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Jadwa Investment

April 2023

# Quarterly Oil Market Update

## Oil markets buffeted by fresh uncertainty


**Summary**

- Oil, along with most risk assets, has been buffeted by the turmoil in the US and European banking sectors following the collapse or bailout of a clutch of US banks and the forced takeover of Credit Suisse. Having traded in an $80-90 pb range since the beginning of the year, Brent dropped to $72 pb in late March as the crisis erupted (Figure 1).

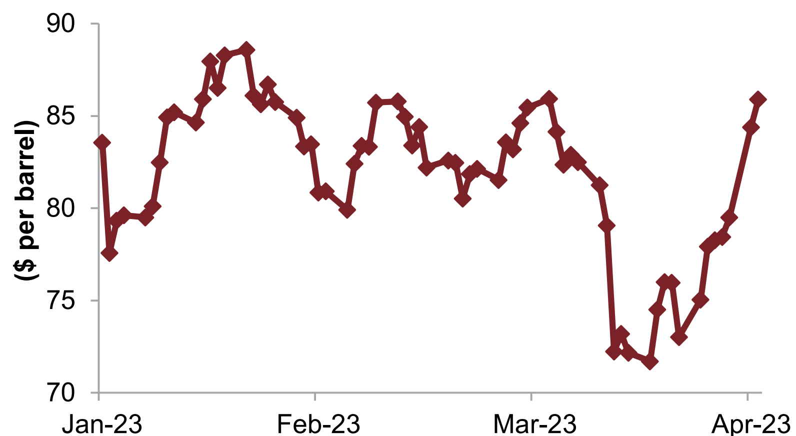
- OPEC Plus responded forcefully, with an early April announcement of a 1.16 mbpd cut in aggregate output from May onwards. The announcement, which caught markets unaware, saw Brent surge 5 percent.

- The cuts seem to reflect OPEC's concerns about the US outlook as multiple interest rate hikes take their toll on economic activity. However, this might be to underestimate the likely impact of China's post-Covid economic renaissance, which should see oil demand strengthen as activity broadens from the consumer to manufacturing and investment.

- Uncertainties are also hanging over Russian and US supply. Russia has had little problem in finding a home for its crude exports (albeit at steep discounts) but is now struggling to place all its product exports. Meanwhile, US shale producers are having to deal with a much higher cost of capital, and the potential fall-out from the US banking crisis.

- All this suggests that the oil market will tighten sharply during the course of the year. This should allow Brent to average $90 pb, with risks broadly balanced. Demand should accelerate in 2024, but OPEC is also expected to take advantage of this by increasing output. Therefore we see Brent easing slightly to $87 pb next year.


**Figure 1: Severe turbulence hit Brent in late March and early April**





For comments and queries please contact:

James Reeve
Chief Economist
jreeve@jadwa.com

Head office:

Phone +966 11 279-1111
Fax +966 11 279-1571
P.O. Box 60677, Riyadh 11555
Kingdom of Saudi Arabia
www.jadwa.com



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*Uncertainties around demand and supply are elevated, with worries about future US demand prompting an unexpected cut from OPEC Plus.*

**Oil markets pressurized by heightened uncertainty:**

Oil prices are in a state of flux with heightened uncertainties around both supply and demand, exacerbated by banking sector tremors on both sides of the Atlantic. The main positive is the revival of China's economy, which it is hoped will rejuvenate the country's demand for oil and other commodities. This is offset by growing signs of distress in the US economy, which is beginning to struggle under the weight of cumulative interest rate increases.

On the supply side, the main recent development was OPEC Plus's announcement of a 1.16 million barrel a day (mbpd) cut in aggregate supply from May. This appears to align with Russia's earlier announcement that it would be cutting output by 500,000 bpd from March. Both announcements appear to indicate a lack of confidence in the demand outlook, though Russia has additional sanctions-related complications to consider.

Non-OPEC supply is unlikely to fall, but it too is facing headwinds and supply growth is set to weaken. The main question here is how far US shale oil producers can raise production given the higher cost of capital and other inputs.

