Special Bulletin

A Japanese Perspective on the International Energy Landscape (365) March 2, 2018

January-February Brent Price Up 21% Year on Year to $67.5/bbl

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

The front-month futures contract on the benchmark Brent crude oil averaged $67.48 per barrel on a daily closing basis in January-February 2018, posting a substantial year-on-year rise of $11.76/bbl or 21%. The average closing price for the front-month West Texas Intermediate futures contract in the period also increased by $9.94/bbl or 19% to $62.96/bbl. Crude oil prices opened higher in 2018 than in the previous three years, relieving oil and gas producing countries and the international oil industry that heavily depend on oil revenues.

In the two months, Brent peaked at $70.53/bbl on January 24 and bottomed at $62.59/bbl on February 12. WTI peaked at $66.14 on January 26 and bottomed at $59.19/bbl on February 13. The peak-bottom gaps were thus limited to $7-8/bbl. Continuing an upward trend since late last year, Brent closed above $70/bbl on January 15 for the first time in 37 months. It remained around $70/bbl in the rest of January before weakening slightly in February.

Various factors have been observed behind the oil price trend. A basic factor behind oil price hikes in January was the improvement of the supply-demand balance (the reduction of oversupply) after a global commercial oil inventory decline throughout 2017. Substantial oversupply emerged in the second half of 2014 and remained until its shrinkage in 2017 when the market was going in the direction of rebalancing. In such situation, (1) the Middle East’s destabilization and growing supply disruption risks in oil producing countries, (2) expectations of global economic growth expansion and robust oil demand, and (3) a money inflow into the oil futures market supported by financial factors were combined to bring about Brent’s first rise above $70/bbl in 37 months. (See “A Japanese Perspective on the International Energy Landscape (358)” for details.)

While the tightening supply-demand balance was a basic factor, the three additional factors exerted great influence. Given that prices were fluctuating depending on developments involving the three factors, I had believed that it would be premature to expect any straight rise in oil prices. In this sense, a turning point came as the New York stock market suffered a steep fall on February 2 and continued wild fluctuations.

The Dow Jones industrial average on the New York Stock Exchange continued to rewrite a record high in 2017 and rose above 26,000 in January 2018, posting a year-on-year rise of some 6,000 points or 30%. The stock hike gained momentum as the market welcomed the enactment of a massive tax cut bill under the Trump administration in late 2017. However, some analysts were concerned that stock prices were rising too much. As a stock market decline started in early February, selling triggered more selling. On February 5, the Dow Jones average suffered a heavy loss of 1,175 points. The New York stock market fall spilled over throughout the world, leading to a global stock market decline in the week from February 5. Behind the stock market fall was a U.S. long-term interest rate hike that was expected to raise fundraising costs for companies and hold down private consumption.

Amid the stock market decline, crude oil prices recoded a sharp downturn. The WTI futures price dropped from a level above $65/bbl on February 5 to $59.20/bbl on February 9, slipping below $60/bbl after remaining above the level from the beginning of the year. The downturn was attributable primarily to financial factors including risk-off selling amid the stock market drop and partly to expectations of growing U.S. shale oil production supported by crude oil prices above $60/bbl, as discussed below.

Supported by a dominant view that the U.S. economy would be robust and firm, buybacks came on the stock market later. After wild fluctuations, the Dow Jones average seemingly restored some stability within a 24,000-26,000 range. While the U.S. economy is firm, we may have to pay attention to financial factors such as the Federal Reserve's interest rate hikes and their impact, as well as financial factors' influence on the global economy.

As the stock market has restored stability, crude oil futures have also been in a temporary lull. In the second half of February, Brent remained around $65/bbl and WTI around $62/bbl.

In the future, we will have to pay attention not only to effects of the abovementioned U.S. economic trend, and financial market and policy developments but also to the Middle Eastern situation and supply disruption risks in oil producing countries that led to crude oil price hikes in the beginning of the year. Particularly, we will have to closely watch Venezuela where crude oil production has remarkably declined due to social and economic unrest.

At the same time, we must pay attention to growing U.S. shale oil production as a factor that holds the key on the supply side. Crude oil prices' stay above $60/bbl for two months will surely provide an incentive for shale oil production expansion. Hedging against future price drops amid the hikes may support this year's U.S. shale oil production.

The International Energy Agency's oil market report in February forecast that U.S. oil production in 2018 would increase by a substantial 1.52 million barrels per day. The increase was revised upward from 1.11 million bpd in its December 2018 report. The market supply-demand balance will change depending on how far shale and other U.S. oil production will increase.

I expect that the supply-demand balance will not necessarily go in the direction of tightening in 2018 as far as the Organization of the Petroleum Exporting Countries retains the current production cut. Rather, the present international oil market has reached a sensitive equilibrium between supply and demand. In such situation, financial factors, geopolitical risks, shale oil production, global economic trends and OPEC policies will complicatedly interact with each other in the international oil market in 2018.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html