

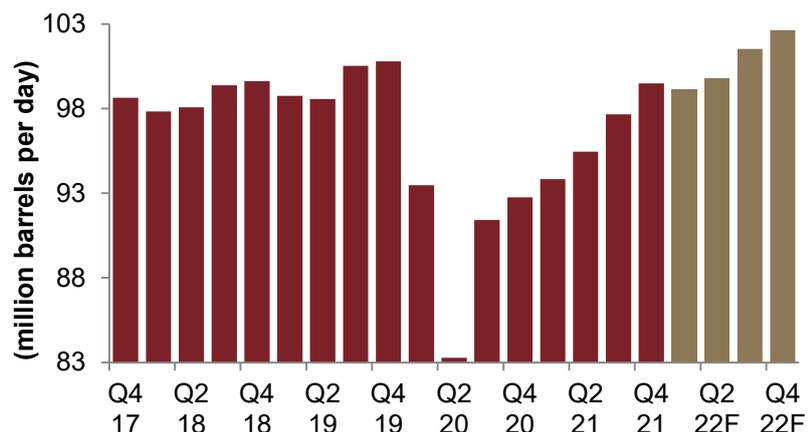


Rising geopolitical risks

Summary

- Global oil demand grew by a healthy 6 percent year-on-year, or 5.6 million barrels per day (mbpd) last year, to an average of 96.6 mbpd. Looking ahead, whilst near-term Omicron related risks remain, so far, the response from governments around the world to surging cases have not been as severe as previous variants. Overall in full year 2022, oil demand is expected to rise by 4 percent year-on-year, to an all time high of 100.8 mbpd.
- As OPEC+ continues to raise monthly oil supply, more attention is being paid to whether some members can actually achieve stated monthly output targets. More specifically, Q4 2021 data shows that the alliance was only able to muster a quarter-on-quarter rise of 240 thousand barrels per day (tbpd), much less than the expected average of 800 tbpd. Looking ahead, the difficulties in sustaining output at stated levels is likely to persist, since lower than expected oil production from some members is not a transient issue, but a structural one.
- Meanwhile, it seems that the US Energy Information Administration (EIA) does not expect a sizable rise in oil prices to have a major impact on US oil output in 2022. This is highlighted by the fact that whilst the administration's current full year 2022 forecast for West Texas Intermediate (WTI) is 42 percent higher than a year ago, it has only revised US oil output up by 3 percent over the same period.
- Brent oil prices have rallied since the start of the year, and are currently trading above \$85 pb, at seven year highs. Whilst part of the uplift is related to receding fears over Omicron's impact on global oil demand, it is also related to a number of significant geopolitical events in key oil producing countries. Looking ahead, dwindling OPEC+ spare oil capacity and declining levels of commercial oil inventory, will, in our view, sustain oil prices over the course of 2022. As a result, we have raised our full year 2022 Brent oil forecast to \$76 pb (versus \$71 pb previously).

Figure 1: Global oil demand expected to increase by 4 percent year-on-year in 2022



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...is expected to help push yearly oil demand up 4 percent year-on-year to all time highs of 100.8 mbpd.

That said, it will not be a smooth upward trajectory for oil demand growth on a quarterly basis...

...with the spread of the Omicron variant around the world posing mild near-term headwinds.

In-line with this, OPEC expects oil demand to decline slightly, quarter-on-quarter, in Q1 2022...

...before rising in the next three quarters.

That said, one area of potential concern in the year ahead lies with China...

...where the government has implemented a zero tolerance of Covid-19 cases...

Strong oil demand outlook for 2022:

OPEC data showed global oil demand grew by a healthy 6 percent year-on-year, or 5.6 million barrels per day (mbpd), in full year 2021, to an average of 96.6 mbpd. Even more encouragingly, Q4 2021 average oil demand had recovered to 99.5 mbpd, more or less in-line with pre-pandemic levels (Figure 1). Looking ahead, an improving global economy, and with it, increased mobility and a loosening of pandemic related measures, is expected to help push yearly oil demand up 4 percent year-on-year to all time highs of 100.8 mbpd. More specifically, the traditional centers of oil demand (US, China, Other Asia and India) are expected to make up 62 percent of the total yearly growth this year. That said, it will not be a smooth upward trajectory for oil demand growth on a quarterly basis, with the spread of the Omicron variant around the world posing mild near-term headwinds. In-line with this, OPEC expects oil demand to decline slightly, quarter-on-quarter, in Q1 2022, before rising in the next three quarters.