**Demand hit by financial sector worries:**

*Banking sector jitters hit markets in March, triggering a sharp sell-off in risk assets, including oil.*

Starting with demand, financial markets have been shaken by the collapse or bailout of a handful of mid-tier US banks in recent weeks, and the forced takeover of Credit Suisse by its rival UBS in Europe. The bank failures to date had idiosyncratic causes and there was no sense of any underlying system-wide vulnerability. That said, contagion can often defy logic and bank shares—and risk assets more widely—have tumbled (Figure 2).

*Brent saw its sharpest weekly fall in three years in late March.*

The oil market did not escape the fallout from these stresses, with Brent seeing its biggest weekly slide for three years in late March. As futures prices began to fall past levels where much oil had been hedged by producers, the banks and other trading houses that had offered these contracts unwound their long positions in oil in a bid to limit their losses. This only exacerbated the fall in oil prices, with Brent touching a 15-month low towards the end of March.

*Financial markets are now pricing in a cut to the Federal Reserve policy rate as early as the third quarter, which would give some support to commodities. However, we doubt the Fed will commence its easing cycle before Q1-24.*

The banking sector turmoil brought forward market expectations of when the Federal Reserve might start *cutting* interest rates (even though it is still in hiking mode). Markets now expect cuts to begin in Q3 of this year, something that would help boost demand for

**Figure 2: US regional bank shares have slumped**

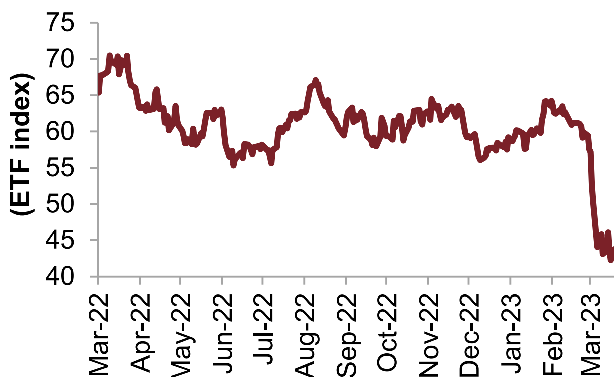
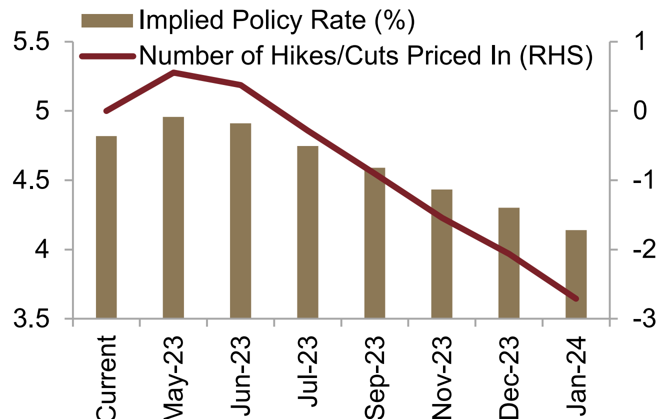



**Figure 3: Markets now see interest rate cuts coming as early as Q3-23**



*US and European oil demand growth is set to soften as their economies cool; however, China is expected to take up the slack.*

*Latest indicators suggest that China is bouncing back strongly from three years of Covid-19 lockdowns. So far, its oil demand has been confined to certain segments, but this is expected to broaden in the months ahead.*

*China's resurgence should have positive spillovers for a number of EMs.*

commodities (Figure 3). However, we do not think that the recent turmoil will be enough to prompt the Fed to start cutting this year, especially with oil prices now moving up again. Rather, we are sticking with our assumption that the easing cycle will begin in Q1-24.

In general, we expect oil demand growth in the US and the eurozone to soften quite markedly this year as rising rates take their toll on manufacturing activity and household spending power. This will be particularly evident in Q4-23 when economic activity in the US is expected to reach a nadir. Nor is there likely to be any support from US oil policy, with the US energy secretary ruling out a near-term refill of the US Strategic Petroleum Reserve: Jennifer Granholm said she would like to see WTI "consistently below" $72 pb before making any additions to the SPR (this declaration might have contributed to OPEC Plus's decision to cut output).

