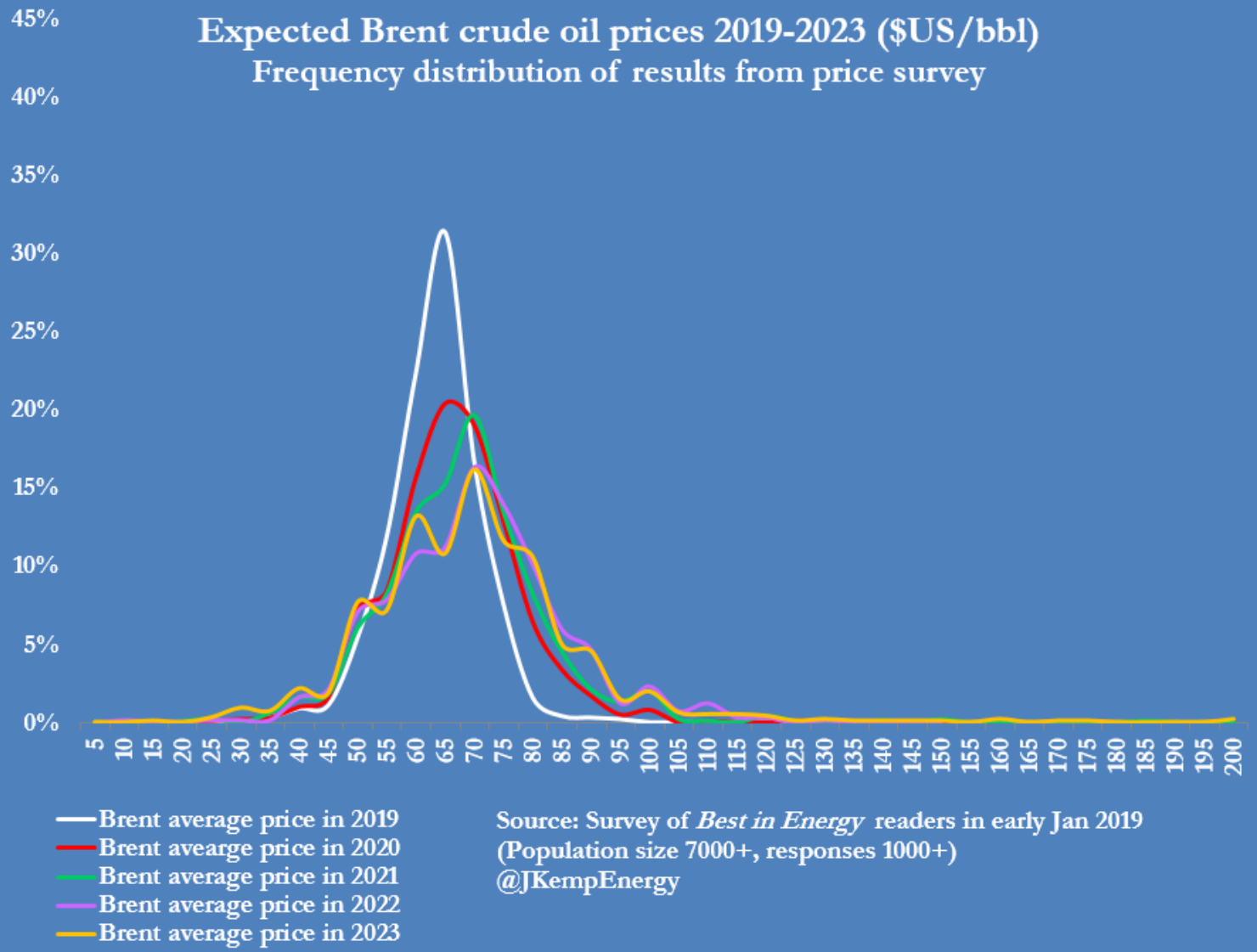
Outlook for oil prices in 2019

Some observations

JOHN KEMP
REUTERS
20 March 2019

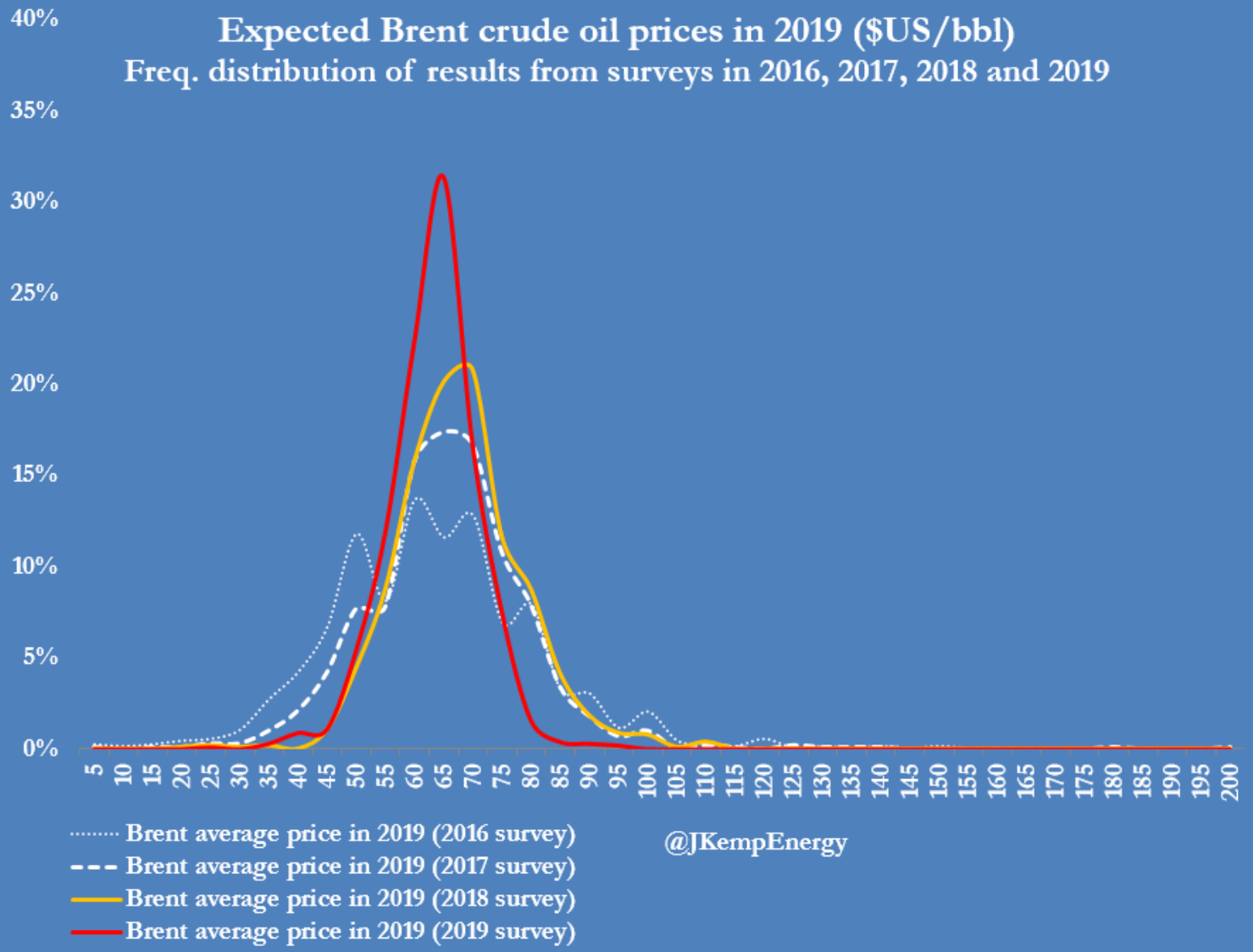
Brent crude price expected to average around $65 per barrel in 2019

Forecasts tightly clustered, price not expected to rise much through 2023



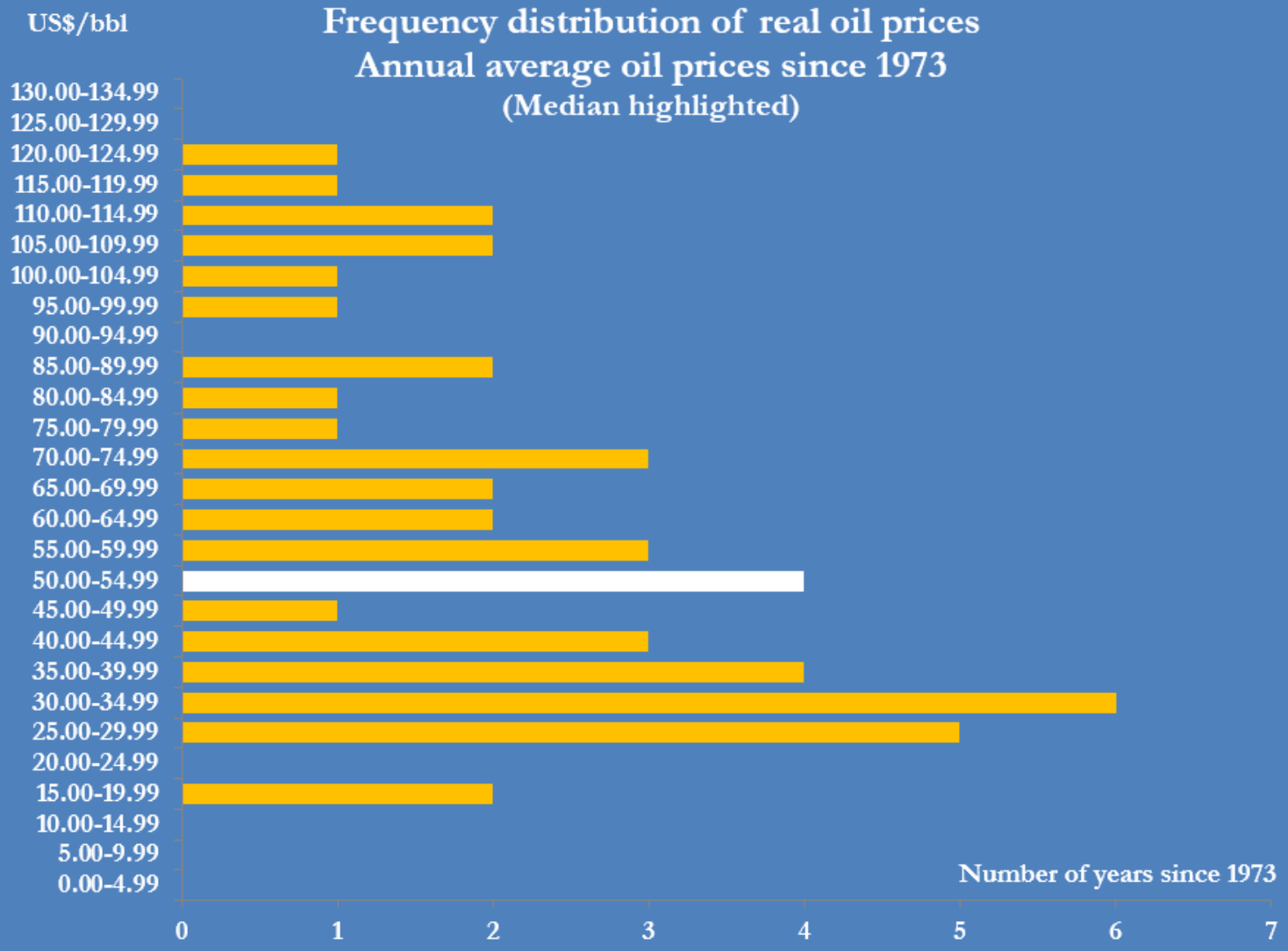
Price forecasts have changed little over last four annual surveys

