Stagnant Demand Threatens International Crude Balance

Producers aren't curbing supply surplus.

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EIA
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Not in the Clear Yet

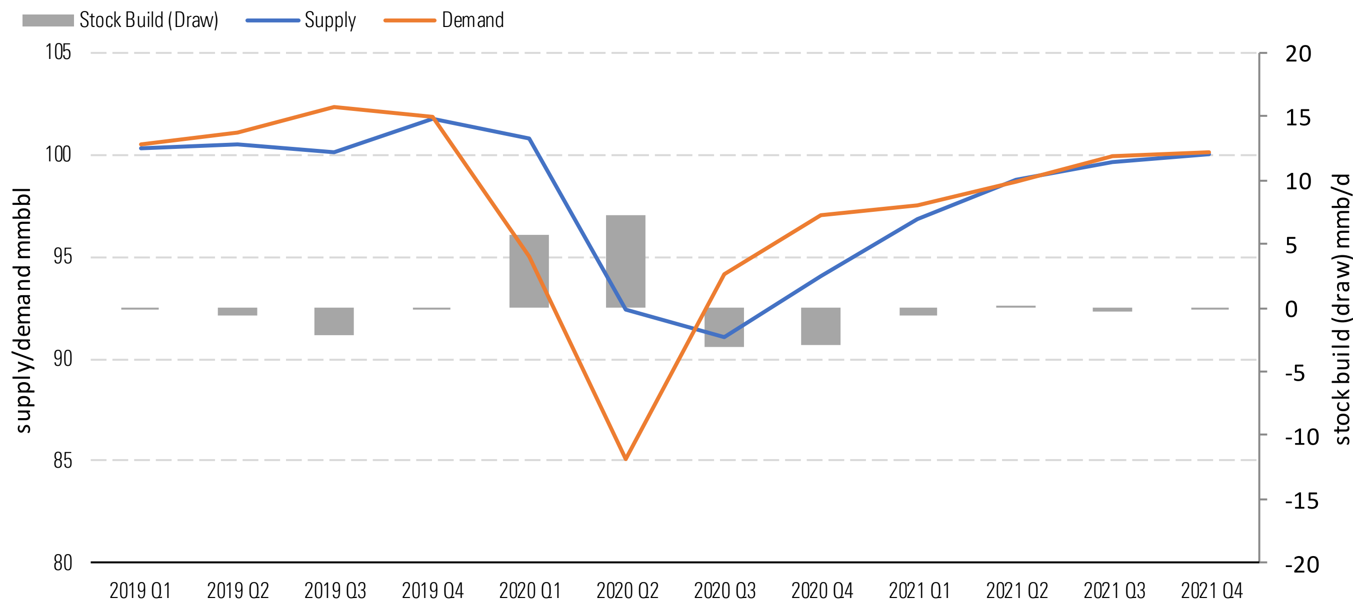
This year's crude market is the most volatile this century. Prices for international benchmark light sweet Brent crude averaged $64/barrel in January, fell 58% to average $27/barrel in April and recovered 70% to $45/barrel in August. The rollercoaster disruption started in March with the twin shocks of OPEC+ producers abandoning restraint and flooding the market at the same time as demand collapsed in the face of coronavirus-induced lockdowns. An OPEC+ agreement to cut output by nearly 10 million barrels/day in May and a partial demand recovery as lockdowns were lifted, helped stabilize prices between $40/barrel and $42/barrel during September and October. We're not in the clear yet, though, with demand recovery sputtering, the OPEC+ partners showing few signs of a united front on supply restraint, and the U.S. presidential election looming in November. Contrary to the current Energy Information Administration, or EIA, forecast, we believe a supply surplus is returning that threatens to dent current crude price levels. This note reviews the international crude balance this year and next.

Earlier this month we reviewed the U.S. crude market balance in light of dramatic events this year (see Resilient U.S. Crude Market Rebalances). After the twin shocks in March, domestic refinery demand dropped by 2.5 mmb/d, a storage squeeze at the Cushing, Oklahoma delivery point for West Texas Intermediate crude futures caused negative prices for the first time and producers shut in 2.0 mmb/d. The crude oil market returned to balance in June and even experienced storage draws in July and August. A big drop in imports and resilient exports played key roles in the rapid rebalancing. This time we turn our focus to the international market.

International Balance

Exhibit 1 shows actual and forecast world hydrocarbon liquid balances from the October 2020 monthly Energy Information Administration short-term energy outlook, or STEO. The majority of liquids supply (blue line, left axis) is crude oil, but condensate and other gas liquids are included. The orange line represents total demand for crude and condensate. The grey bars against the right axis are implied increases in inventory when supply exceeds demand and implied stock draws when demand exceeds supply.

