US crude oil production
(year-on-year change)



...leading to tit for tat trade dispute between the two largest economies, and oil consumers, in the world.

Overall, we have maintained our recently revised Brent oil price forecast of $68 pb for 2018.

sentiment, rather than any direct impact on oil demand itself. Currently, the lingering fear is that the Chinese government may retaliate to US's tariff measures, leading to tit for tat trade dispute between the two largest economies, and oil consumers, in the world. Such a fallout would have inevitable negative effects on global growth, and would put significant pressure on the oil prices, especially with OPEC and non-OPEC countries raise output and the US potentially releases some of its SPR.

Looking ahead, whilst supply factors were responsible for the rise in prices in Q2, the demand side could play a bigger role in prices Q3 and Q4, directly as a result of US-China trade tensions. That said, any improvement in trade tensions would pull prices back towards the supply side, which could result in Brent prices rebounding above $75 pb mark.

Brent oil prices are currently around $72 pb, and year-to-date average stands at $71pb. Due to uncertainty linked to trade tensions, and rising supply from OPEC/non-OPEC and US, together with the possibility of SPR releases from the US, we have maintained our recently revised Brent oil price forecast of $68 pb for 2018.