INFOCUS

MACRO COMMENT

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Oil market at a crossroads

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HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

The price of oil has risen to its highest level since 2014 and many commentators expect it to rise above USD 100 per barrel soon. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the factors that pushed prices up and explains why very diverse scenarios could unfold.

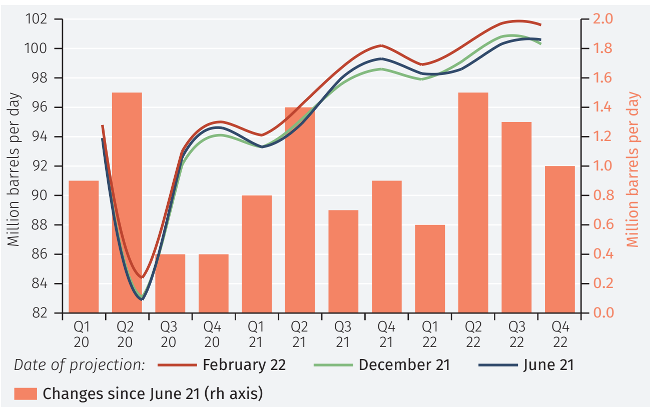
After Putin's declaration of support for the two separatist republics of Donetsk and Luhansk in Ukraine's east, the oil price has returned close to USD 100/bbl (per barrel). Many observers expect the price to rise further and approach the highs reached in 2008 before the collapse of Lehman Brothers. The oil price rise, which has been ongoing since early 2021, is due to three main factors: stronger demand, weaker supply and geopolitical tensions.

1. Stronger demand

Since the beginning of 2021, demand for petroleum products has exceeded expectations. Economic growth has been stronger than anticipated despite the spread of new covid variants. Furthermore, the European natural gas crisis, which caused prices to almost quadruple compared to the pre-covid average, has encouraged many electricity producers to switch to oil. According to the International Energy Agency (IEA), this has raised the demand for crude oil by nearly 0.5 million barrels per day (b/d).

Furthermore, on the basis of more detailed information from the petrochemical sectors in China and Saudi Arabia, the IEA has revised the global demand statistics for petroleum products since 2007.[1] In 2021, demand is estimated at nearly 1 million b/d higher than before (see Figure 1).

1. Global oil demand projections



Sources: International Energy Agency Oil Monthly Report and EFGAM calculations. Data as at 22 February 2022.

This information is not new to market insiders and is largely incorporated into current prices. However, the higher level of demand at the end of 2021 raises the demand profile for the next few years and tightens the market compared to previous assessments. This is exemplified by the rapid decline in the stocks of petroleum products to around 7% below the average of the past five years, a gap not seen in over 20 years (see Figure 2).

2. OECD total petroleum products stocks

Sources: International Energy Agency Oil Monthly Report and EFGAM calculations. Data as at 22 February 2022.

2. Weaker supply

The second factor supporting oil prices is the difficulty OPEC+ countries have had in complying with their production targets. In January, the 19 OPEC+ countries subject to quotas produced 37.8 million b/d of oil, 0.9 million b/d less than planned, according to IEA estimates. This contrasts with the typical OPEC pattern of producing in excess of agreed quotas. That prevailed until the broadening of the cartel to include Russia and other producers which gave birth to OPEC+ at the end of 2016.

Looking ahead, it is worrisome that in several countries, including Angola, Mexico and Nigeria, the estimated sustainable capacity is lower than the January production targets. Nonetheless, the IEA estimates the overall spare capacity of OPEC+ at 6.4 million b/d compared to January output, concentrated in Saudi Arabia, the UAE and Iran, the latter not subject to quotas but to sanctions that limit its exports. This makes it possible that OPEC+ production increases in 2022 but it will mean that countries with spare capacity will be required to take on most of the burden.

US shale oil output is also expected to rise further, spurred by prices significantly above the break-even level estimated at

[1] See IEA *Oil Market Report*, February 2022.

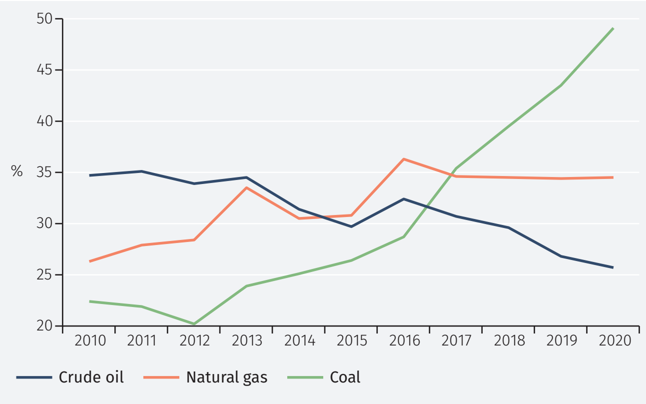
around USD 55/bbl. This, combined with the anticipated rise in OPEC+ supply, will rebalance the market in 2022. Under normal circumstances, this would lead to a fall in the oil price, but the outlook for global energy markets is today highly uncertain.