Market seen anchored or balanced around $65-75



Brent has averaged $63 so far this year, down from $72 in 2018

Real prices are (just) in the top half of the distribution since 1973



Source: *BP Statistical Review of World Energy, 2018* and author calculations

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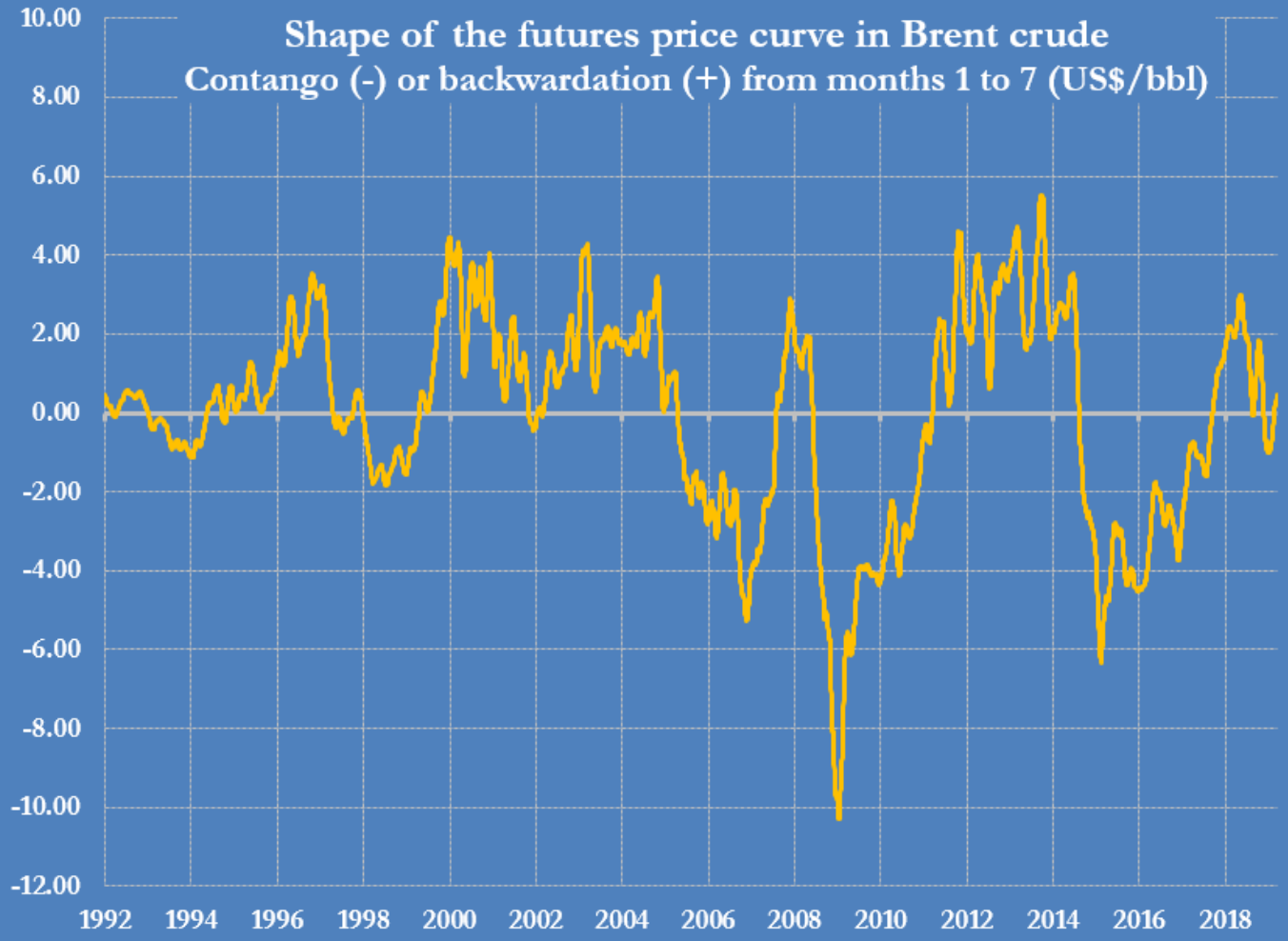
Brent six-month calendar spread reverts to backwardation of $1/bbl

Traders currently expect market to be roughly balanced in 2019



Price difference between 1st listed contract month and 7th listed contract month for Brent futures (U.S.$/bbl)
Contango (-) or backwardation (+) averaged over 30 days

Source: Thomson Reuters Eikon, ICE Futures
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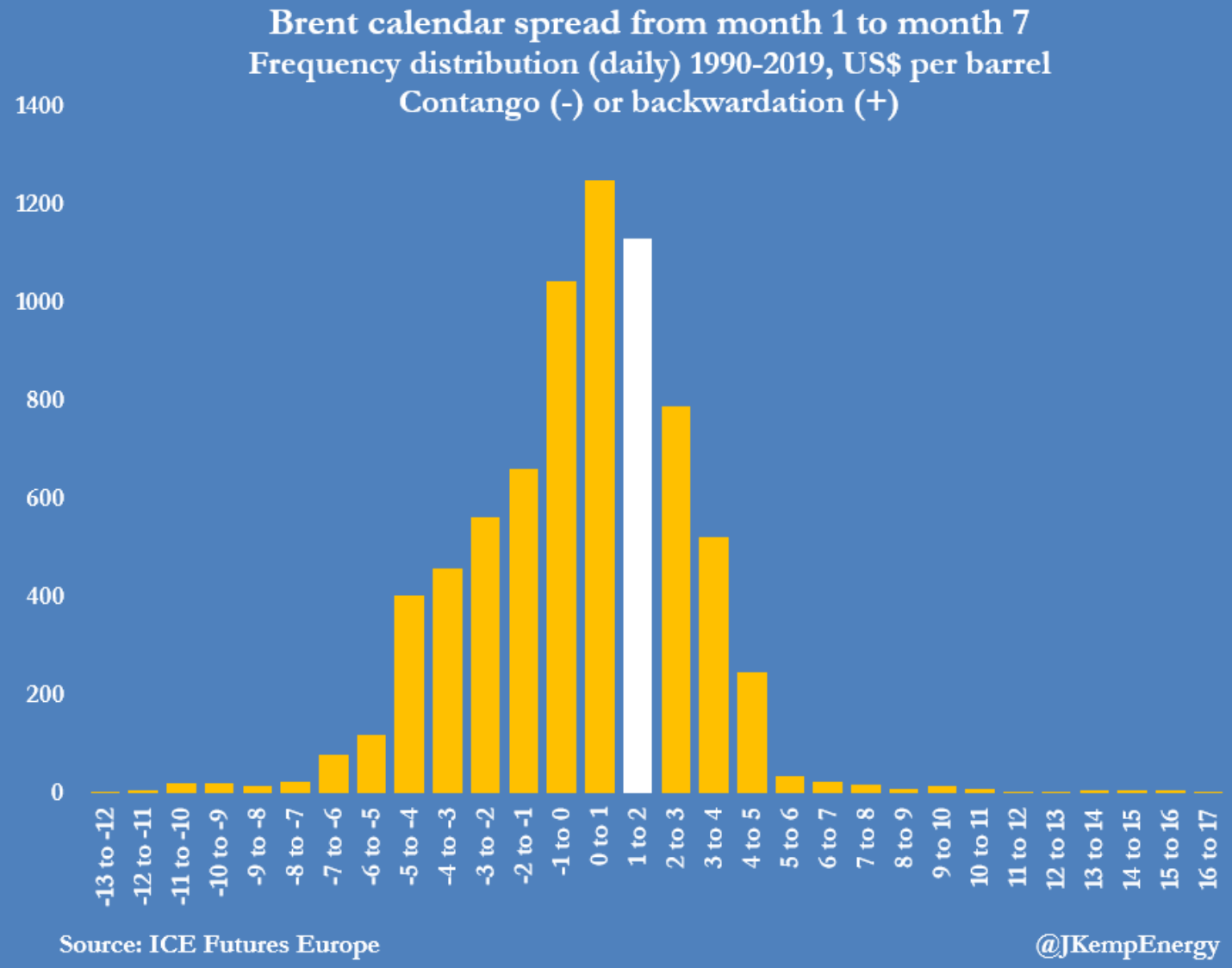
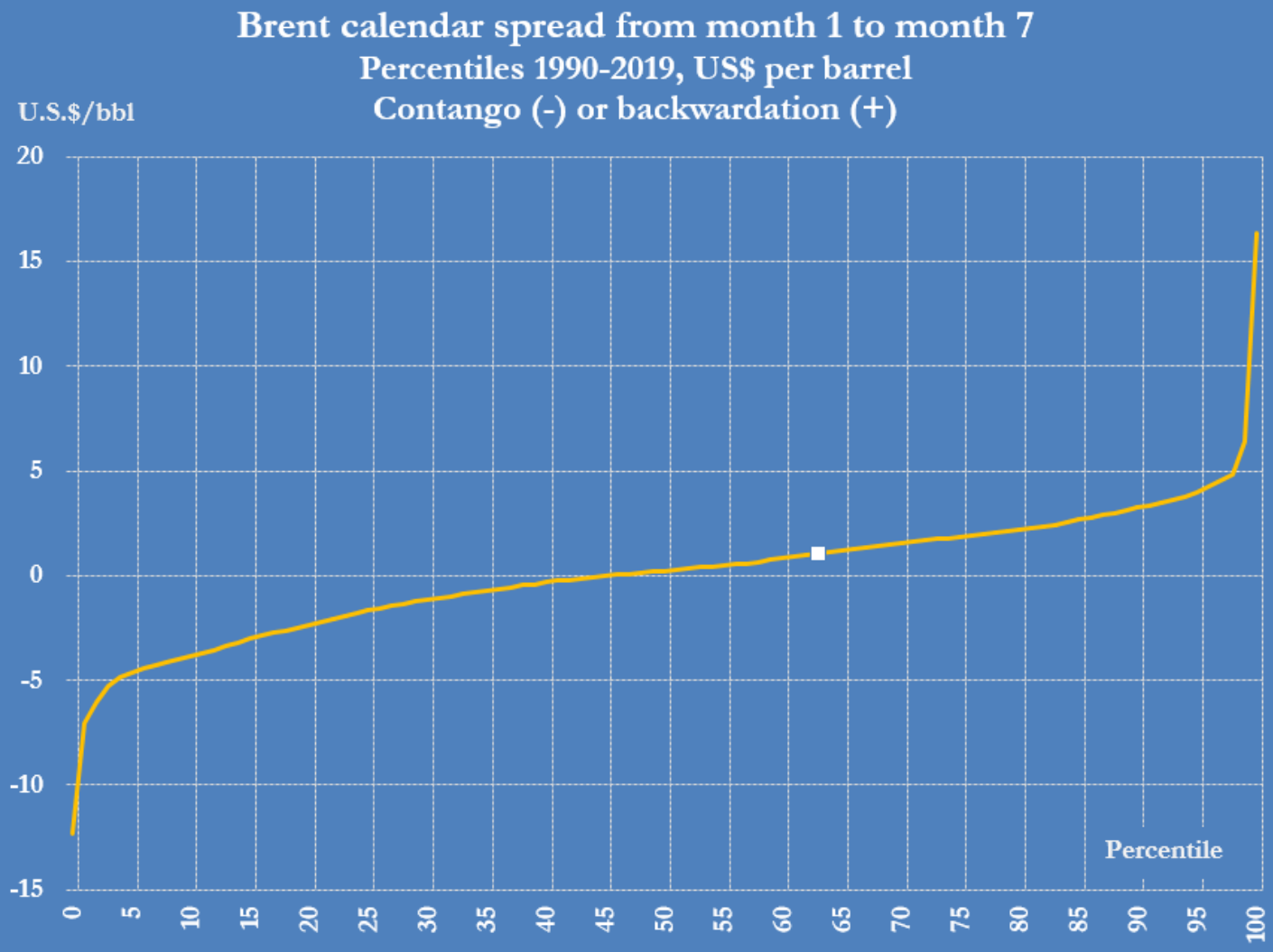
Brent six-month calendar spread slightly above long-run average