Exhibit 1 STEO World Crude/Liquids Balance October 2020



Source: EIA, Morningstar.

In the first half of 2020 the world market was oversupplied with crude after Saudi Arabia started its production war with Russia following the breakdown of the November 2016 OPEC+ agreement in late February. The resulting flood of crude from Saudi Arabia hit the market just as COVID-19-induced lockdowns took effect globally in March, causing widespread demand destruction. While producers rapidly shut in output, curtailments didn't match the drop in consumption and global inventories rose rapidly during the second quarter. In May the OPEC+ partners came together to stem the tide of falling prices by agreeing to a 9.7 mmb/d reduction in output, tapering to 7.7 mmb/d in August. As lockdowns eased and consumers responded to cheap oil, demand recovered somewhat and exceeded production during the third quarter. The October STEO forecasts world demand exceeding supply in fourth-quarter 2020 through the first half of 2021, causing inventories to draw down. In the second half of 2021 demand and supply are forecast to balance as demand and output continue to recover.

The STEO outlook assumes demand for crude exceeds supply over the coming three quarters. This narrative relies on a number of factors, including the OPEC+ members adhering to their agreement to hold output as well as demand continuing to recover as economies emerge from COVID-19 lockdowns. As we discuss next, starting with the OPEC + production cuts, the demand recovery assumptions behind the STEO forecast are far from certain.

OPEC+

Although notoriously undisciplined in the past, OPEC + producers have paid more than lip service to 9.7 mmb/d cuts agreed to in May. They delayed a previously agreed rollback to 7.7 mmb/d by a month to August and now have to decide whether to go ahead with a January 2021 adjustment down to 5.8

mmb/d. The OPEC+ producers all need higher revenues to help fight the damage their economies have incurred as a result of the pandemic. We expect there to be broad compliance with the already agreed quotas in the balance of 2020. The group will baulk at deeper cuts if second or third waves of COVID-19 reduce demand to the point where lower quotas are warranted before the end of 2020. Even a postponement of the already agreed tapering to 5.8 mmb/d in January will be tough to reach agreement on. We don’t expect further OPEC+ cuts to materialize unless there is a significant inventory build and price collapse.

Supply Risks

In the meantime, additional supply risks are associated with the potential return to market of 1.2 mmb/d of Libyan crude production shut in for the past eight months by the armed conflict. As of Oct. 16, about 300 mb/d of Libyan production has returned to the market after the warring factions agreed a ceasefire. Another 300 mb/d is promised soon, although how much actually reaches export docks in the fourth quarter is uncertain. A last-minute settlement to a Norwegian oil strike in October scuppered chances of OPEC+ benefiting from disruption to that country’s production this month.

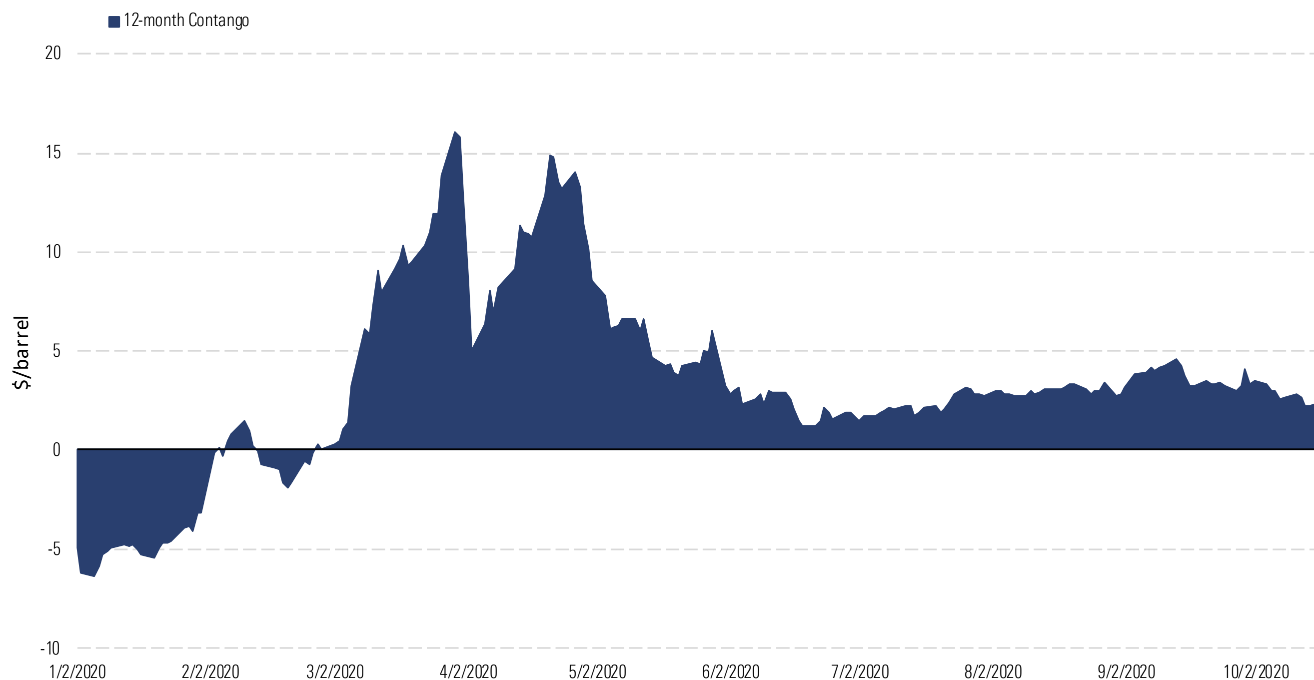
Looking ahead to the presidential election, a win for former Vice President Joe Biden could change U.S. sanctions policies against Venezuela and Iran to allow those countries to resume significant exports although any new strategy won’t be initiated overnight. Market sentiment will change in the case of a Biden win such that Venezuelan and Iranian output will be expected to expand in coming years with both countries currently exempted from OPEC+ quotas. Other OPEC+ members will be wary of allowing either Iran or Venezuela to regain market share at their expense next year. Concerns about sanctions policy will therefore have more psychological influence on sentiment than physical impact on inventories.