3. Geopolitical tensions

This is in no small part due to the ongoing Ukrainian crisis that has recently helped push up prices and kept natural gas prices high. There are fears that Russia will mount a full-scale invasion of Ukraine and that the West will impose harsh sanctions that could limit, if not completely block, imports of oil and natural gas from Russia.[2] In the most extreme case, OPEC+ and other producers' spare capacity would be insufficient to compensate immediately for the demise of Russian oil and natural gas.

Russia produces around 10.3 million b/d of crude oil and 22.5 trillion cubic feet of natural gas, exporting around half of it. The European Union is the main market for Russian exports, followed by China, whose imports are growing rapidly. The EU depends on Russia for 25% of its imports of crude oil, 35% of its natural gas and 50% of its coal (see Figure 3). The risk of disruptions to the supply of these inputs justifies the increased risk premium on crude oil and the prices of other energy commodities.

3. EU share of energy imports from Russia



Source: Eurostat. Data as at 22 February 2022

Based on a simple model, the current price of West Texas Intermediate oil (WTI) of USD 92/bbl is about USD 21/bbl higher than fair value. It is notable that the gap has widened recently in parallel with the intensification of tensions between Russia and Nato. The revised demand level has led to an increase in the estimated fair value of approximately USD 15/bbl.

Scenarios for the oil market

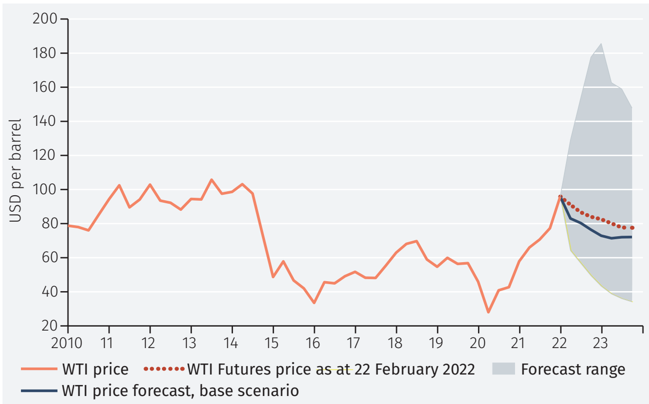
The outlook is more uncertain than normal due to increased geopolitical risk and supply side developments. In the base scenario, oil production increases as projected by the IEA lead to a moderate supply surplus in 2022 and 2023. If this were a good guide to future outcomes, our model forecasts the WTI oil price to gradually decrease towards USD 70/bbl, a little below what is incorporated in the prices of oil futures contracts. Of note, the model forecast is now about 20% higher than before, reflecting the tightening of the oil market due to increased demand.

An alternative scenario sees OPEC+ increasing production by less than planned, bringing the gap to almost 1.5 million b/d, while other producers are unable to compensate for the lower OPEC+ production. In this scenario, the price of WTI oil could rise above USD 130/bbl.

Another scenario sees the imposition of an embargo on Western countries' imports of Russian energy products.[3] Global supply would not drop commensurately because a part would be diverted to China which would not participate in the embargo, which would thereby free supplies from other producers. However, global oil supply could be reduced by up to 2.5 million b/d in the second quarter of 2022 before normalising towards the end of the year following a mix between the return of diplomacy and the increase in supply from other producers, including Saudi Arabia. In this scenario, the oil price could rise as high as USD 180/bbl (see Figure 4).[4]

A final scenario considers an increase in supply from non-OPEC+ producers, mainly from the US, attracted by high prices.

4. WTI price and model forecast



Sources: Refinitiv and EFGAM calculations. Data as at 22 February 2022.

[4] See EFGAM Macro Flash Note, *Pain in Ukraine.*
[3] One important question related to sanctions is whether the EU would be able to substitute Russian energy with energy supplies from elsewhere. This seems difficult to do in the short term and some commentators note that it is not clear if a Russian energy embargo is a credible threat.
[4] The forecast range goes from the one-standard deviation upper forecast in the scenario of embargo on imports from Russia to the one-standard deviation lower forecast in the scenario of increased non-OPEC + supply.

Global production would exceed the base scenario by around 1.5 million b/d starting from the second half of 2022, leading to a progressive increase in inventories. The price of WTI oil could fall below USD 40/bbl in this case, at which point US shale oil production would become unprofitable and likely decrease again in an attempt to support prices.

Conclusions

Energy markets have been tense since the spring of 2021. Increased demand for petroleum products and lower-than-planned supply from OPEC+ have tightened markets, accelerating the fall in inventories to well below the average of the last five years. And geopolitical tensions linked to Ukraine have further helped push the prices of oil and other energy commodities higher.

The outlook for energy prices is uncertain. If there is an escalation of the crisis in Ukraine resulting in a shortage of energy due to an embargo on Russian exports of oil and natural gas, the WTI oil price could rise above USD180 pb. In this case, the consequences for economic growth would be meaningful and negative, especially for the European Union which is highly dependent on Russian energy imports.

Conversely, if diplomacy eventually prevails and OPEC+ countries comply with their production targets, the oil market will see a moderate supply surplus in 2022 and 2023. In this scenario, the WTI oil price is forecast to fall towards USD70 bp over the next few quarters.

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