Economics

September 26, 2016

Oil Markets in 2016

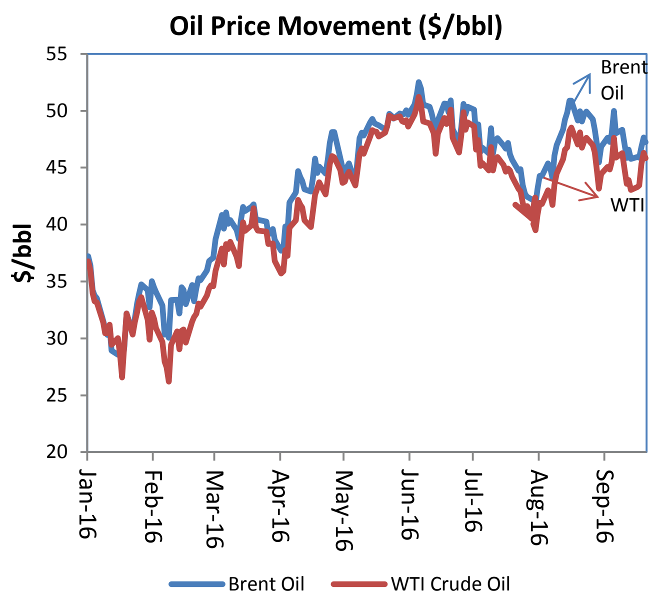
The 14 member-OPEC (Organization of the Petroleum Exporting Countries) nations which supplies 34% of global crude oil is headed for another round of supply freeze talks this week. However, it is unlikely to result in any agreement between the member nations.

Movement in prices

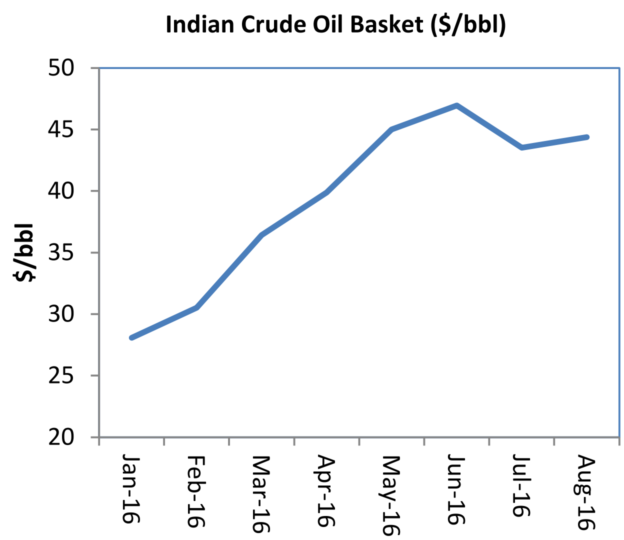
Reversing the price decline seen in the second half of 2015, crude oil prices have rebounded significantly since the start of 2016. Global benchmark oil prices have risen by over 40% in the last 9 months and are currently around $47/bbl for Brent and $42/bbl for WTI (West Texas Intermediate).

During the first 6 months of 2016 crude oil recorded an upward trend with the prices ranging between $32-50/bbl. The pace of price increases has however moderated in the last 3 months and has been subject to periods of fluctuations. Also, despite the recent increases, oil prices continues to be over $15/bbl lower than the prices in June'15 and nearly $50/bbl lower than that in Sep'14. Crude oil markets since the second half of 2014 have witnessed a significant decline in prices (a decline of over 120%).

In the Indian context, the price of the Indian Crude Oil Basket has risen 58% for the period January to August'16.



Source: CNN



Source : PPAC

Price Drivers

Although the supply and demand dynamics of the oil markets have undergone significant changes in the last 2 years, oil prices this year have been driven by a number of factors, some of them being short term in nature, such as:

- Multiple supply outages and disruption in producer regions (wildfires in Canada, attack on oil infrastructure in Nigeria, supply disruption in Kuwait, Libya and Iraq)
- Decline in non-OPEC production viz. US oil output (by close to 1 mn bbl/day this year)
- Weakness in the US dollar (the US dollar index has declined 4% since Jan’16),
- Improving global demand indicators viz in India
- Favourable market sentiments.

At the same time, the upward movement in oil prices has faced resistance from growing supplies with OPEC producers pumping oil at almost full capacity. Further, following the easing of international sanctions in Jan’16 Iran’s oil supplies have enhanced international markets. Also the buildup in inventories/stocks to near record highs augmented supplies. Demand was tempered to an extent by lower Chinese offtake.

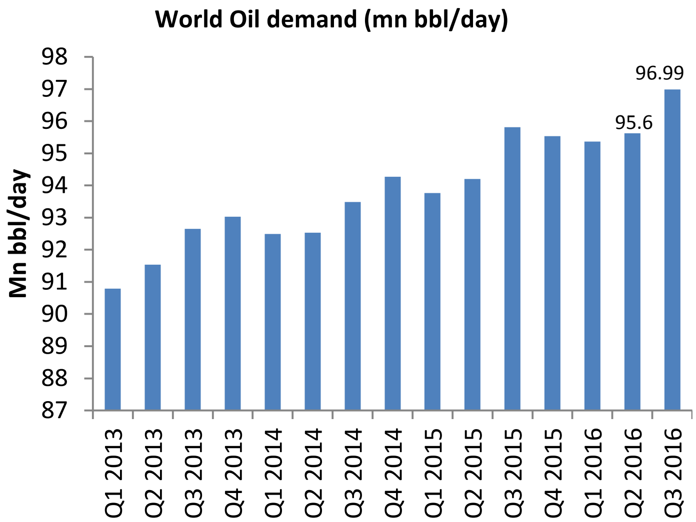
The slowdown in product (gasoline) demand and the easing and recovery of disrupted supplies have hence put downward pressure on prices.