The main offset will come from China, where the removal of Covid-19 restrictions has unleashed considerable pent-up demand. Post-easing data are only now beginning to appear, and these show that China's overall oil demand in January was up some 800,000 bpd compared to a year earlier (OPEC figures). However, this disguised sharp differences in the various segments, with aviation fuel demand surging as families criss-crossed the country to meet with relatives and even to venture abroad (Figure 4). There was also firm demand for naphtha, the key petrochemicals feedstock. However, demand for other types of fuel remained weak. This should change as China's manufacturing sector moves into expansion mode (Figure 5) and as the authorities continue to offer (limited) fiscal support to the key property sector. In short, China's oil demand should become broader and deeper as the year progresses.

China's economic heft is such that its revival should have positive spillovers for other East Asian economies. Vietnam, Indonesia and Thailand all stand to benefit from enhanced trade and tourism flows. More generally, Emerging Market central banks began their hiking cycles earlier than their DM counterparts, and as a result appear to be more on top of inflation. This could allow them to begin easing sooner, which would certainly give a helpful tailwind to activity later in 2023. Mexico, Brazil, Indonesia, Malaysia, Thailand and the Czech Republic are some of the large EMs that might decide to begin easing this year.

**Figure 4: Chinese international travel has bounced back...**

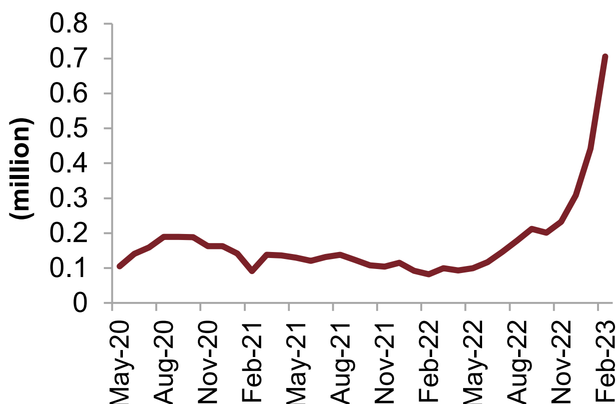



**Figure 5: ...and manufacturing is growing again**

*The main agencies project total demand growth this year at 1.5-2 mbpd.*

The uncertainties around the US economic outlook mean that the range of forecasts for global demand growth is quite wide. The US Energy Information Administration (EIA) thinks that global liquids demand will rise by 1.5 mbpd in 2023 and by a further 1.8 mbpd in 2024. The International Energy Agency (IEA) sees a stronger demand picture this year, with a 2 mbpd gain. However, the most bullish of the main agencies is OPEC, which projects a demand gain of 2.3 mbpd in 2023 (Figure 6).

**OPEC Plus cuts, while US and Russian output faces headwinds:**

*OPEC Plus announces production cuts from May, taking analysts by surprise. The motivation appears to be the weakening US economic outlook.*

The OPEC secretariat's optimism is evidently not shared by the organization's policymakers. In early April, OPEC Plus announced cuts of 1.16 mbpd, which will come into effect in May and last until the end of the year (Box 1, Figure 7). This is separate from a 500,000 bpd cut announced by Russia in March (see below), although Moscow said that this would now be extended to the end of the year.

The cuts caught analysts by surprise, not least because oil prices had been trending upwards following the mid-March slump. It seems that OPEC policymakers were concerned that the looming US slowdown could be severe enough to send prices well below $70 pb if pre-emptive action was not taken.

## Box 1: OPEC Plus cuts

On April 2, Saudi Arabia announced that it would be implementing a "voluntary" cut of 500,000 bpd, or just under 5 percent of its output, "in coordination with some other OPEC and non-OPEC countries". These cuts will be made in May and the new ceiling will remain in place until the end of 2023 at least. When added to the reductions announced by OPEC Plus last October, the new pledges bring the total volume of cuts by OPEC Plus to 3.66 mbpd, equivalent to around 3.7 percent of global demand according to Reuters calculations.

*Many OPEC member are struggling to get production up to prevailing quotas. Thus, it is largely Saudi Arabia and its Gulf allies that are taking the strain of the new cuts.*

With a number of OPEC members struggling to get production to existing quota ceilings, the cuts will be borne largely by the Kingdom's Gulf allies. Iraq (somewhat surprisingly) has stepped in with a 211,000 bpd pledge, while Kuwait and the UAE are providing a further 270,000 bpd reduction between them. Algeria, Oman, Kazakhstan and Gabon account for most of the rest.