As the largest oil consumer and top three producer, U.S. output has significant bearing on international crude balances. Domestic production fell this year but export volumes remain robust at around 3 mmb/d (see Resilient U.S. Crude Market Rebalances). The October EIA STEO forecasts average U.S. crude output in 2020 of 11.4 mmb/d, down 0.8 mmb/d from 2019 and retreating further to 11.1 mmb/d in 2021. According to weekly EIA data, U.S. crude production on October 9 stood at 10.5 mmb/d and imports were 5.3 mmb/d for total supply of 15.8 mmb/d. Refinery demand was 13.6 mmb/d, down 12% versus the same time last year leaving an implied domestic crude surplus of (15.8-13.6 mmb/d) or 2.2 mmb/d that has to be exported otherwise it adds to inventory levels. (The export balance during the week ending October 9 was lower than the prior week's 2.8 mmb/d because of production shut in by Hurricane Delta). Until refinery demand recovers, exports of about 3 mmb/d continue to be required to balance the market. During the first three quarters of 2020 that level of U.S. exports has been absorbed by Europe and Asia in part due to OPEC+ production cuts. Any reduction in OPEC+ discipline or increase in supplies from Libya, Venezuela and Iran will compete with U.S. exports to weigh on prices unless international demand expands to take up the slack. If U.S. exports lose traction the domestic market cannot absorb the resulting supply surplus, adding downward pressure to prices, signaling a need for further production shut-ins by domestic producers.

Demand Reversal

The trickiest part of the international crude market balance remains forecasting demand recovery during the balance of this year into early 2021. If the current second wave of COVID-19 being experienced in the West results in locked-down economies again, it will reverse the recovery in oil demand we've seen since March. Absent a new round of OPEC+ cuts that we deem unlikely, the result will be an oversupplied market with inventories building before year-end. The signal to watch for in futures markets is a contango condition where deliveries further out are priced higher than today. That means current supply exceeds demand—incentivizing storage. Such a contango condition exists in Brent as of Oct. 16 with prices for delivery in October 2021 at $2.31/barrel higher than December 2020 (Exhibit 2). The spread isn't wide enough yet to justify traders profiting from contango because it doesn't cover the cost of storage. But if demand doesn't mop up the current oversupply then contango will widen and prompt prices will come under further pressure.

Exhibit 2 Brent Contango 2020



Source: CME Group, Morningstar.

The unique nature of this year's pandemic-induced demand destruction makes it difficult to predict the pattern of recovery. The recent second wave of the virus is eliciting different responses from governments than the first wave in March. Total lockdowns are hard to implement in the democratic West although more disciplined approaches are still being adopted in Asia. Even if economies open up, questions persist about demand recovery due to extensive changes in work routines and consumption habits. These uncertainties make it hard to forecast the international crude balance at the end of this year let alone into next year.

Risk of Collapse

We believe the market is currently oversupplied and demand is stagnating in the face of new waves of the virus. In that case inventories will build in the fourth quarter as supply exceeds demand. That means the international market may not return to balance until well into next year unless further OPEC+ discipline reduces supply before then. If producers don't respond to the surplus by reducing output prices will remain under pressure with a risk of collapse back to $30/barrel if economic recovery slows.

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