Traders see market tightening, on balance, but no strong directional signal



Brent calendar spread trading around 63rd percentile

No strong conviction on market tightening or easing in 2019



Source: ICE Futures Europe

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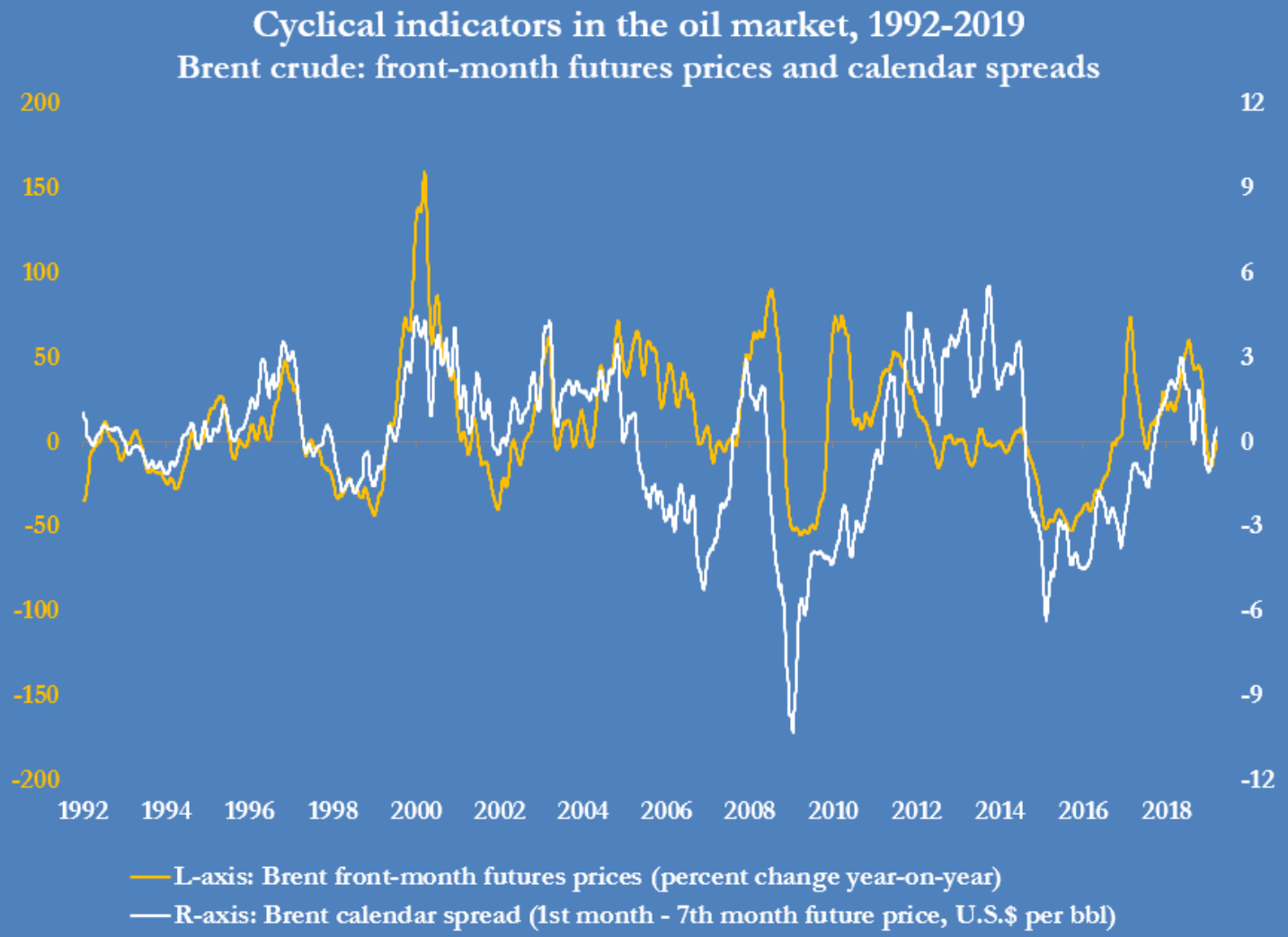
Brent spot price and spreads both point to market expected to balance

Prices and spreads have steadied after slumping in Q4 2018



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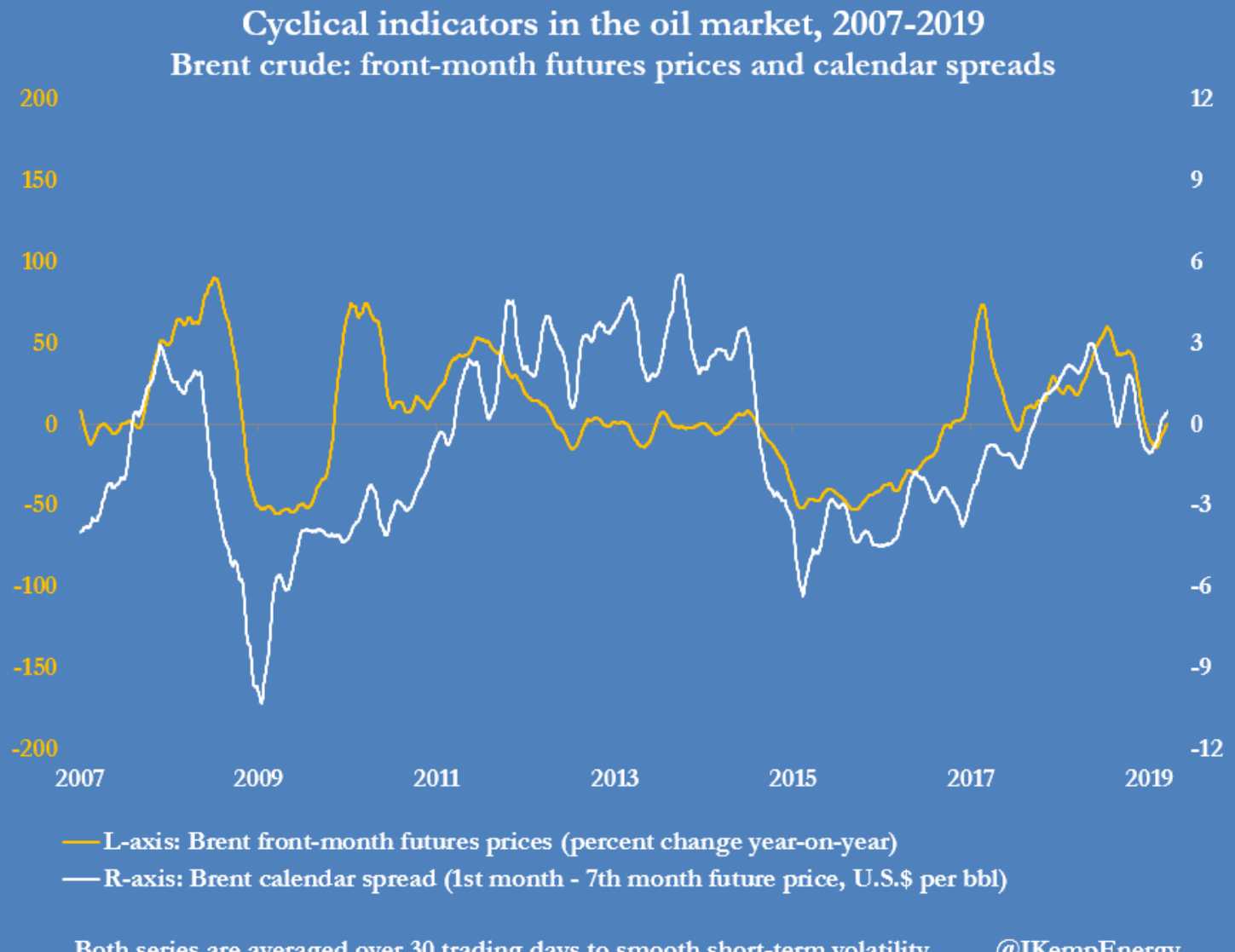


Principal influences on oil prices in 2019

External variables
(mostly independent of oil prices)

(1) Global economy
- U.S./China trade war
- Financial conditions
- Global business cycle

- Oil-exporting countries
- Commodity-dependent economies

Internal variables
(mostly dependent on oil prices)

(2) U.S. shale production growth
- Reaction to lower prices

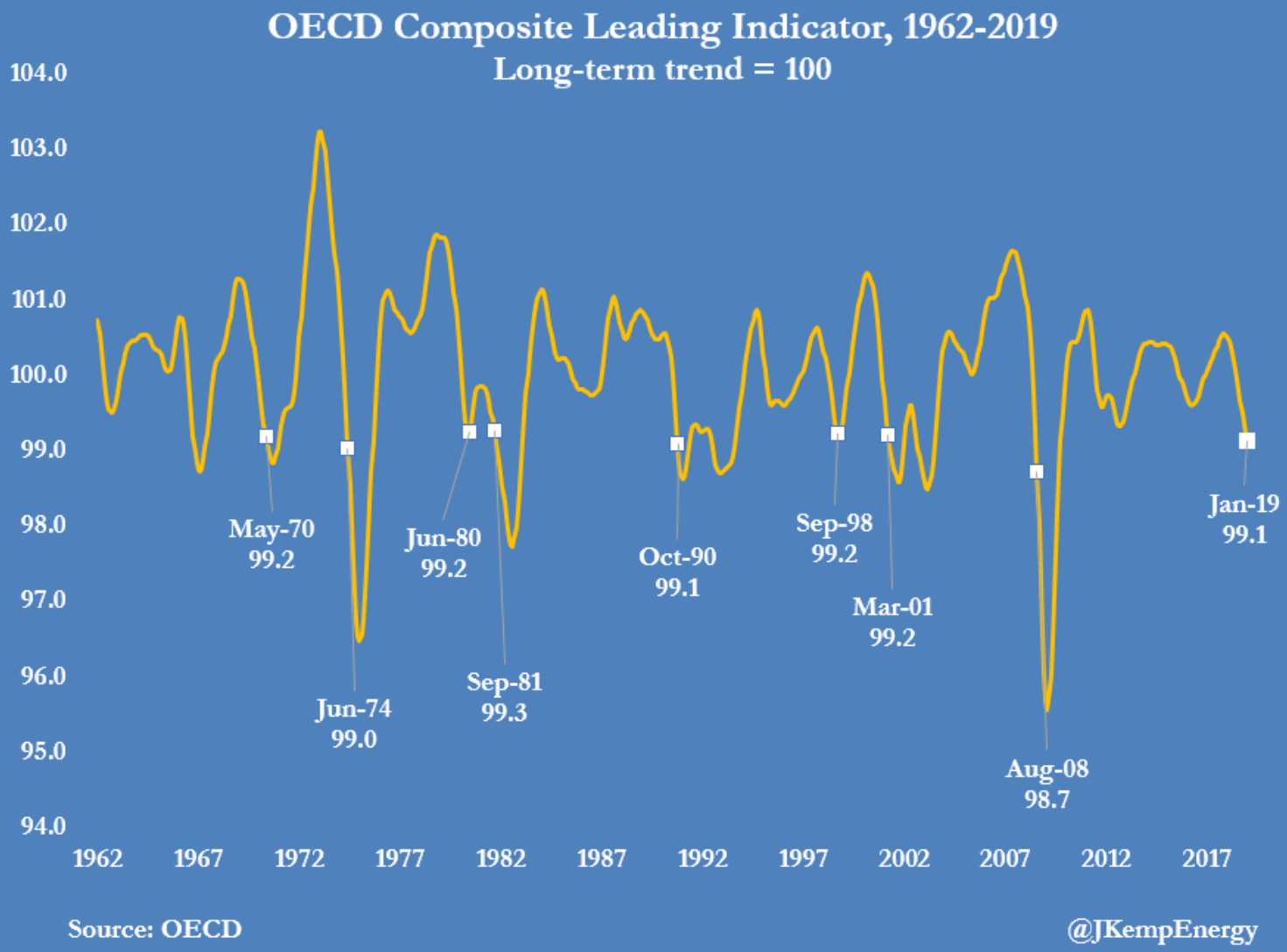
(3) OPEC+ output reductions
- Reaction to lower prices
- Group discipline
- Trump pressure

(4) U.S. sanctions on Iran
- Renewal of waivers
- Availability of replacement bbl
- Price impact

