Special Bulletin

A Japanese Perspective on the International Energy Landscape (348) November 2, 2017

Brent Rose Back above $60/bbl for First Time in 27 Months – Oil Market Has Come to Turning Point? –

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

On October 27, the front-month Brent crude oil futures contract closed at $60.44 per barrel, up $1.14/bbl from the previous day, topping $60/bbl on a daily closing basis for the first time in 27 months, since July 3, 2015. Up to now, it has remained above $60, hitting a year-to-date high of $61.37 on October 31. The front-month West Texas Intermediate crude oil futures contract has also been rising, closing on October 31 at $54.38/bbl, the highest since last February.

The development came one month after my "A Japanese Perspective on the International Energy Landscape (344)" report summarized the crude oil price trend through early October. The key point is whether we should view the Brent futures price's rally above $60/bbl as indicating a turning point. To consider this question, I would like to analyze a supply and demand trend in the international oil market and key points in the following:

In brief, the keys to anticipating the future market direction include the strength of the oil market trend toward rebalancing (a supply-demand equilibrium) and U.S. shale oil's roles in the trend. As noted in my earlier report, the market is slowly going in the direction of supply-demand equilibrium. Oil inventory build and overhang has been a fundamental factor behind the weak crude oil futures market. As of August, OECD commercial oil inventories stood at some 3 billion barrels, exceeding the average for the past five years. However, they have continued a downward trend since last January, signaling the rebalancing.

Why is the direction of rebalancing seen with inventories slowly decreasingly? One important reason is that global oil demand has been growing robustly. Global oil demand in 2017 is expected to expand by 1.58 million barrels per day from the previous year thanks to economic expansion, according to the International Energy Agency. On the other hand, non-OPEC oil production growth from the previous year is limited to 670,000 bpd, failing to catch up with oil demand growth. The Organization of the Petroleum Exporting Countries and some non-OPEC oil producing countries have implemented a coordinated production cut since last January, demonstrating their stricter-than-expected compliance with the production cut. This year, global oil supply growth has slipped below demand growth, resulting in a slow and gradual oil inventory decline.

Since early October, growing tensions over the Kurdish problem in Iraq have attracted attention from market participants. Various geopolitical risks in the Middle East had been identified but failed to become an influential factor for trading in the oil market amid oversupply. As the supply-demand balance has slowly changed, however, the new geopolitical risk involving the Kurdish problem might have become an influential factor for trading for the first time.

When crude oil prices remained in a boxed range between $50/bbl and $55/bbl, U.S. shale oil production growth prevented these prices from rising above the ceiling of the range. Market players then dominantly believed that as oil prices rose to a certain range to stimulate U.S. shale oil production for which costs have dropped to $40/bbl, U.S. shale oil production was expanded after some time lag to push down oil prices. The market belief has basically remained unchanged and built into the market.

A major reason for the Brent price to have topped the ceiling which existed in the first half of this year may be that oil inventories have been decreasing clearly on a macro basis. As for non-OPEC oil production, shale oil production has enhanced its resistance to low oil prices and is expected to increase by 480,000 bpd from the previous year in 2017. Given non-OPEC oil production growth expected at 670,000 bpd for this year, however, it is evident that non-OPEC production other than U.S. shale oil production has been slumping. As Canada is expected to expand oil production in 2017 by 270,000 bpd from the previous year, non-OPEC oil producing countries other than the United States and Canada can be viewed as reducing oil production this year. Non-OPEC oil producing countries are thus bipolarized. This may be the reason why WTI prices in the U.S. market where participants are more sensitive to U.S. (and Canadian) oil production growth have been increasing at a slower pace than Brent prices while Brent prices reflecting the global macro supply-demand balance better are rising more quickly.

However, the future path for crude oil prices may not necessarily be easily projected. We must pay attention to uncertain factors. If Brent prices remain around $60/bbl with WTI prices staying in a $54-55/bbl range, U.S. shale oil production may be stimulated. In such case, a change in U.S. oil production may be seen after a time lag of some three months. So, we may have to pay much attention to market developments in early 2018. In fact, the IEA expects that global oil demand growth in 2018 would total 1.41 million bpd against a non-OPEC oil production increase at 1.55 million bpd (including 1.11 million bpd in the United States). This outlook indicates that concerns about oversupply may not easily or persistently be eliminated. If the current oil price hikes encourage U.S. shale oil production to increase early next year, downward pressure may arise on oil prices again.

In this sense, we may have to pay much attention to the next general OPEC meeting scheduled for November 30. OPEC is dominantly expected to extend a coordinated production cut planned to end in March 2018. Given the future supply-demand balance, rebalancing may be delayed without the extension of the oil production cut. While market fundamentals including robust global oil demand will remain favorable for OPEC, non-OPEC oil production growth driven by U.S. shale oil will still stand in the way of the OPEC production cut next year. As a matter of course, global economic developments and geopolitical risks in oil producing countries could shake the oil market environment. Many people may hesitate to conclude that the turning point has clearly come in the oil market. We may have to keep close watch on future international oil market developments.

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