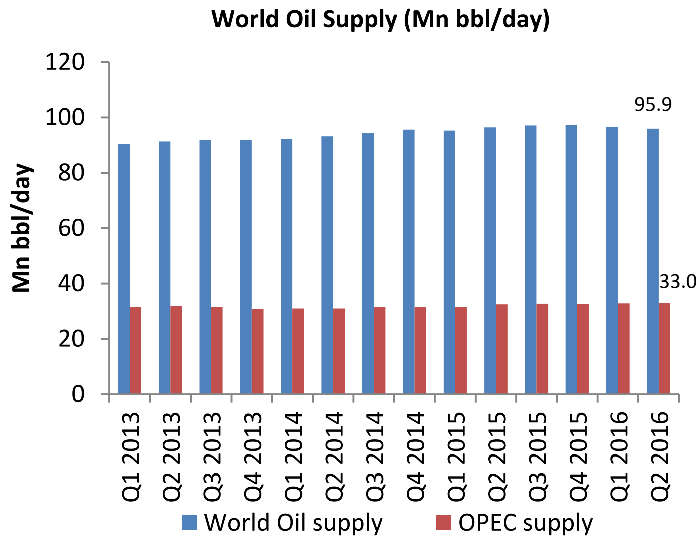
Demand – Supply Dynamics

Demand

Global oil demand growth has been slowing. In the first quarter of 2016, global oil demand grew 1.7% (year-over-year basis). The growth in oil demand slowed to 1.5% in Q2 2016 and further to 1.2% in Q3-2016 (compared with the growth of 2.5% in Q3-2015). Demand growth in the first 9 months of 2015 (Jan-Sept’15) was 1.8% and for the comparable period in 2016 it is lower at 1.5% (95.9 mn bbl/day).

On a quarterly basis though there has been improvement in demand in Q3-2016 (1.4%), following marginal growth in Q2-2016 (0.3%) and negative growth in the previous 2 quarters. Oil demand is in part aided by energy demand from India as well as gasoline demand in US and Europe, which has been slowing. Demand is unlikely to see any perceptible improvement from current levels (96 mn bbl/day) for the remainder of the year.





Source: IEA

Supply

Global oil supply has been surpassing demand since early 2014. The supply – demand gap has however been narrowing this year, owing to decline in non-OPEC output and supply outages in specific locations. In Q1-2016 supply exceed demand by 1.3 mn bbl/day, compared with the 1.5 mn bbl/day for the comparable period last year. In Q2-2016 supply outpaced demand by 0.3 mn bbl/day, significantly lower than 2.3 mn bbl/day in Q2-2015.

OPEC oil supplies have been steadily increasing to touch record high of 33 mn bbl/day in Q2-2016 (6% increase from Q2-2014 and 2.5% increase from that in 2015). OPEC has all along been maintaining its high production levels despite the fall in oil prices. OPEC supplies are likely to increase further with member nations unable to agree to limit output and fresh supplies coming on stream viz. from Iran. Iran oil production is slated to increase from the current 3.5 mn bbl/day to over 4 mn bbl/day. Overall OPEC supplies have been able to offset the decline in supplies from non-OPEC regions as well as from its own member nations.

Technology driven improvements in extraction, transportation and transport fuel efficiency have been leading to improved supplies. In case of US oil supplies, the fall in oil prices since 2014 has resulted in a drop in new investments and many small oil wells shutting down. Production however improved from the efficient wells, aided in part by advances in technology, costs and operating efficiencies. The limited quantum of new investments in the USA could have a bearing on future production capacity and output. With the lifting of US crude oil export ban in Dec’15, US oil exports are likely to see an increase, albeit a gradual one.

Global oil markets are likely to be well supplied in the absence of a pickup in demand and addition of new inflows (viz. rom OPEC). Also, oil inventories/stocks are at record levels (OECD stocks at 3.1 mn bbl) and are expected to increase further. The supply- demand gap is likely to persist well into 2017.

Forward Price Outlook

Growth in most emerging market economies (viz. China), which have been the drivers of commodity demand in the last decade has been strained and is unlikely to revive anytime soon. Likewise, economic activity in the advanced economies despite the loose monetary policy and stimulus measures has been at best mild. Against this backdrop, global crude oil demand situation is unlikely to see a noteworthy improvement.

The global energy demand-supply trend and outlook i.e. slowdown in demand and rise in supply, indicate limited upside for crude oil prices from current levels. Low oil prices could prevail for the next couple of years. Supply disruptions in producer countries could result in short term price volatility, albeit marginal in nature. We expect crude oil prices to rule around $45-50/bbl for the remainder of 2016.

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