(5) U.S. sanctions on Venezuela
- Availability of replacement bbl

Global economic growth has slowed sharply over the last year

OECD leading indicator has fallen to level normally associated with recession



Source: OECD

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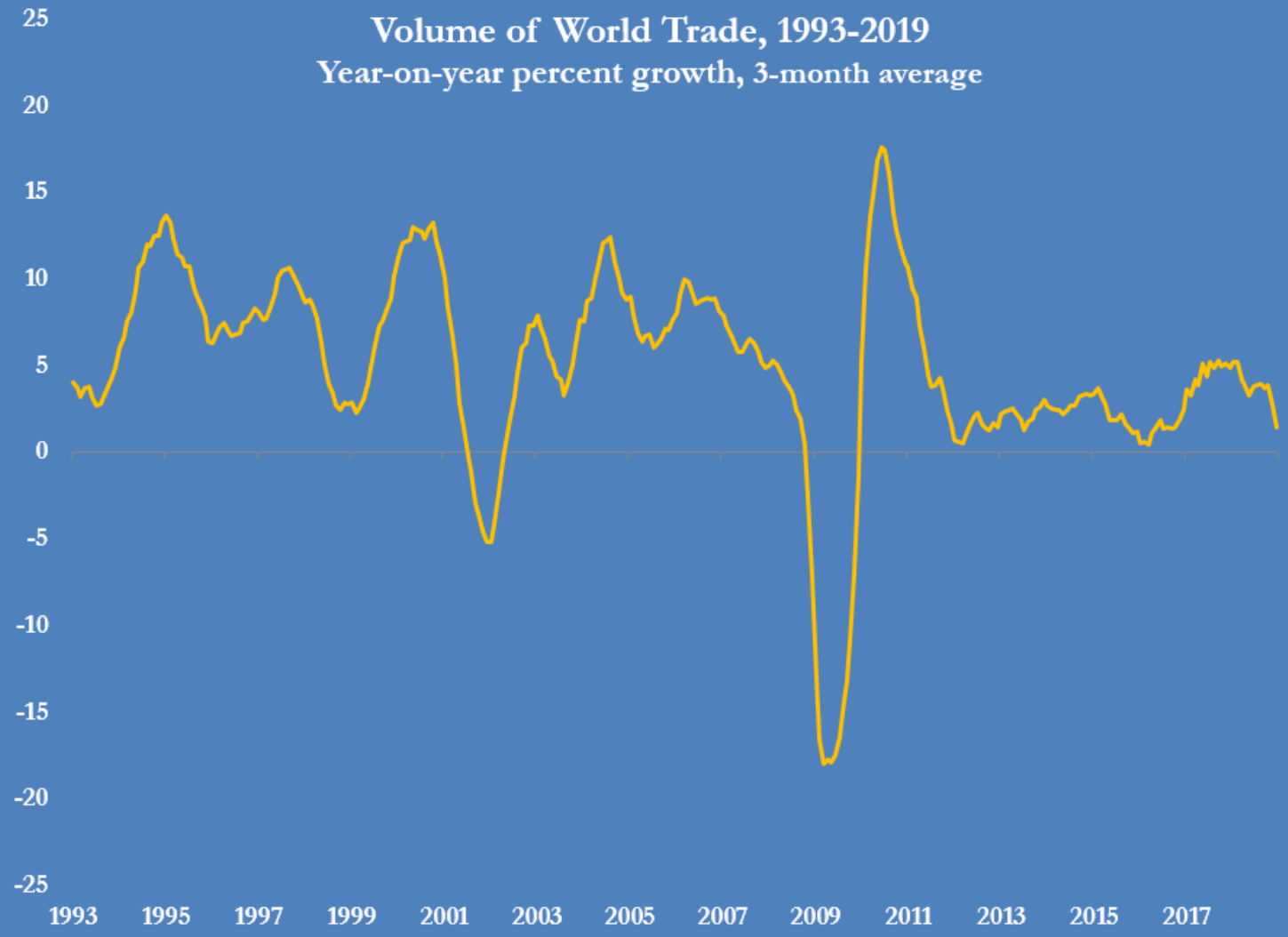
World trade growth has slowed significantly since 2017

Trade volumes actually fell in Q4 2018



Source: Netherlands Bureau for Economic Policy Analysis, *World Trade Monitor*

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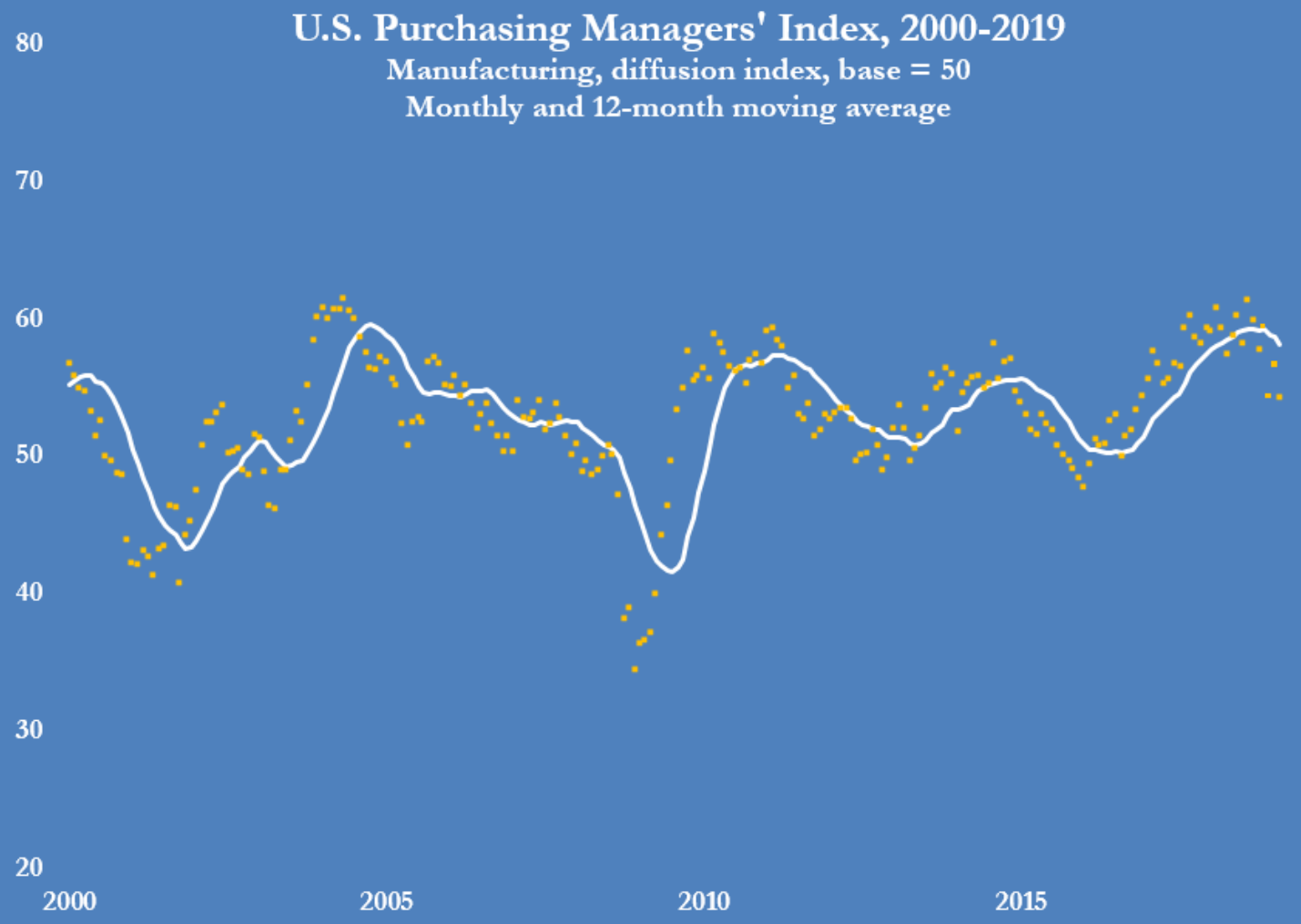
U.S. manufacturing growth has slowed since Aug 2018

ISM manufacturing index shows deceleration to more moderate expansion



Source: Institute for Supply Management, *Manufacturing Report on Business*

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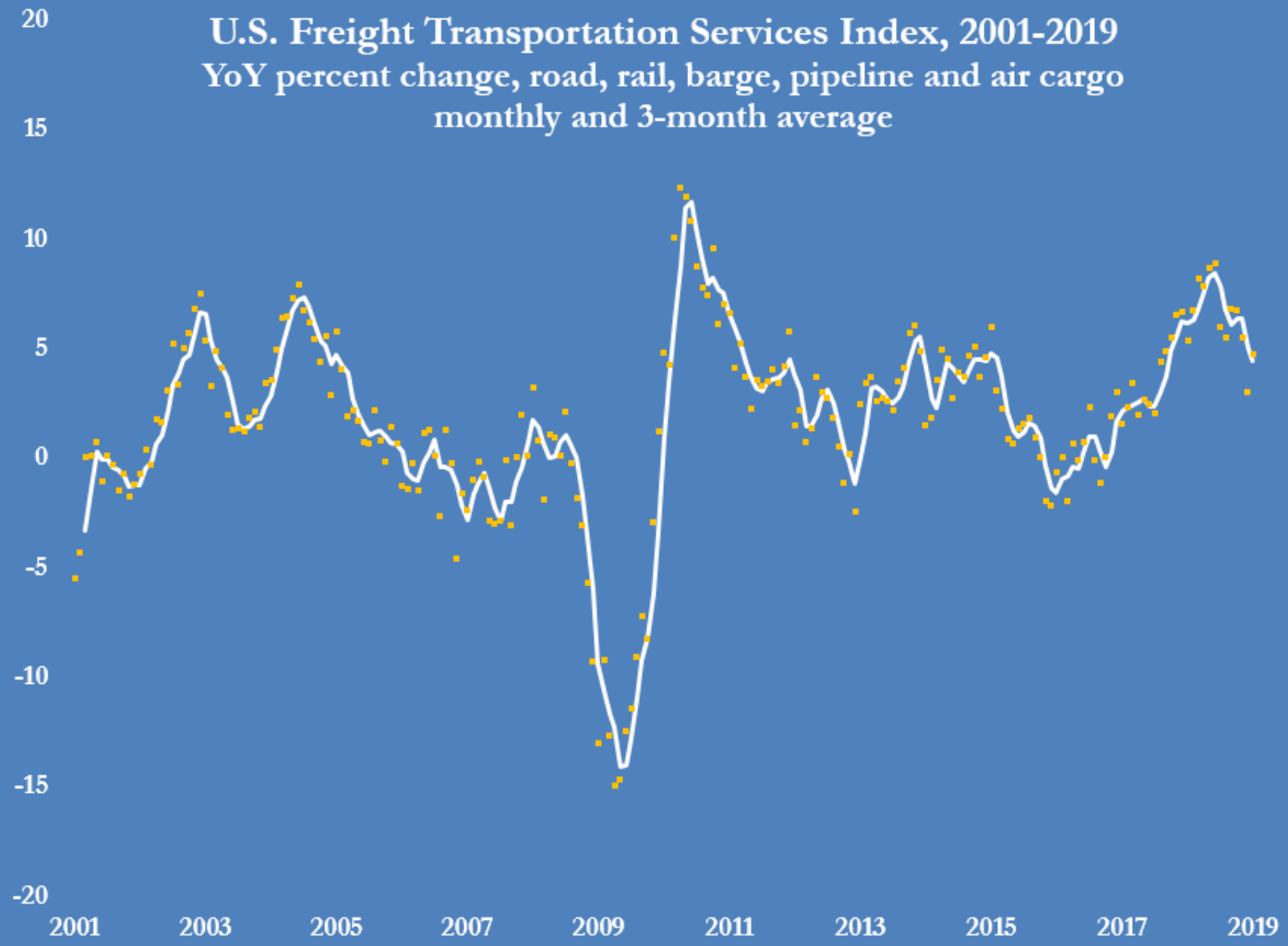
U.S. business investment shows signs of slower expansion