Omicron's mild effect on oil demand:

OPEC annual oil demand growth estimates for 2022 (of 3.2 mbpd) are the least optimistic of the three major oil agencies, with the International Energy Agency (IEA) expecting annual rises of 3.3 mbpd, and the US's Energy Information Administration (EIA) 3.6 mbpd. That said, the IEA expects the steepest declines in oil demand on a quarter-on-quarter basis in Q1 2022 (Figure 2), with demand for jet fuel likely to be the most severely affected by the spread of the Omicron variant. This is demonstrated by the fact that since the identification of Omicron towards the latter half of November last year, daily commercial flights have declined 10 percent from recent highs (Figure 3). More broadly speaking though, whilst the risks of renewed lockdowns and more stringent mobility restrictions are yet still possible, so far the response from governments around the world to surging Omicron cases has not been as severe as previous variants. For example, in India, which was acutely affected by the outbreak of the Delta variant last year, state-controlled refiners reportedly requested their full contractual volumes for February from Aramco, in anticipation of a rebound in demand (with sales of gasoline and diesel down by circa 3 percent month-on-month in the first half of January).

Overall, initial indicators suggest that risks to global oil demand from the outbreak of the Omicron variant are contained. Having said that however, one area of potential concern in the year ahead lies with

Figure 2: Expected quarterly change in global oil demand (Q4 2021 to Q1 2022)

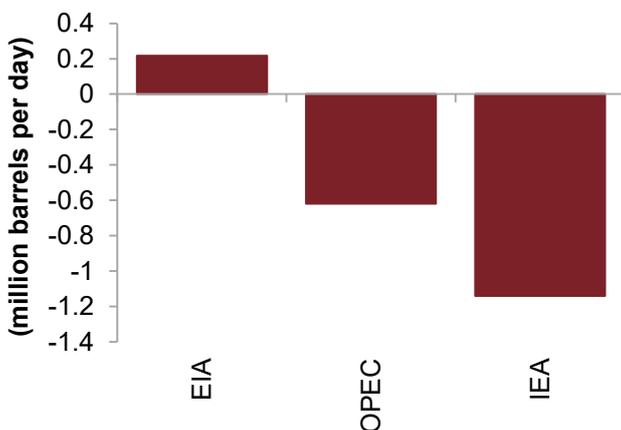
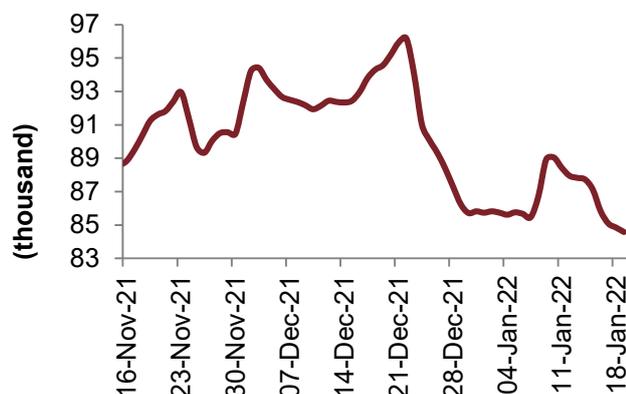


Figure 3: Decline in number of daily commercial flights (seven day moving average)





...which has resulted in severe lockdowns in regions where a very small number of cases have emerged.

If this policy persists, it may negatively impact China's 2022 oil demand growth.

Q4 2021 data shows that OPEC+ was only able to muster a quarter-on-quarter rise of 240 tbpd...

...way below an expected average of 800 tbpd.

Looking ahead, the difficulties in sustaining output at stated OPEC+ levels is likely to continue...

...since lower output from some members is not a transient issue, but a structural one.

As such, the focus has now shifted to whether all members can actually achieve stated monthly output targets.