**Figure 6: OPEC's demand outlook is strong...**

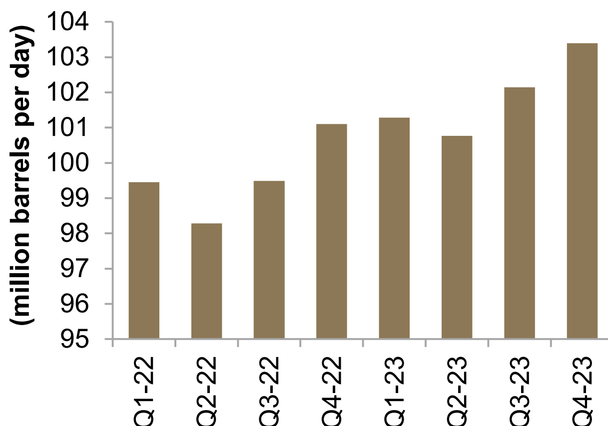
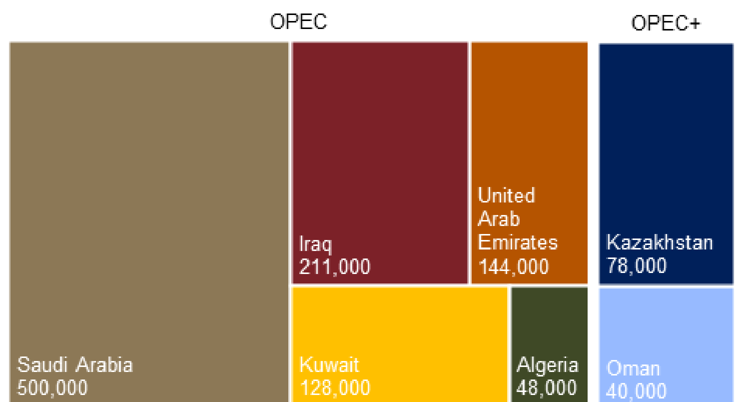



**Figure 7: …even as output cuts are pledged for May**



*Cracks are beginning to appear in Russia's efforts to place its oil products, such as diesel and gasoline. China and India have been eager buyers of Russia's crude, but they have little use for Russia's products.*

A further reason for the OPEC Plus decision might be to align with Russia, which has in recent weeks been struggling to find export markets for all of its oil. The country has had little problem in placing its crude, given voracious appetite from China and India (albeit with steep discounts). However, cracks are beginning to appear in its efforts to find homes for oil products, most of which used to be absorbed by Europe. China and India have little need of Russia's oil products since they already produce copious amounts of diesel, gasoline, naphtha, etc. Turkey has taken up some, but not all of the slack.

A somewhat chaotic shipping environment has not helped, and Russia's product exports have started to sag (Box 2, Figure 8). Moscow's announced 500,000 bpd production cut was ostensibly in retaliation for western sanctions, though it might also have been in recognition of a deteriorating demand picture.

*The situation has not been helped by a somewhat chaotic shipping environment. The big shipping firms want nothing to do with Russian oil, and it has been left to a gaggle of small, inexperienced firms to fill the gap.*

## Box 2: Seaborne confusion

There are growing signs of strain in Russia's overall oil export effort. Oil analytics firm Petro-Logistics said that there were increasing numbers of tankers that appear to be at anchor, waiting for export destinations to be finalized (or even agreed). Surprisingly, given its ban on Russian oil and gas imports, some ships were said to be heading to the US, though many apparently turned back mid-way across the Atlantic.

*With European markets all but closed off, the distances that Russia's oil must travel have also increased. This has added to the pressure on shipping firms.*

The confusion and growing disarray speaks in part to the withdrawal of major trading firms (Gunvor, Trafigura, Vitol) from the Russian crude market following the imposition of western sanctions. The big players have been replaced by a gaggle of little-known firms, often based in Dubai or Hong Kong, which have taken on the bulk of the shipping. These firms are inexperienced, lacking the logistical expertise or connections of the bigger players. Meanwhile, the distances to market have increased substantially: it takes around a month to ship crude from Russia's Baltic ports to India, compared with a week from the same terminals to Rotterdam. In short, Russia is having to rely on largely untested middlemen to shift its oil over much larger distances. This might begin to test the patience of oil product buyers in particular, whose specifications are much more exacting than crude customers.