Durables orders for new capital equipment ex defence and aircraft decelerate

U.S. freight volume growth has decelerated since summer of 2018

Freight volumes growing around +4% down from +8% in middle of last year



Source: U.S. Bureau of Transportation Statistics

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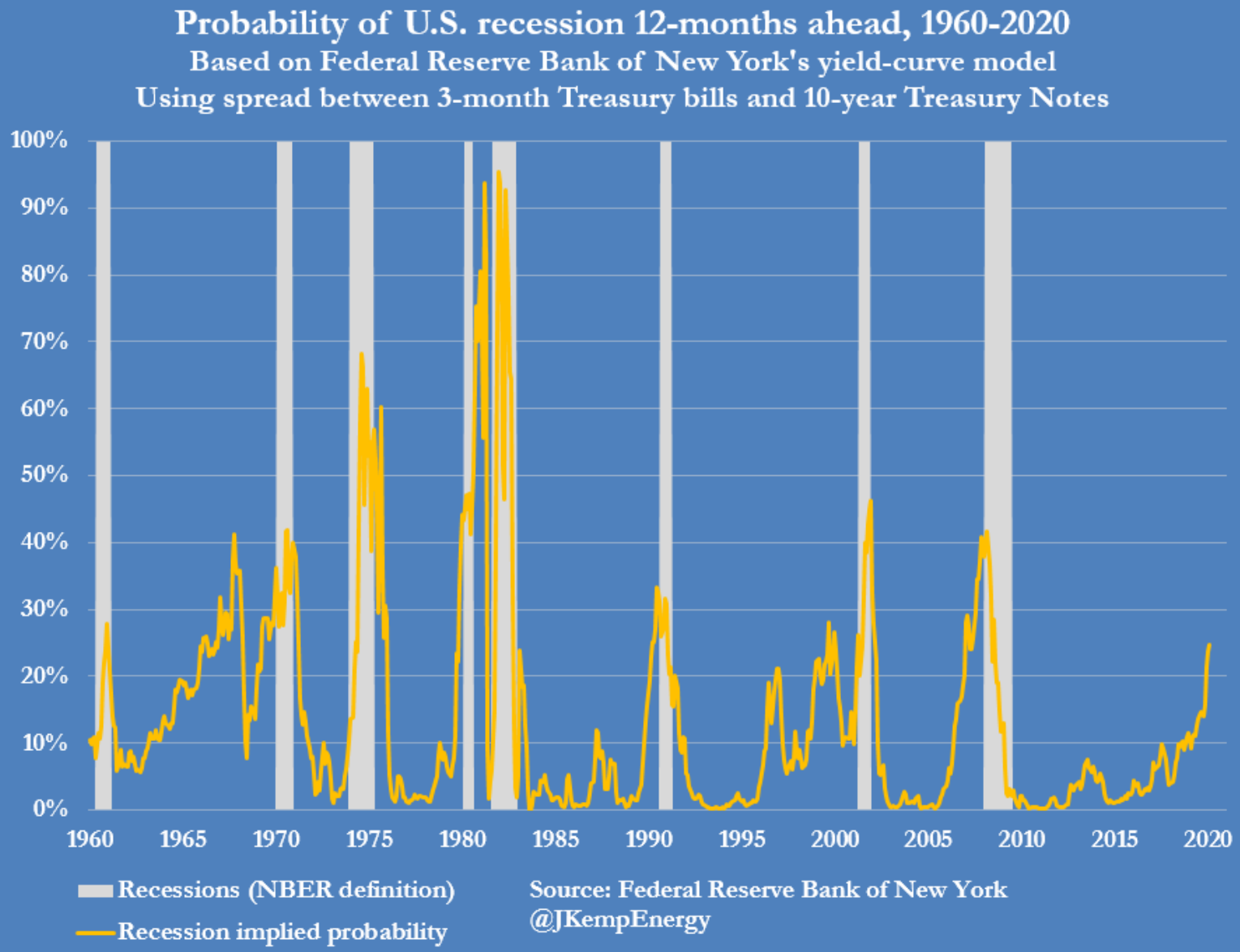
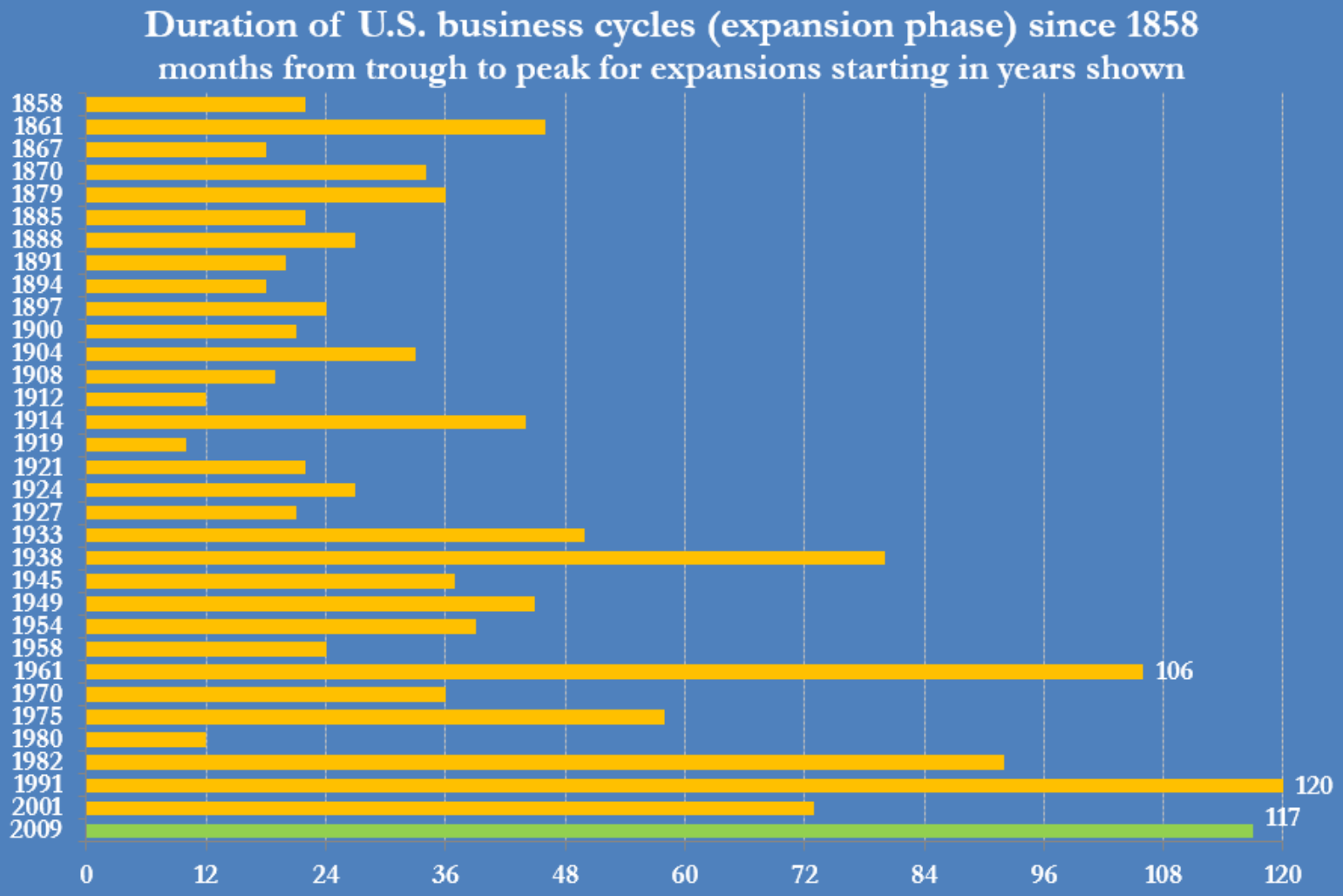
U.S. Treasury yield curve flattening signals heightened recession risk

New York Fed yield curve model shows 25% probability of recession in Feb 2020



U.S. business cycle now very mature

Do expansions die of old age or are they murdered? Risks of policy error?



Source: National Bureau of Economic Research

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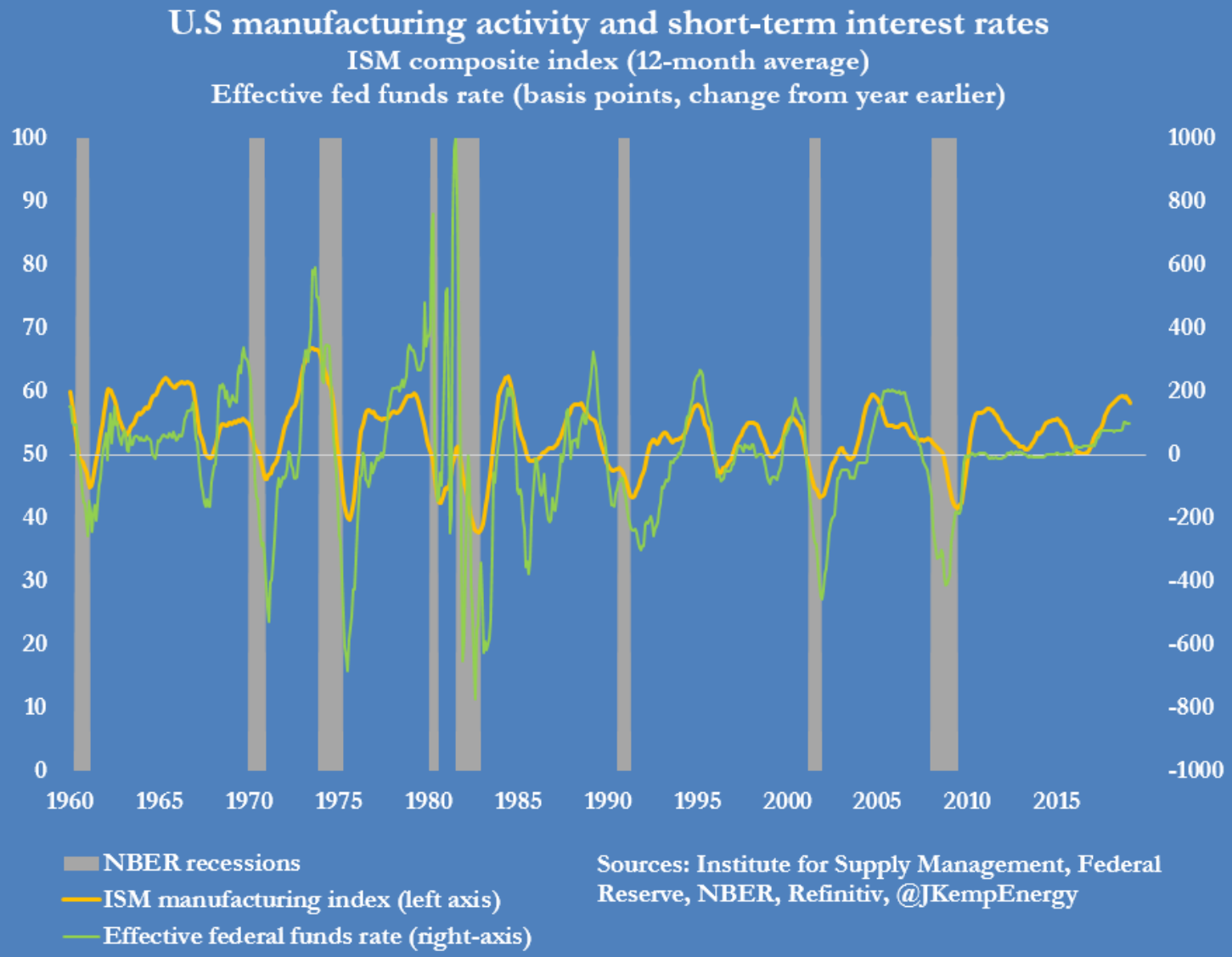
U.S. Federal Reserve typically responds to signs of slowing economy

If manufacturing growth decelerates further, Fed likely to ease monetary policy



Scenarios for the global economy in 2019

U.S./China relations, business reaction, Fed response dominate outlook

U.S./China relations

(1) Comprehensive settlement

(2) Limited trade deal

(3) No deal

Fed policy response

(1) Continued tightening

(2) Extended pause

(3) Easing

Global economic outlook

(A) Re-acceleration

(B) Extended slowdown

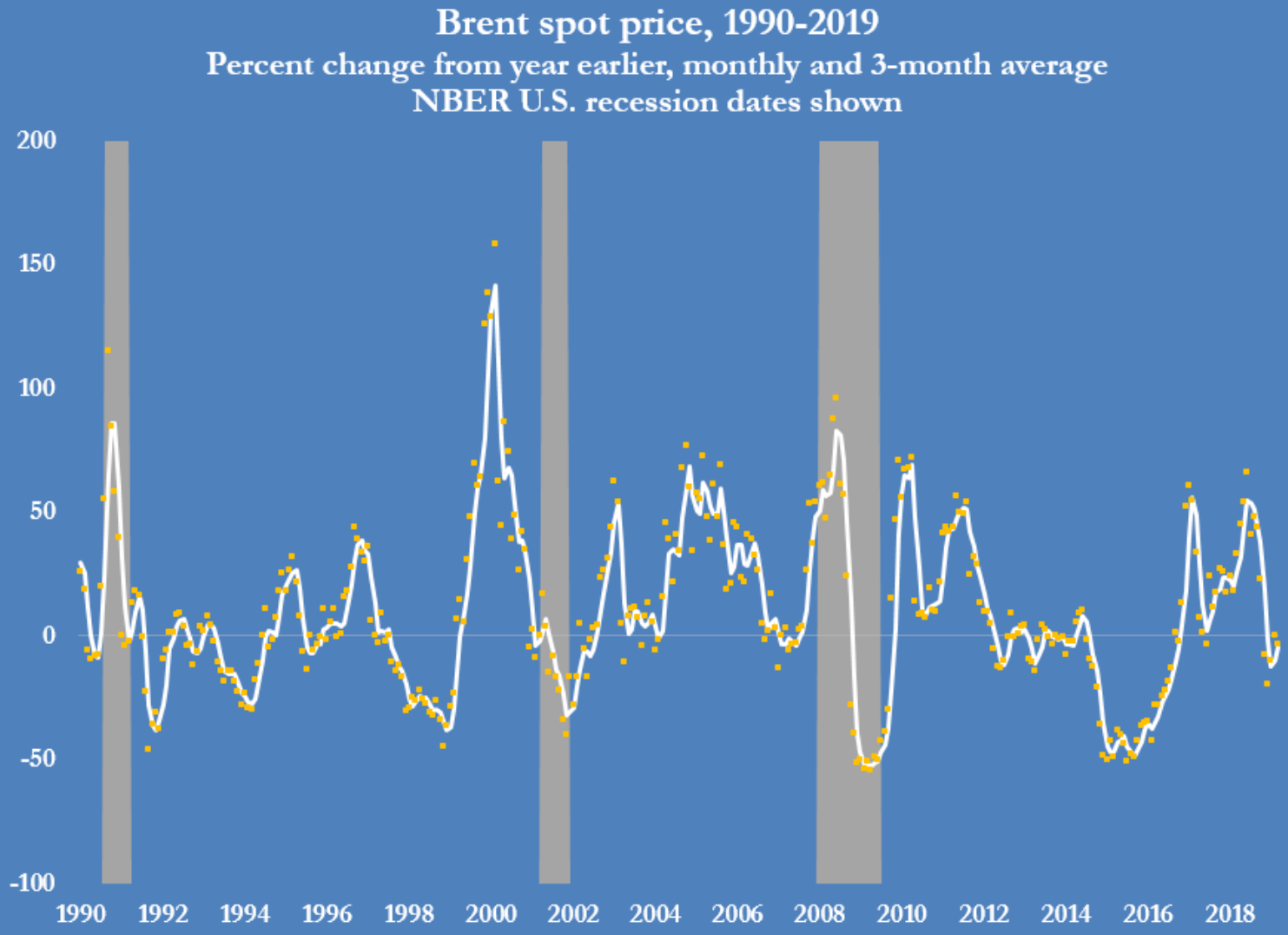
(C) Recession

Mid-cycle slowdown or end of cycle?