China. Last year saw a yearly decline in oil imports (Figure 4) (the first in twenty years), and although the decline was a result of government policy towards domestic refiners, rather than weaker demand, another major policy could impact oil demand this year. More specifically, the Chinese government has implemented a zero tolerance of Covid-19 cases which has resulted in severe lockdowns in regions where a very small number of cases have emerged. If this policy persists with Omicron (which is generally believed to have higher rates of transmission), it may negatively impact China's 2022 oil demand growth, which OPEC expects to rise by 5 percent.

OPEC plus: focus shifts from compliance to capacity:

Since April 2020, when the current declaration of cooperation (DoC) between OPEC and partners (OPEC+) was agreed, the focus of attention had been on each member country's ability to stay within stated output targets. However, since August of last year, when OPEC+ began unwinding supply by around 400 thousand barrels per day (tbpd) each month (or by an average of 800 tbpd over a quarter), the focus has shifted to whether all members can actually achieve stated monthly output targets. Whilst initially (in Q3) OPEC+ was able to add the stated output, Q4 2021 data shows that the alliance was only able to muster a quarter-on-quarter rise of 240 tbpd, way below an expected average of 800 tbpd (Figure 5). A breakdown of output during the quarter shows that steepest level of under compliance came from a trio of African countries (Eq. Guinea, Angola and Nigeria) and Malaysia.

Looking ahead, the difficulties in sustaining output at stated OPEC+ levels is likely to continue since lower output from the above three African members and Malaysia is not a transient issue, but a structural one. For example, in the case of Malaysia, the national oil company (NOC), Petronas, consistently reduced its capital expenditure over the course of the last decade, with full year 2021 investment half of 2012's total. In-line with this, crude oil output also followed a downward trajectory, with output in 2021 declining 35 percent over highs seen back in 2010. That said, the problem of hitting output targets is by no means restricted to the above-mentioned countries; there are reports that Iraq's main loading terminal in Basrah is facing constraints and bottlenecks, which could impact the level of oil shipped to customers. At the same time, Russia's oil output seems to be hitting maximum capacity. This is demonstrated by the fact that under the current agreement both Saudi Arabia and Russia (the two largest oil producers in OPEC+) were each supposed to raise oil output by 100 tbpd per month from

Figure 4: Chinese oil imports
(annual daily average)

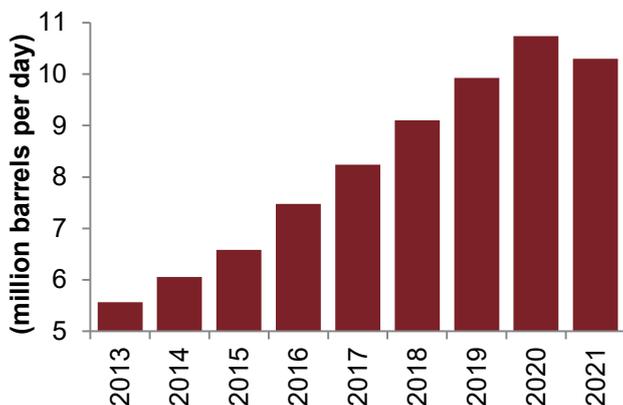
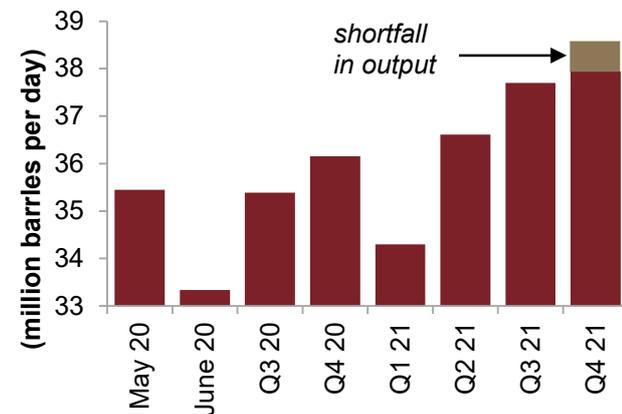


Figure 5: OPEC+ not able to deliver full increase in supply in Q4 2021





For 2022, it seems that the EIA does not expect a sizable rise in oil prices to have a major impact on US oil output.

This is highlighted by the fact that although the agency's current full year 2022 forecast for WTI is \$21 pb higher than a year ago...

...but it has only revised US oil output up by 300 tbpd over the same period, to an average of 11.8 mbpd.