Whatever the motivation, most expect that Russia's oil production will be well down this year. OPEC, the EIA and the IEA expect Russia's liquids output to be in the 10.3-10.4 mbpd range this year.

**Figure 8: Russian seaborne oil products exports are under pressure**

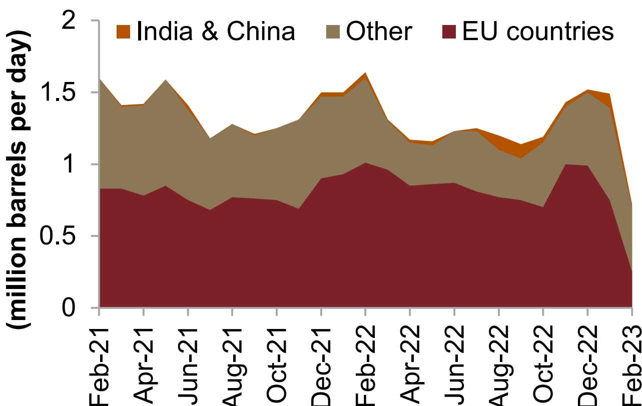
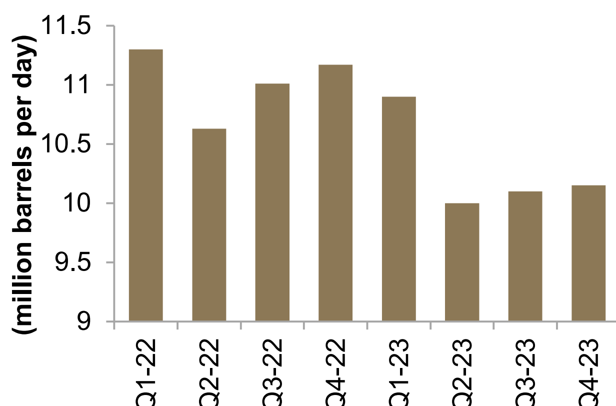



**Figure 9: IEA sees Russian liquids down 7 percent this year**



*Most see Russia's oil production declining this year. The range of decline is around 600-700,000 bpd.*

Assuming a mid-point in this range, Russia's output would be 650,000 bpd or 7 percent lower than 2022 (Figure 9).

*US shale production is also seeing headwinds. Already suffering from rampant cost inflation and higher interest rates, the fallout from the US banking crisis could also have an impact. Independent shale firms tend to rely on funding from mid-tier regional banks—exactly the sort that are under pressure from the latest crisis.*

Non-OPEC supply remains dominated by the US, which OPEC sees adding a further 1.07 mbpd in 2023 (a slight softening on the 1.17 mbpd gain in 2022). This is more bullish than the EIA, which sees just a 600,000 bpd gain in US output. In recent years, US shale production has been constrained by a tight labor market, cost inflation, an increasingly thin premium acreage, and demands for greater capital discipline from shareholders. A more recent drag has been the higher cost of capital as interest rates have surged. Indeed, there may be some direct fallout from the recent banking sector stresses, since these have led to renewed scrutiny of mid-level, regional banks—exactly the sort of institution that provides capital to the smaller independent shale producers. True, firms now have a lot of cash on their balance sheets following last year's oil price surge, but the industry remains extremely capital intensive and any retrenchment in lending would soon have an impact on drilling activity. A key metric to watch is the rig count, which is already edging down (Figure 10).

There should be some offset from other non-OPEC producers, such as Canada, Norway, Brazil and Kazakhstan. For example, the Norwegian authorities expect a 7 percent gain in output this year, as new fields from the Norwegian shelf come on line and replace declining fields. The aggregate gain in output from these countries should be at least 700,000 bpd (enough to offset Russian losses).

**We expect the market to tighten as the year progresses:**

*Summing up the outlook, the market is expected to tighten during the course of the year as China's demand firms and Russian output declines.*

Drawing these strands together, the global oil market is expected to tighten quite sharply from May, and move into deficit in the second half of the year. In 2024, both supply and demand look set to strengthen as the US Fed begins its interest rate easing cycle, and as OPEC responds with enhanced production.