Is the global economic cycle in 1998 or 2001?

Brent prices and the economic cycle – 1998 or 2001?

Intra-cycle and end-cycle slowdowns have different consequences for oil market



Source: ICE Futures Europe, National Bureau of Economic Research

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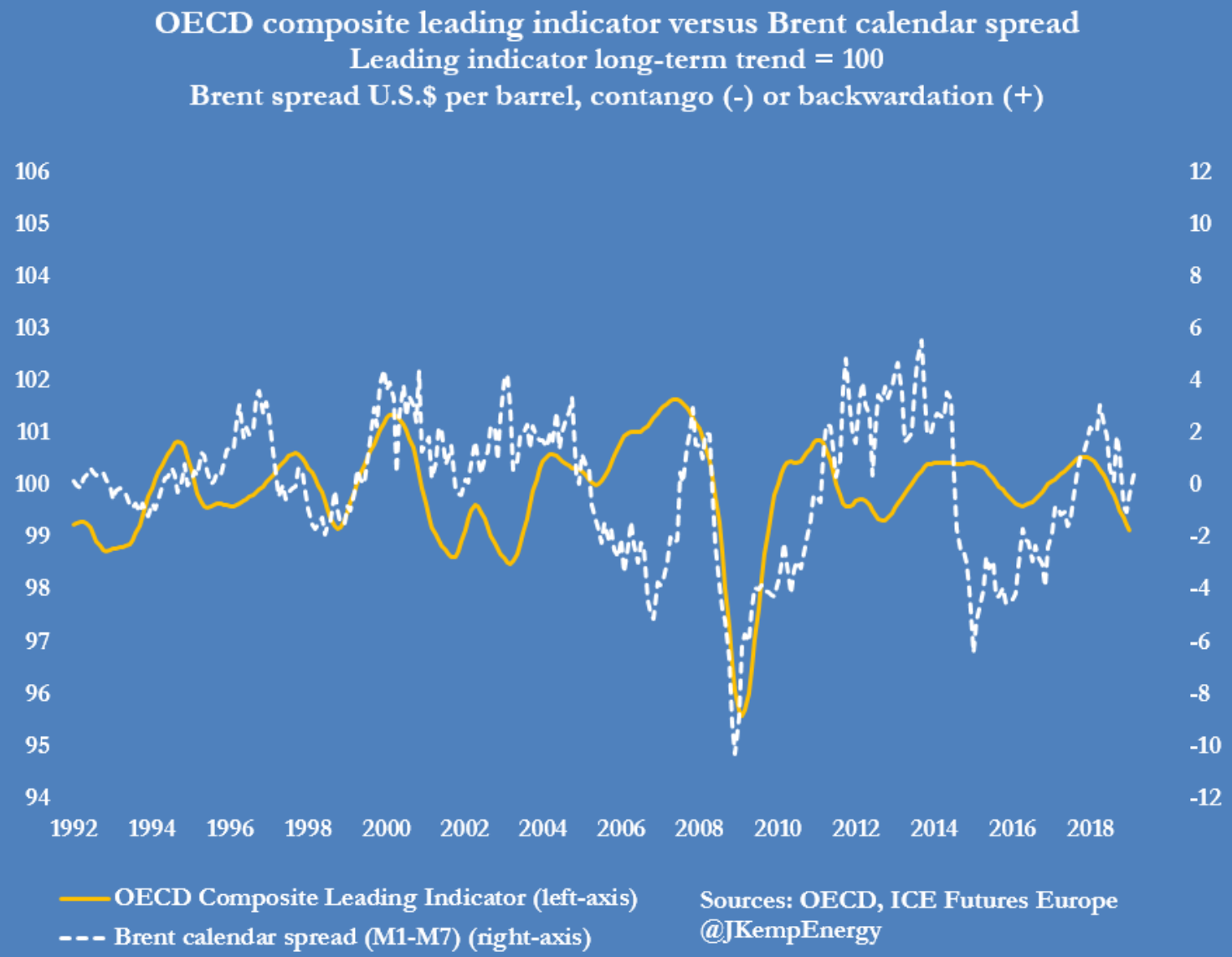
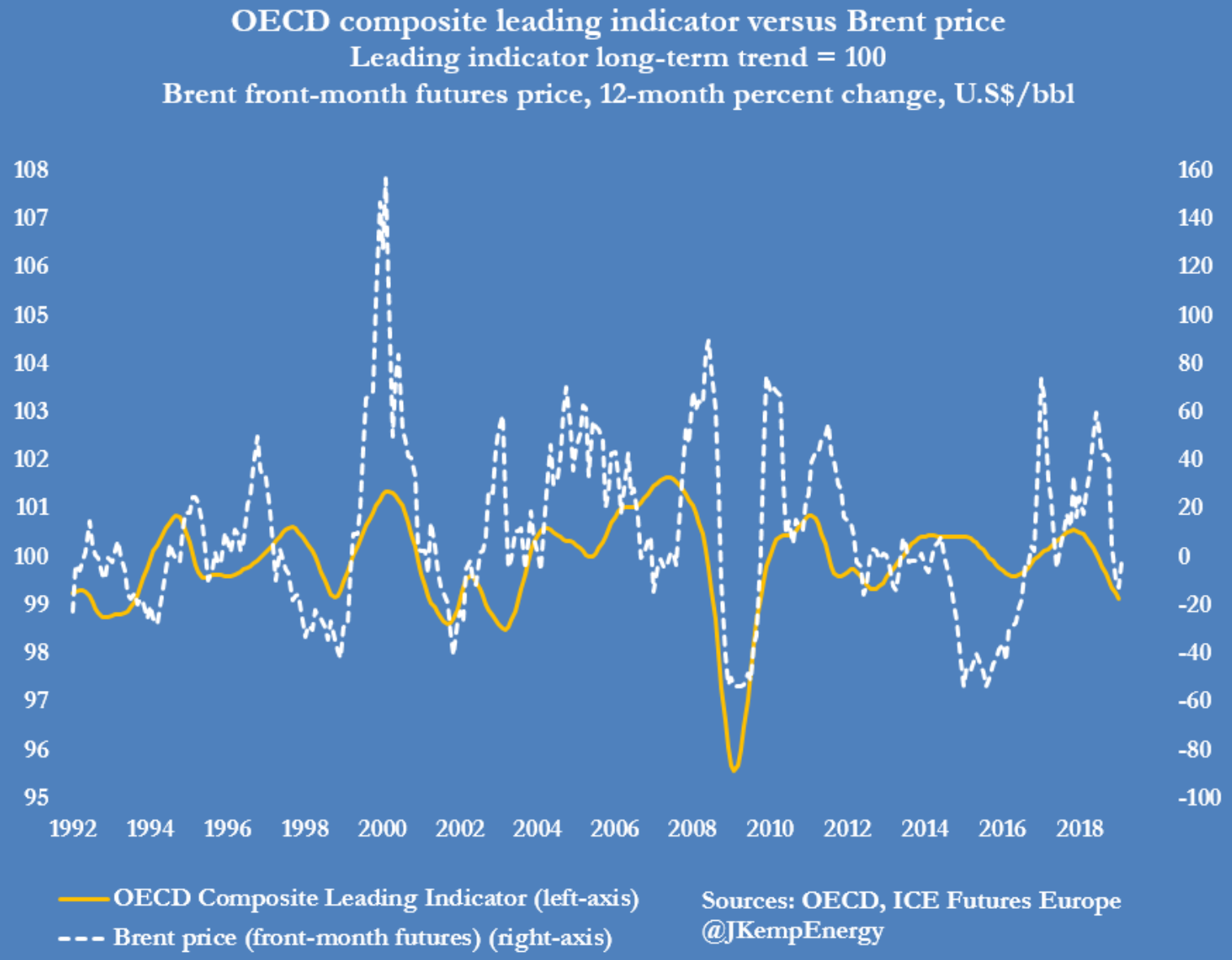
Brent calendar spread and the global economic cycle

Spreads slumped in Q4 2018 as economic and consumption outlook deteriorated



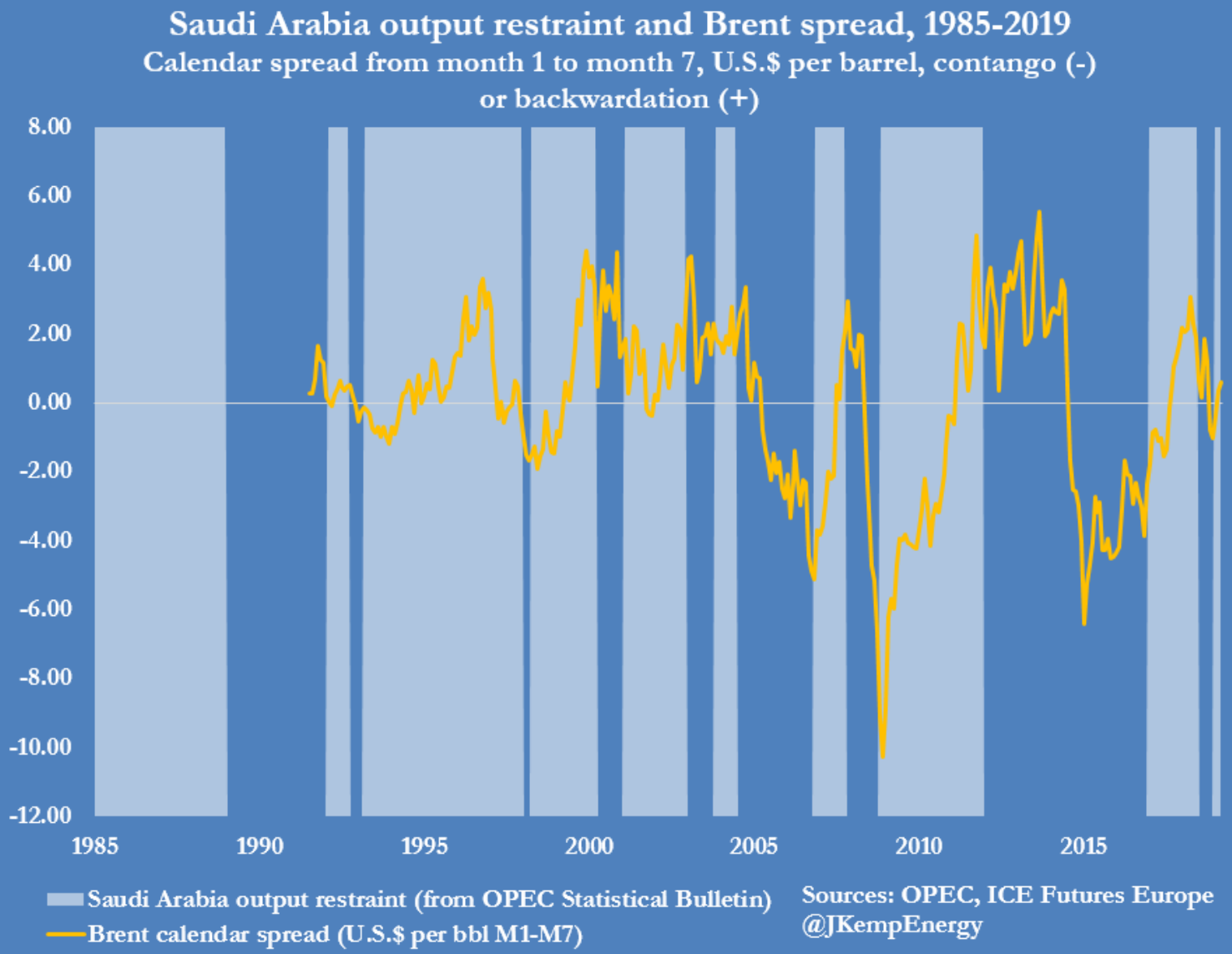
Brent spot price and the global economic cycle

