Will Oil Prices Move away from the current $40-45/bbl Range since July?

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

Crude oil prices have strangely been stable since July, seesawing within a narrow range. The front-month futures contract’s daily closing price for West Texas Intermediate rose slightly from $39.82 per barrel on July 1 to $42.67/bbl on August 12 but has remained within a narrow range of $40-42/bbl for the past 1.5 months. The daily closing price deviated from the range on only five trading days in the period. The price of Brent, the other benchmark crude, also increased slightly from $42.03/bbl on July 1 to $45.43/bbl on August 12, staying in a $42-45/bbl range. It rose beyond $45/bbl on only three trading days in the period. Crude oil prices have thus remained within a boxed range.

The recent stability starkly contrasts with wild fluctuations from early this year. Crude oil prices shot up on growing U.S.-Iran tensions at the beginning of this year and crashed due to oil demand evaporation under the novel coronavirus pandemic from March and a price war between Saudi Arabia and Russia. In April, the WTI price turned negative for the first time ever. The Organization of the Petroleum Exporting Countries and Russia with some other non-OPEC oil-producing countries revived their joint production cuts in May to counter the crash. The record OPEC-plus joint production cuts were coupled with an oil demand rebound amid the reopening of businesses and the lifting or easing of lockdowns under the pandemic to allow oil prices to rise moderately. The first half of this year thus saw an unprecedentedly dramatic fluctuation in the history of crude oil prices. As noted in the outset of this report, however, crude oil prices transitioned from the wild fluctuations over six months to stability in July. The stability indicates a lull after an oil price recovery from May.

Why have crude oil prices been so stable? There may be various factors working compositely behind the present stability. The most important point is that the market lacks any major price-moving factor or that various factors are balanced. On the demand side, demand evaporation that caused the crash earlier this year has already gone, with demand recovering. Lockdowns had brought about demand evaporation but have been globally lifted or eased to pave the way for business reopening that has led to an oil demand recovery. The dramatic change on the demand side has supported oil price hikes. While the momentum for an economic recovery still exists globally, its impact on oil prices might have relatively weakened from that of an escape from the worst phase.

Furthermore, oil market participants are conscious that any recovery from the coronavirus disaster would take much time or that a second or third wave of coronavirus infections could come. The worst period for the world economy and global oil demand was the second quarter of this year, which was widely expected to be followed by a V-shaped recovery. In fact, the world economy and oil demand are recovering from the worst period. In the face of realities regarding the impact of the pandemic, however, market participants are concerned that the recovery would be a U-shaped or slow one or an L-shaped one including a prolonged recession. Some analysts have recently pointed to a K-shaped recovery featuring various regional recovery patterns, noting that some regions or
fields are recovering, with others failing to do so.

As such perceptions about the world economy and oil demand have become widespread among market participants, oil demand recovery (and hopes on demand recovery) has seemingly lost its power to support oil prices. From this viewpoint, oil prices are expected to show remarkable changes depending on future developments regarding the coronavirus disaster. If hopes on an end to the coronavirus disaster grow in a manner to make the world economy’s steady recovery path clearer, oil prices could break away from the present lull and launch the next uptrend. If the world economy is likely to remain in a trough due to a second or third wave of coronavirus infections, however, oil prices could come under downward pressure again.

Complicating the future course of oil prices are responses from the supply side. The OPEC-plus group has made utmost efforts to implement production cuts to support oil prices after their crash. However, group members in principle compete each other for greater market shares and have their respective national interests, making it difficult for them to maintain their solidarity for a longer time period. They have enhanced their solidarity in the emergency situation including the oil price crash but could emphasize their differences in stances and strategies if oil prices rise back to some extent.

Another attention-attracting factor is U.S. shale oil production that has stayed outside the OPEC-plus group and exerted the greatest influence on the global oil supply-demand balance. The oil price crash forced some parts of its production to be suspended at high-cost shale oil fields, resulting in a steep year-on-year fall in U.S. oil production. In response to the oil price recovery, however, the U.S. oil production drop has decelerated since early June. Signs of a production rebound can be seen. U.S. shale oil production sensitive to oil price changes has suppressed oil price hikes, though depending on oil demand recovery. Therefore, the OPEC-plus group must delicately adjust their production in consideration of the supply-demand balance and formulate a sensitive strategy to support or stabilize oil prices.

Given the abovementioned environment surrounding the international oil market since July, it might have become difficult for oil supply and demand fundamentals to exert visible influence on oil prices. This means that market players have found it not easy to proactively take short or long positions depending on demand or supply factors. They have taken a wait-and-see attitude in preparation for the next major change in the international oil market.

In such situation, oil supply and demand factors have had less influence on oil prices, leading oil prices to be moved by their relations with or the influence of financial markets. Crude oil futures as risk assets have been linked to stock prices. The dollar weakened toward late July due to concerns over the future U.S. economy, contributing to a slow and gradual rise in crude oil prices, according to market participants. While supply and demand factors’ influence on oil prices has been limited, financial markets’ influence on the prices has become relatively larger.

Nevertheless, we must take note of the possibility of oil prices changing sharply from late this year to next year. The most important point in this regard would be future developments regarding the coronavirus disaster and the global economic trend. How the supply side would or could respond to demand side changes would also be important. I would like to closely watch the future international market and price trends including geopolitical risks and other unpredictable factors.