Prices have already responded positively to the OPEC Plus cuts and the sense that the financial sector turbulence might be dissipating. Brent was trading at around $85 pb in the immediate aftermath of the OPEC announcement, returning to the previous (pre-financial jitters) range of $85-90 pb (Figure 11). We also note that refining margins are currently quite wide, which should help to support crude demand, particularly once the US refinery maintenance season ends in May.

**Figure 10: US oil rigs beginning to decline**

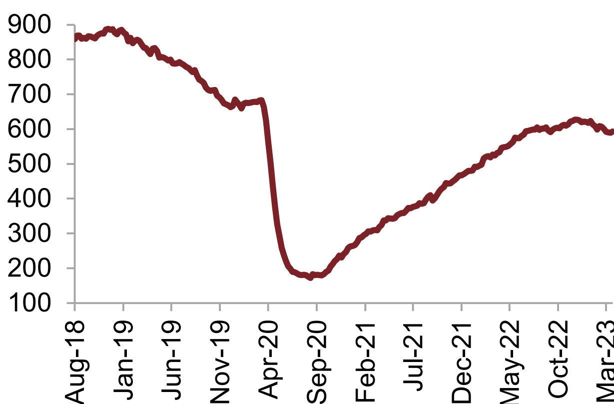
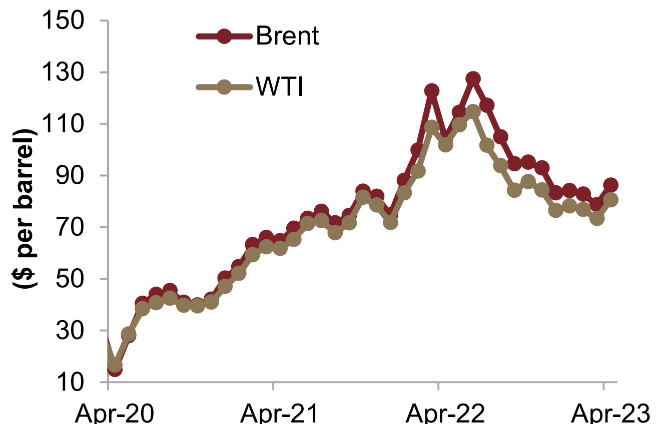



**Figure 11: Brent and WTI**



*We continue to see Brent averaging $90 pb in 2023. Risks are balanced, with the possibility of a worse-than-expected US slowdown counterbalanced by the evident willingness of OPEC to take action.*

We see Brent shifting above $90 pb in H2-23 as China's post-Covid 19 resurgence intensifies, and US shale problems become more evident. We therefore maintain our forecast for Brent at an annual average of $90 pb.

The biggest risk to the forecast is the prospect of the US suffering such a sharp slowdown (or recession) that it sparks a major sell-off in risk assets, including oil. Such a scenario should be avoided, if only because a retrenchment in US activity has already been priced into valuations, but a "risk off" over-reaction should certainly not be ruled out. Recessions are hardly ever "orderly" events, with second-round effects that are difficult to predict, never mind contain. An offsetting upside risk is potential further OPEC policy action. The April announcement was unexpected and shows that the organization is not afraid to act in support of prices.

On the assumption that demand and supply develop as we expect, then a price of around $87 pb appears likely for 2024. The risks here are slanted towards the upside given the "risk-on" momentum that might accompany Fed rate cuts.

*Longer term price developments are likely to be driven by the dearth of oil major capital investment, particularly in long-cycle projects. Shale producers might benefit in the short run, but even they are facing a challenging geological situation. Thus, OPEC producers are well-placed for longer-run market share gains.*

The medium term outlook will be heavily influenced by non-OPEC capacity expansion (or the lack of it). There has been a well-documented dearth of such investment in recent years, partly Covid-19 related, partly a response to higher interest rates, and partly an oil major response to public concerns about fossil fuel development. Goldman Sachs notes that long-cycle deep water and conventional oil fields are facing steepening decline rates given a lack of capex (even for maintenance spending), while Russia's production looks set to be hemmed in for some time by a lack of foreign technology. This leaves US shale and OPEC as the engines of oil supply growth in the medium term. US shale also faces headwinds given capital access and an ageing geology, which leaves OPEC (and especially Saudi Arabia and the UAE) well placed to secure additional market share in the years ahead.

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