Spot price slumped in Q4 2018 as economic and consumption outlook worsened



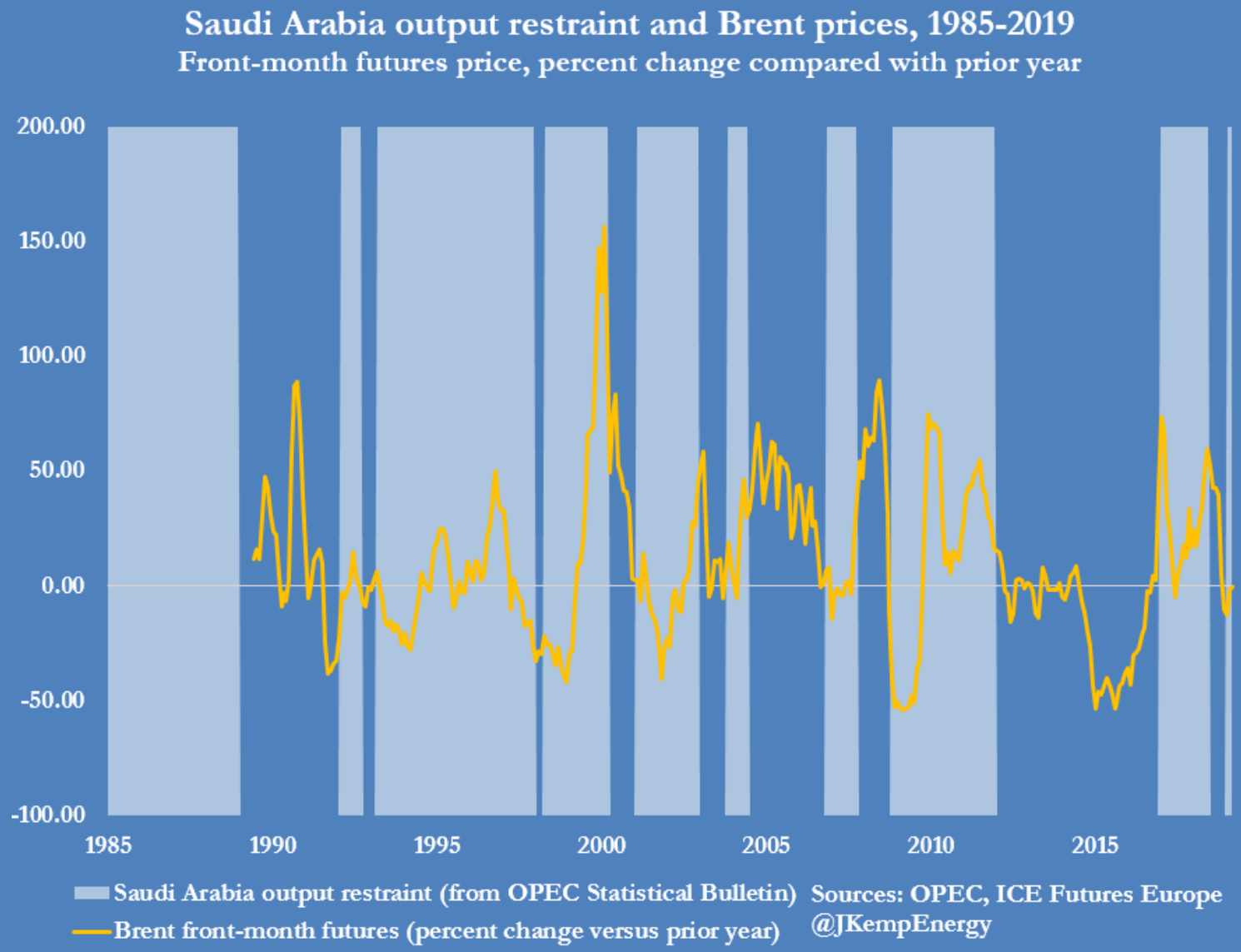
Saudi Arabia has resumed traditional role as swing producer

Kingdom can always force oil market into backwardation if it cuts deeply enough



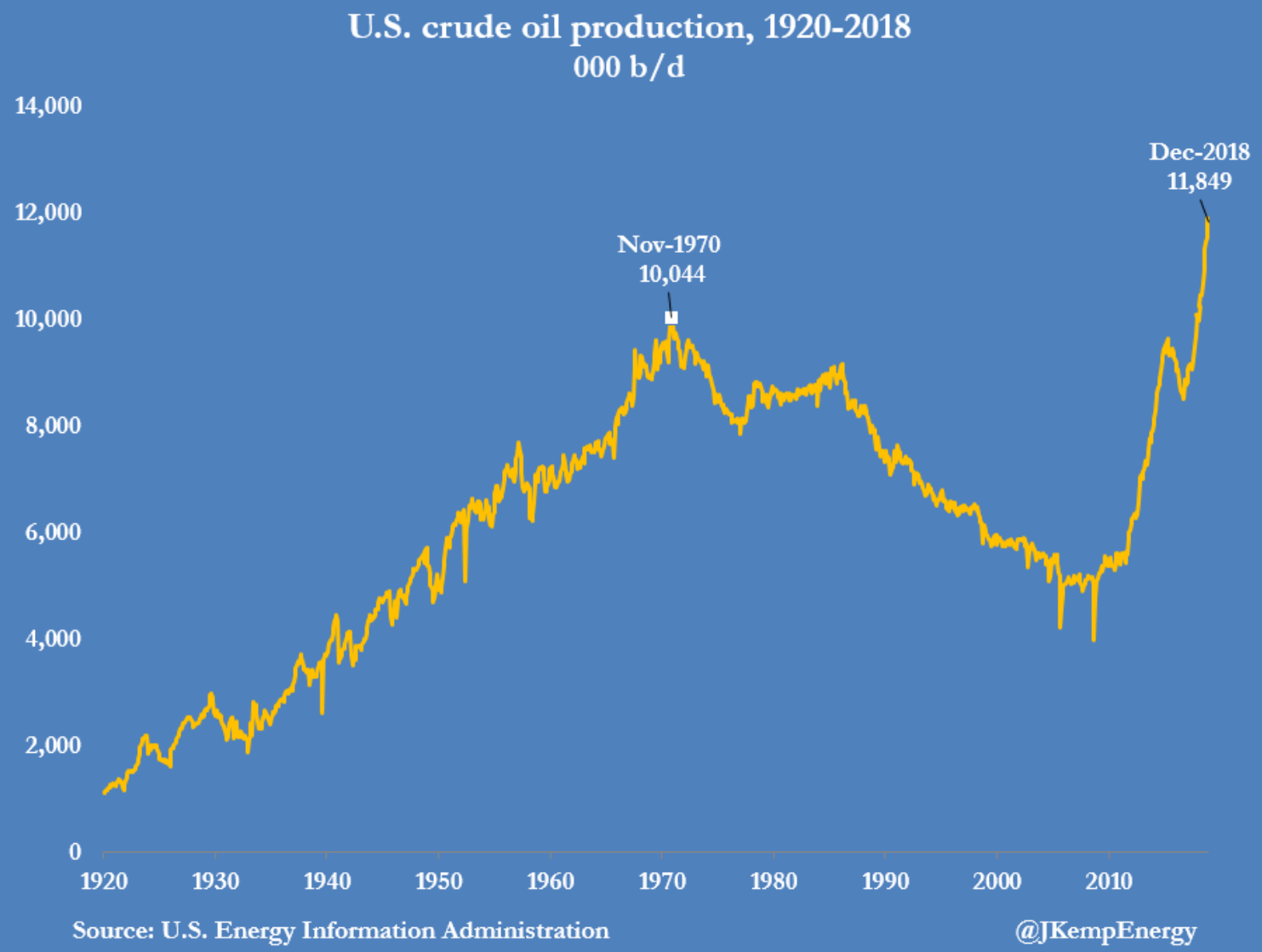
Saudi Arabia is sacrificing market share to protect prices and revenues

Policy alternates between price-defence and volume-defence



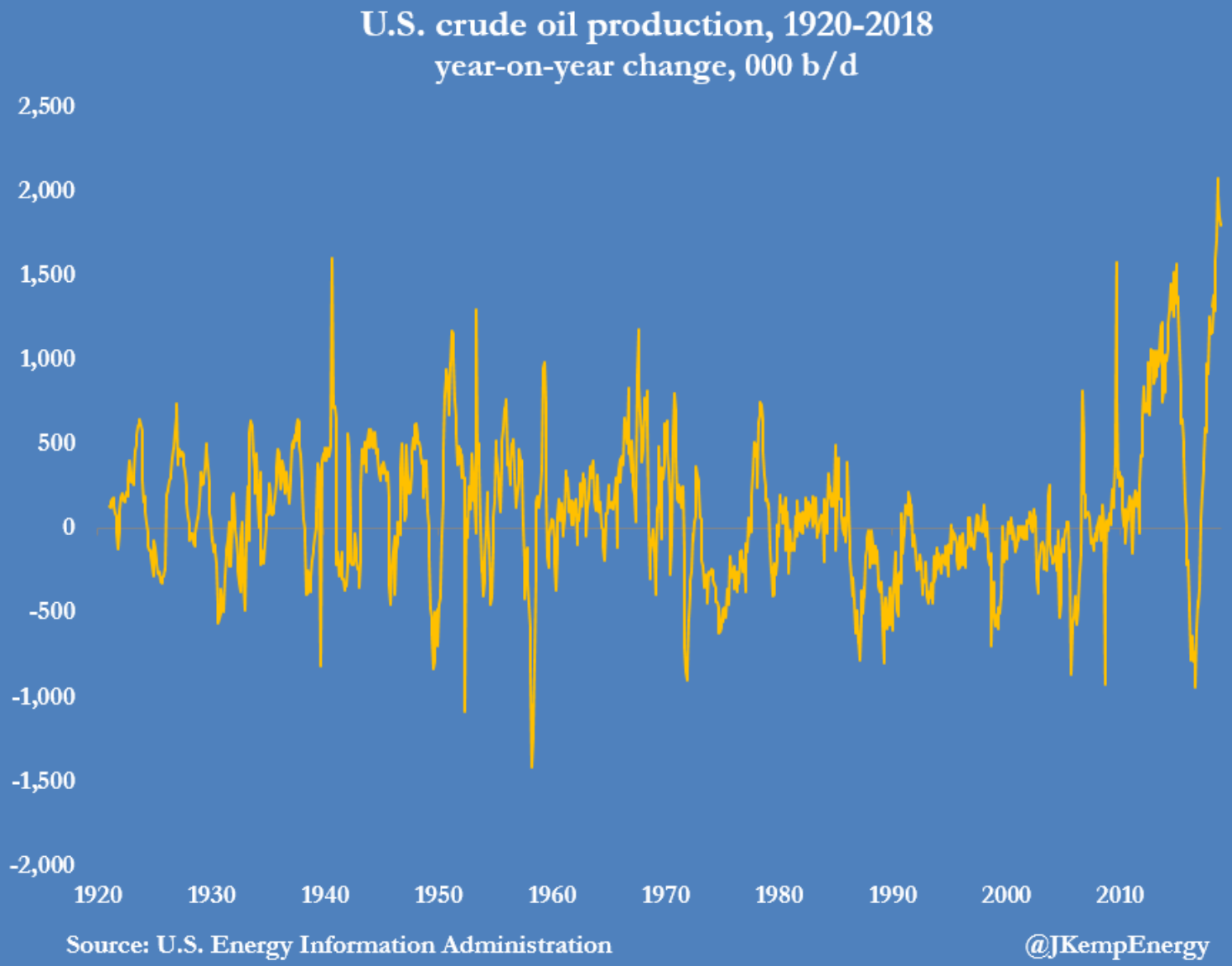
U.S. crude production has surged in response to price rise since 2016