Also, the sector is unlikely to get much support from the current US government, which is keen on accelerating a clean energy transition.

Brent oil prices have rallied since the start of the year, and are currently trading above \$85 pb, at seven year highs.

August onwards, however only Saudi Arabia has managed to do so consistently (Figure 6).

US oil at pre-pandemic levels by 2023:

According to EIA data, US oil output declined by 1 percent year-on-year in 2021, to an average of 11.2 mbpd. For 2022, it seems that the EIA does not expect a sizable rise in oil prices to have a major impact on US oil output. This is highlighted by the fact that although the agency's current full year 2022 forecast for West Texas Intermediate (WTI) is \$21 pb higher than a year ago (at an average of \$71 pb), it has only revised US oil output up by 300 tbpd over the same period, to an average of 11.8 mbpd (Figure 7, Box 1). Looking further ahead in 2023, whilst the EIA expects US oil output to hit pre-pandemic levels of 12.4 mbpd, it is still predicting a reasonable level of yearly growth of around 5 percent (although this is based on lower yearly WTI price of \$64 pb).

Box 1: Higher oil output, but less govt. help

Output from the largest US shale oil formation -the Permian- recently hit all time record highs of around 5 mbpd. The Permian is a particularly attractive place to raise oil production because of its low breakeven costs (ranging between WTI oil price of \$46-53 pb) and has generally higher rates of oil production per rig. As such, the longer that oil prices remain elevated, the higher the likelihood of larger quantities of US shale oil hitting the market. That said, and as the EIA's forecasts suggest, US supply growth is not likely to be as aggressive as in the past; because i) many shale operators are expected to maintain capital discipline (see our previous [Oil Update](#)) and ii) the sector is unlikely to get much support from the current US government, which is keen on accelerating a clean energy transition. Indeed, some recently proposed reforms (such as raising on and off shore oil royalty rates and introducing methane emission charges) will, if implemented, raise US oil companies' operating costs.

Oil price outlook:

Brent oil prices climbed 8 percent quarter-on-quarter in Q4 2021, to an average of \$80 pb. Since then, prices have rallied further and are currently trading above \$85 pb, at seven year highs. Whilst part of this uplift is related to receding fears over Omicron's impact on global oil demand, it is also partly related to a number of significant geopolitical events in key oil producing countries. Besides domestic

Figure 6: Saudi Arabia's oil output rising in-line with OPEC+ agreement

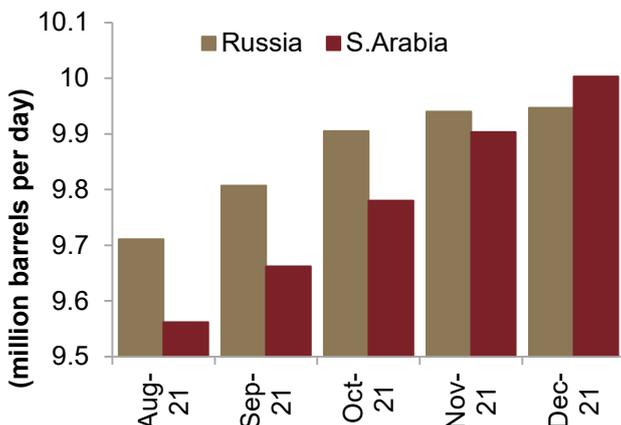
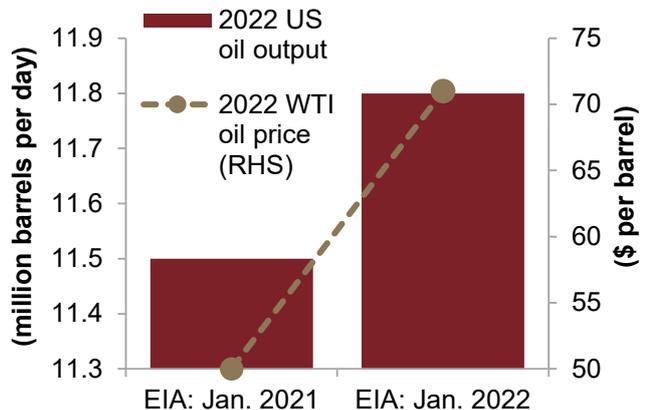


Figure 7: EIA's sizable revision in oil prices not accompanied by a similar revision in US oil output





Whilst part of the uplift is related to receding fears over Omicron's impact on global oil demand...

