Special Bulletin

A Japanese Perspective on the International Energy Landscape (278) July 1, 2016

Crude Oil Prices and International Oil Market Situation in 1st Half of 2016

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

The daily closing levels of the front-month futures price in the first half of 2016 averaged $41.2 per barrel for the benchmark Brent crude oil, down $18.1/bbl or 30.6% from a year earlier, and $39.8/bbl for the other benchmark of West Texas Intermediate, down $13.4 or 25.4%. The January-June 2016 period thus saw the lowest half-year averages for these crude oil futures prices since the second half of 2014 when the latest crude oil price plunge started.

This is because the first quarter saw the very low average of $35.2/bbl for Brent and $33.6/bbl for WTI, including a January-February period when the WTI futures sank to $26.2/bbl on February 11, the lowest level since May 2003. Since April, however, crude oil prices have rebounded, staying above $40/bbl. In June, WTI rose back above $50/bbl for the first time in about one year and stayed around the level. As a result, the second quarter average rose by more than $10/bbl from the previous quarter to $47.0/bbl for Brent and $45.6/bbl for WTI.

A basic factor behind the above-mentioned price trend has been a substantial oil supply glut in the international market. According to the International Energy Agency, an oil supply surplus totaled as much as 1.3 million barrel per day in the first quarter of this year, indicating that a substantial oil supply glut had continued since 2014. In the circumstances, the Chinese economy's downside risks, symbolized by a sharp decline on the Shanghai stock market early this year including February, led to a combination of global economic fears, stock market drops and oil price plunges. Another major factor behind the oil price plunge was market players' growing recognition of Iranian crude oil's comeback to the international market (a further supply expansion) following a decision to lift Western economic sanctions on the country.

In the second quarter, meanwhile, the oil supply surplus declined gradually, leading oil market participants to recognize that oil supply and demand were going in the direction of rebalancing. There is a view that a supply surplus in the international oil market in the second quarter of this year could have fallen to about 200,000 bpd if oil production by the Organization of the Petroleum Exporting Countries in June leveled off from April or May. An oil supply surplus has clearly shrunk from the high level in the first quarter, indicating that the international oil market was going in the direction of rebalancing.

Given the change, market participants have growingly recognized that while global oil demand would moderately increase, non-OPEC oil production would decline on a substantial fall in

U.S. shale oil output that had supported non-OPEC oil production growth in the last few years. Such market sentiment is a major factor that has brought about the crude oil price rebound since April.

Other important factors supporting the recognition of the supply and demand rebalancing trend include developments related to a supply decline since April. Oil workers' strikes in Kuwait, a large-scale Canadian mountain fire affecting oil sand production and armed rebels' attacks on oil facilities in Nigeria also exerted some influences on market sentiment. In the meantime, Iran steadily increased oil production after the termination of Western sanctions, restoring pre-sanction export and production levels. Saudi Arabia kept its market share strategy and sustained a high production level exceeding 10 million bpd even in the abovementioned supply and demand environment. In this sense, the overall international oil market has never seen any supply shortage. However, the basic direction of the rebalancing has brought about the recent oil price trend.

How will developments be in the second half of this year? While the basic direction is an improvement in the supply-demand balance, we must take note of great uncertainties existing in the market. As described above, crude oil prices have come to a lull, seesawing since the recent rally above $50/bbl. The current trend is difficult to describe as a steady upward trend. The future trend is difficult to predict.

World economy risks may be the largest factor behind the uncertainties and concerns. We must remember that the Chinese economy's downside risks led to oil price weakness in the first half of this year, particularly the first quarter. The Chinese economy has restored some stability due partly to government economic stimulus measures after the remarkable Shanghai stock market turmoil came to a lull. Given overcapacity, and foreign exchange and financial risks, however, all problems have not necessarily been resolved. We must closely watch future developments regarding these problems. At present, however, the United Kingdom's vote to leave the European Union has attracted much more global attention than the Chinese economic risks.

The U.K.'s decision to leave the EU through a national referendum will take some time to be implemented. However, international financial markets have been destabilized as market participants tried to foresee the impacts of the U.K.'s secession from the EU. Just after the referendum, fears about world economy deceleration and risk-off moves triggered a global stock market decline, resulting in a sharp fall in crude oil prices. Later, stock and oil prices rose back as markets restored stability on buying in reaction to too heavy selling. However, the impacts of the U.K.'s leave from the EU could be prolonged, providing various complex risk factors for the world economy, including other EU members' possible "domino" leave from the EU.

It may be clear that developments regarding these world economy risks may be one of the most important points for considering crude oil prices in the second half of this year. Key points on the supply side will include what impacts crude oil prices' rebound close to $50/bbl would exert on U.S. shale oil production, how oil supply interruptions in major oil producing countries since April would change, and how Saudi Arabian oil policy would evolve under the leadership of Deputy Crown Prince Mohammed bin Salman. While the overall direction of the international oil market in the second half of this year will be rebalancing, we must closely watch what will actually happen in the market.

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