Special Bulletin

A Japanese Perspective on the International Energy Landscape (263) March 18, 2016

WTI Rises back above $40/bbl for the 1st time in 3 months on Weaker Dollar

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

On March 17, the front-month futures contract on West Texas Intermediate crude oil on the New York Mercantile Exchange closed up $1.71 per barrel from the previous day at $40.20/bbl, topping $40/bbl on a closing basis for the first time in three months, since December 3. A factor behind the day's WTI rise was a weaker dollar. On March 16, the U.S. Federal Open Market Committee decided to leave the policy interest rate unchanged (refrain from raising the rate), leading the assumed number of policy interest rate hikes in 2016 to drop to two from four as expected in last December. As the decision prompted market players to believe that the Fed would raise interest rates slower than expected earlier, dollar selling gained momentum. The dollar fell below 111 yen briefly.

As frequently pointed out, factors behind crude oil price fluctuations include financial factors as well as supply and demand factors, and geopolitical risks. Among the financial factors is the occasionally strong correlation of oil prices with the dollar. The first reason for the correlation is that crude oil prices are denominated in dollars, leading the dollar's rise or fall against other currencies to trigger crude oil selling or buying. The second reason is that the dollar's strength or weakness influences demand for oil as an asset substitutable for dollars. On March 17, the dollar's fall led market players to see dollar-denominated oil prices as lower from the viewpoint of other currencies and buy oil. This means that market players' favor for oil substitutable for dollars increased due to the dollar's fall. The dollar fall's impact on oil prices can be explained in this way.

The slowdown in the U.S. policy rate hike came as a surprise to market players in a sense and attracted much attention, leading to the oil price rise through oil prices' relationship with the dollar. The benchmark WTI futures price sank to $26.21/bbl, the lowest level since May 2003, on February 11 and rebounded gradually later, gaining by around $14/bbl over more than one month to exceed $40/bbl.

Global economic instability, which triggered crude oil prices' plunge in February, has faded away for now, contributing to the crude oil price rally. Early this year, fears about the Chinese economy's deceleration brought about a vicious cycle of risk-off markets. Stock prices plunged along with crude oil prices then, leading to economic instability in the world. Through events such as a meeting of Group of 20 finance ministers and central bank governors, however, financial markets have recovered some stability. The Dow Jones industrial average on the New York Stock Exchange rose back from 15,660 on February 11 to 17,481 on March 17.

Apart from such financial factors, however, an oil glut has remained from the viewpoint of supply and demand fundamentals. Latest data (as of March 11) released by the U.S. Energy Information Administration indicate that U.S. commercial crude oil inventories on the day increased by 1.32 million barrels from a week earlier to a record high of 523.18 million barrels. Commercial oil inventories (crude oil and petroleum products in total) in the member countries of the Organization for Economic Cooperation and Development reached an extraordinarily high level above 3 billion barrels as of January 2016, according to the International Energy Agency.

The IEA and other organizations see an excessive supply at least at present or for the first half of this year. Toward the second half or the end of this year, however, oil supply and demand are widely predicted to rebalance gradually as global oil demand increases steadily, with U.S. crude oil output falling due to reduction in shale oil production, although the future course of the world economy, including China, remains uncertain. Nevertheless, oil supply is too abundant at present or for the immediate future.

In February, four major oil producing countries agreed to freeze any increase in crude oil production at the level in January this year, as noted in my report, “A Japanese Perspective on the International Energy Landscape (260)”. In the face of remarkably weak crude oil prices, Saudi Arabia, Russia, Venezuela and Qatar agreed to fix their respective oil production levels at the levels for January 2016 (freeze any increase) on condition that other major oil producing countries follow suit. Regarding the effectiveness or workability of the agreement, a problem is whether Iran would join the agreement while coming back to the international oil market upon the lifting of economic sanctions by Western countries. Nevertheless, the first concerted action by major oil producing countries since the plunge of crude oil prices in the second half of 2014 attracted attention from market players, influencing market psychology. However, how effective the agreement would be is still uncertain.

In the future, Iran is expected to actually come back to the market. How much crude oil Iran would provide to the market is also still uncertain. In fact, of course, many experts say that the optimistic supply amount announced by Iran has little chance to be realized. If any additional supply comes to the market plagued with excess supply, however, it may be a great burden for the market. Furthermore, global economic instability, though fading away at present, has not been eliminated completely. In this sense, I think that any decisive conclusion cannot be made on whether crude oil prices would continue to rally following the WTI price’s rebound above $40/bbl.

The distribution of market expectation shown in trading of put options on the crude oil futures market indicates that some market players expect crude oil prices to remain top-heavy or turn downward again. We may have to refrain from making any immature forecast and closely watch the crude oil market where prices fluctuate occasionally depending on a major factor among supply and demand, geopolitical, financial and other factors that interact with each other in a complex manner.

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