...it is also related to a number of significant geopolitical events in key oil producing countries.

Looking ahead, dwindling OPEC+ spare oil capacity and declining levels of commercial oil inventory...

... will, in our view, sustain oil prices over the course of 2022.

As a result, we have raised our full year 2022 Brent oil forecast to \$76 pb (versus \$71 pb previously).

upheaval in Kazakhstan a few weeks ago, tensions have been rising in the Arabian Gulf, with a string of maritime incidents, and a recent suspected drone attack on a oil terminal in the UAE. In addition to this, there has been a steady build-up of tensions around the Crimea Peninsula, along the Russian-Ukrainian border, with potentially broader implications for oil and gas supplies into mainland Europe (we note regional gas prices retreated from record highs recently, but remain elevated).

Looking ahead, despite a slight lull in oil demand growth in Q1, the outlook for the rest of the year is very promising, with all three major energy agencies (OPEC, EIA, IEA) expecting global oil demand to reach record levels by Q4 2022. At the same time, with no sizable rises in US oil supply expected in the near term, OPEC+'s spare capacity is likely to garner more attention over the next few months (Box 2).

Box 2: OPEC+ spare oil capacity

At the end of last year, OPEC+ spare capacity stood at 5 mbpd, and, under agreed output targets, should decline to around 2.6 mbpd by mid-2022 (Figure 8). Currently, around 70 percent of spare oil capacity resides with its Gulf members, but it is important to highlight that the use of any spare capacity (beyond the agreed monthly rises in output) would i) need a general agreement from all of OPEC+, and ii) a more specific agreement from under-producing members, to transfer part of their quotas (and therefore market share) across to other producers.

Overall, dwindling spare oil capacity and declining levels of commercial oil inventories (which recently dropped below their ten year average) (Figure 9), will, in our view, sustain oil prices over the course of 2022. We note that whilst a break-through in negotiations between Iran and a number of countries could well lead to 1 mbpd of oil hitting the market at some point during the year, as we highlighted in our last [Oil Update](#), such a deal remains elusive.

Taking all the above into account, we have raised our full year 2022 Brent oil forecast to \$76 pb (versus \$71 pb previously).

Figure 8: OPEC+ spare capacity expected to drop to circa 2.6 mbpd by mid-2022

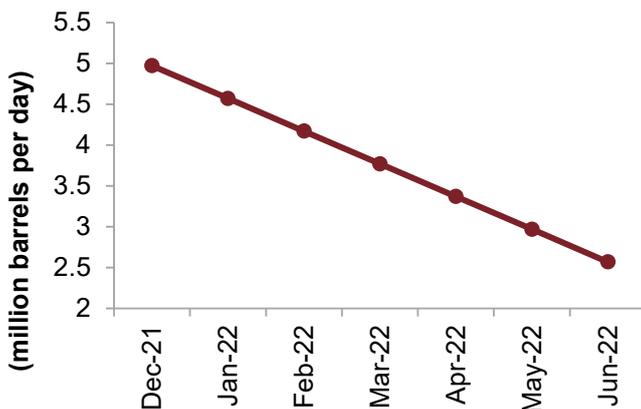
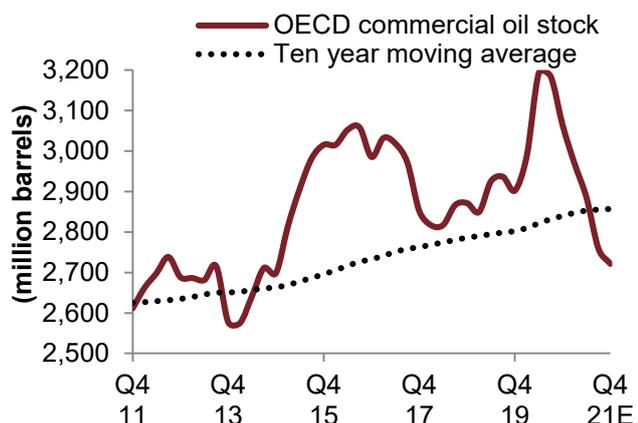


Figure 9: OECD commercial crude oil stocks





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