Shale producers have increased output at fastest rate anywhere in history



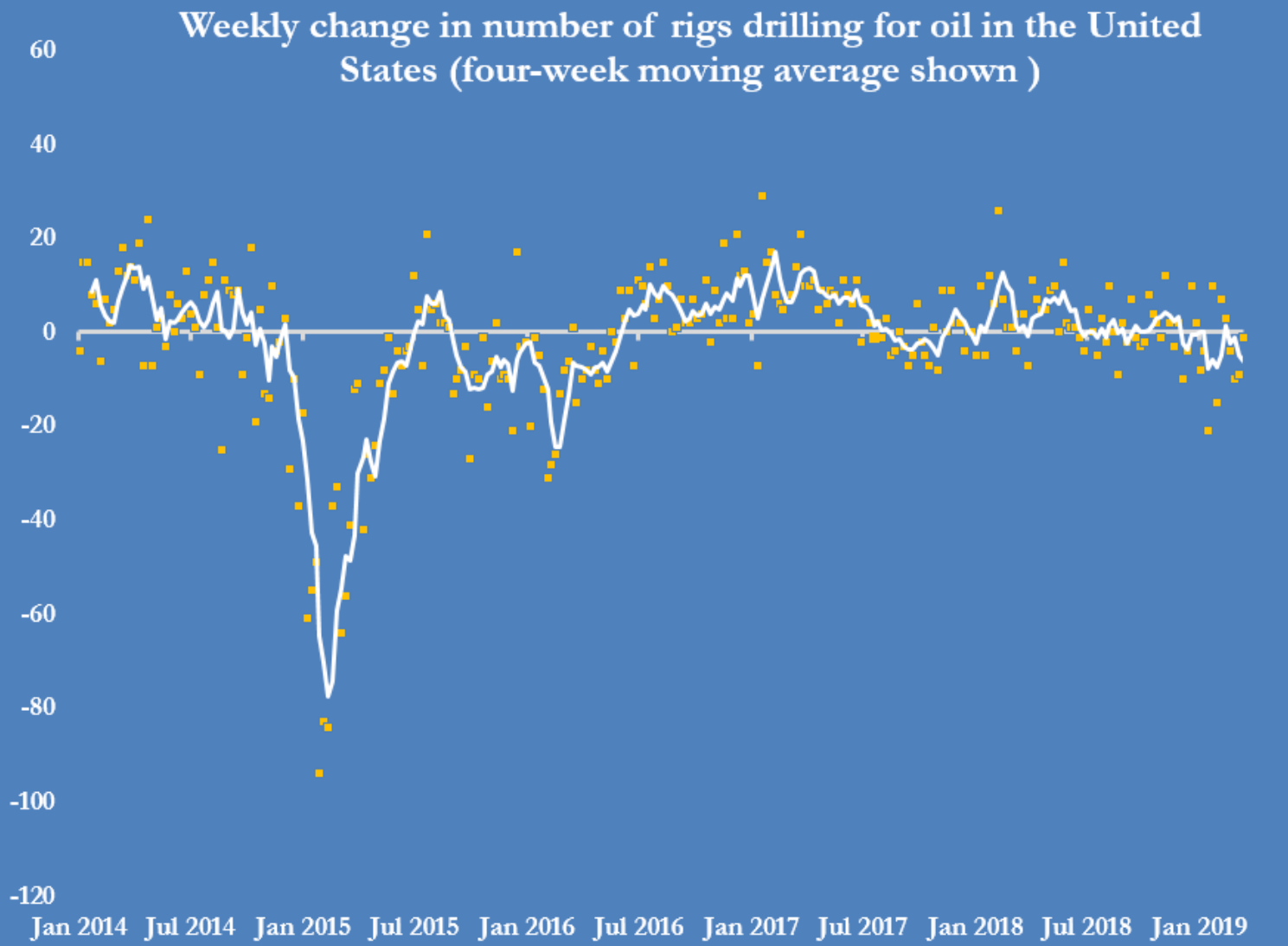
U.S. crude output increased by >2 million b/d in year to Aug 2018

Second shale boom (2016-2018) may be decelerating in response to lower prices



U.S. shale producers have been cutting rig count since end of 2018

Rig count typically follows changes in WTI with lag of 16-20 weeks



Source: Baker Hughes

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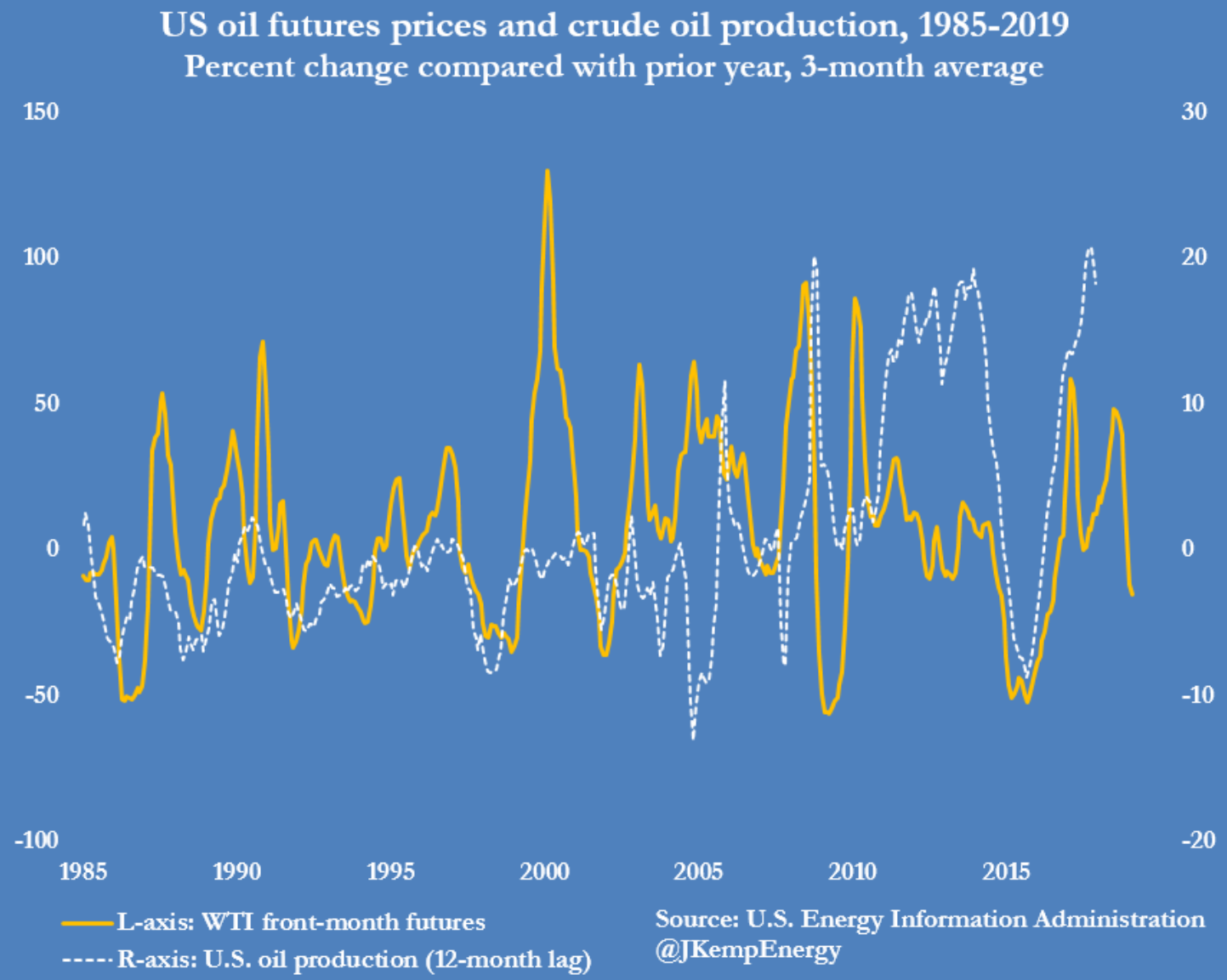
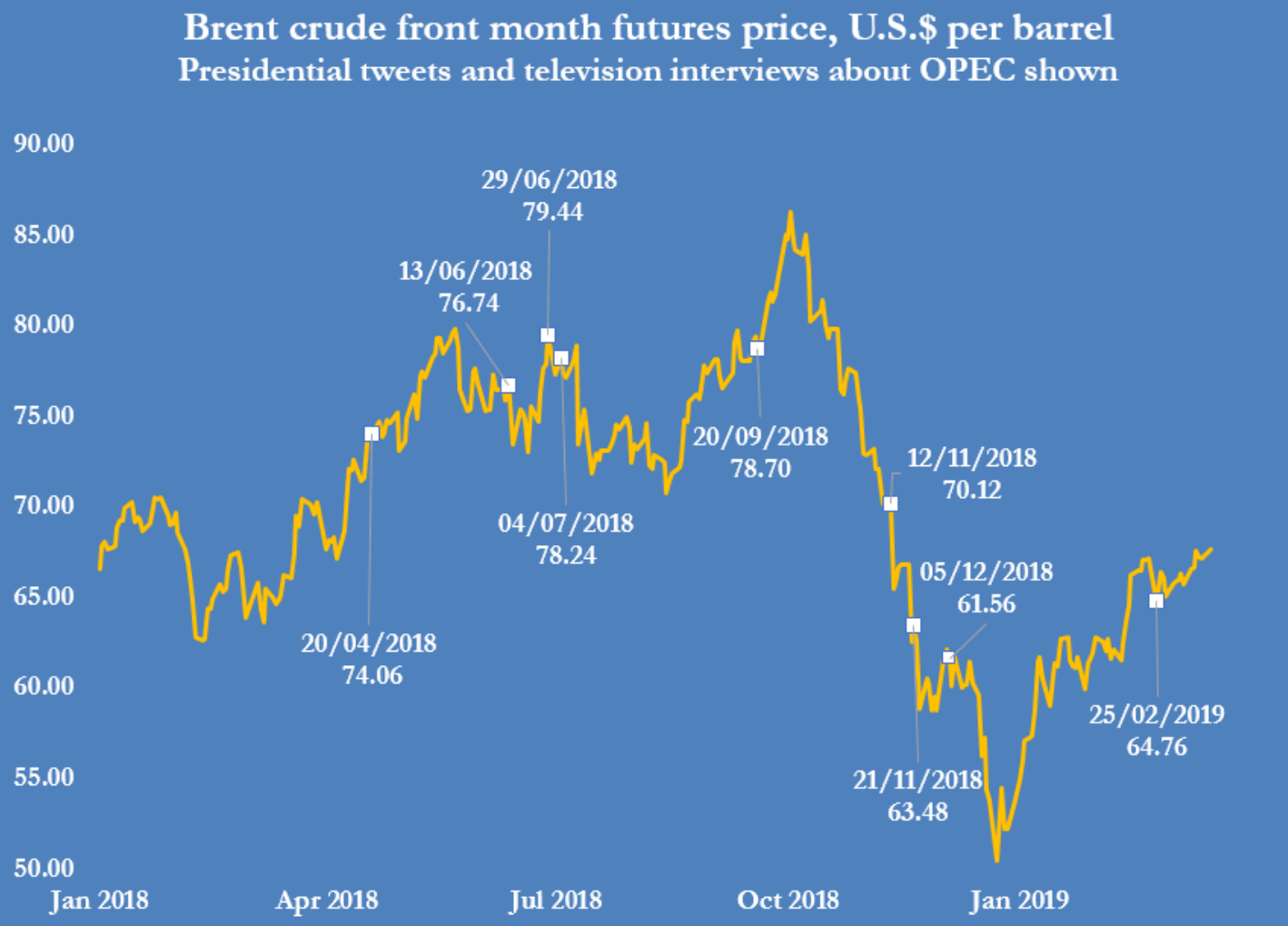
U.S. oil output normally responds to prices with ~12-month lag

Prices to drilling = 3-4 months, drilling to completion and output = 6-9 months



White House has revealed preference for prices below $75 or even $70

Presidential interventions via twitter as focus turns to re-election campaign



Conclusions

Key sources of uncertainty

Oil outlook will be dominated by developments in the global economy

- U.S./China relations, business confidence, trade growth
- Fed reaction function
- Intra-cycle slowdown or end of cycle?
- Final boom?

White House must choose between aggressive sanctions policy and low oil prices

- Squeezing Iran and Venezuela
- Political impact of rising prices
- Gearing up for 2020 campaign
- NOPEC legislation and tweets
- Leverage over Saudi Arabia?

Saudi Arabia must choose between raising prices and protecting market share

- Kingdom's price target: $75? $80? $85? $90?
- Replacing sanctioned barrels from Iran and Venezuela
- Spare capacity and production ceiling
- Future investment
- Revenue needs and social transformation
- Aramco privatisation?