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OIL MARKET IN 2019

OPEC+ COMPLIANCE WILL BE KEY

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SUMMARY

- Global oil supply is undergoing a structural shift. The US oil industry is growing in importance relative to the OPEC. As a result, despite the output collapse among important OPEC producers such as Iran and Venezuela, increased production from non-OPEC producers more than compensated in 2018.
- Slowing global growth, new US pipelines facilities in H2 2019 and the diminished importance of OPEC have raised concerns around a potential oil glut. However, we believe that financial markets may be overestimating the risks of a global recession. Moreover, lower oil prices – prices were between 14% and 18% lower in January than their 2018 average – are likely to stimulate economic activity and oil demand, particularly in emerging markets. As a result, global oil demand is expected to accelerate slightly (+1.4 million barrels per day (mbd) in 2019 vs +1.3mbd in 2018).
- All in all, the global oil supply/demand balance could shift from a current significant surplus to zero at the end of the year if the OPEC+ complies with its decision to cut output by 1.2mbd and extends these cuts until the end of the year. OPEC+ discipline will therefore be key for oil prices in 2019.
- Our analysis suggests that we are now close to the long-term fundamental equilibrium price, with West Texas Intermediate (WTI) at USD54 per barrel, against a current equilibrium price of USD53. On a 12-month horizon, the oil price equilibrium is expected to increase to USD60 for WTI if global growth reaches 3.5% and the US dollar weakens by 5%, as expected in our core scenario.
- Much like 2018, geopolitical factors are expected to play an important role in the oil market this year. US-China trade negotiations, US sanctions on Iran, OPEC+ decisions, political troubles affecting several important producers (Venezuela, Iraq, Libya, Angola…) will continue to determine oil price dynamics. However, assuming that spot prices converge towards their equilibrium, our oil price forecast remains unchanged at USD70 for Brent and USD60 for WTI at year’s end.

KEY RISKS IN 2019

UPSIDE	DOWNSIDE
OPEC+ extends 1.2mbd output cut beyond summer 2019	OPEC+ production cut agreement unravels
Oil prices at current levels spur economic activity and oil demand, particularly in emerging countries	US-China trade negotiations collapse
US and China resolve trade dispute, increasing confidence and global economic activity	New US pipelines operational before H2 2019
Refining sector falls short of IMO 2020 sulphur regulation requirements	Global economic recession
Political turmoil in Iraq and/or Libya limits OPEC output	
Iran retaliates against US sanctions by disrupting oil shipments in the Strait of Hormuz	

Will 2019 be a repeat of 2018?

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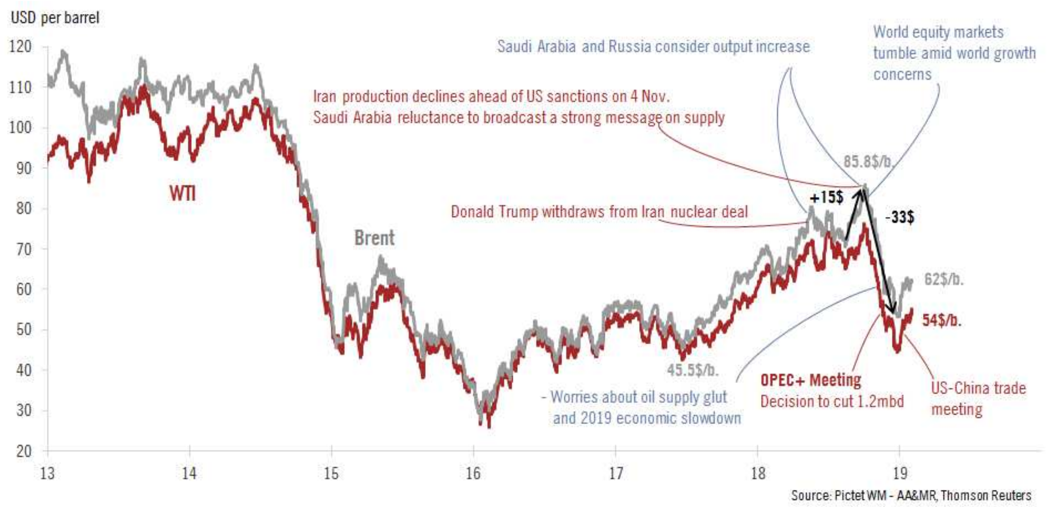
After a 2018 full of surprises and volatility, what does 2019 hold for oil markets? Oil prices increased steadily from USD45.54 on 26 June 2017 to a peak of USD85.5 on 4 October 2018. Bouts of volatility during this period were essentially related to geopolitics (US sanctions on Iran, OPEC+ decisions, war in Syria, shifts in the relationship between the US and Saudi Arabia). Yet oil market fundamentals appeared to be sound, with confidence in the resilience of the world economy and the logistical bottlenecks facing US shale oil supporting oil prices during this period.

But 4 October marked a paradigm shift, in our view. With tariff disputes already denting confidence, the world suddenly became concerned about the risk of an oil glut. In the space of a few weeks, the price of Brent collapsed by USD33, erasing all the gains it had made previously in 2018.

CHART 1: WTI AND BRENT PRICE



A new start in 2019?

The rebound observed since the 27 December was triggered again by geopolitical factors, specifically the resumption of US-China trade negotiations. Whether the OPEC+ decision on 7 December to cut oil supply by 1.2mbd contributed to oil's revival is unclear, as the decision was initially received cautiously (if not with scepticism) by financial market because of doubts about OPEC+ discipline.

For sure, in 2019, geopolitics will continue to play an important role, interfering with the price equilibrium. However, we continue to believe that for all the volatility seen in 2018, market fundamentals, including demand-supply metrics, should not be ignored, as they determine long-term trends in oil prices.

Global oil supply increases despite collapse in important players

Previous concerns about a collapse in crude output among a number of major producers materialised in 2018. In particular, Iranian production collapsed by more than 1mbd after the US administration withdrew from the Iran nuclear deal in May 2018 and is now back to pre-deal levels.

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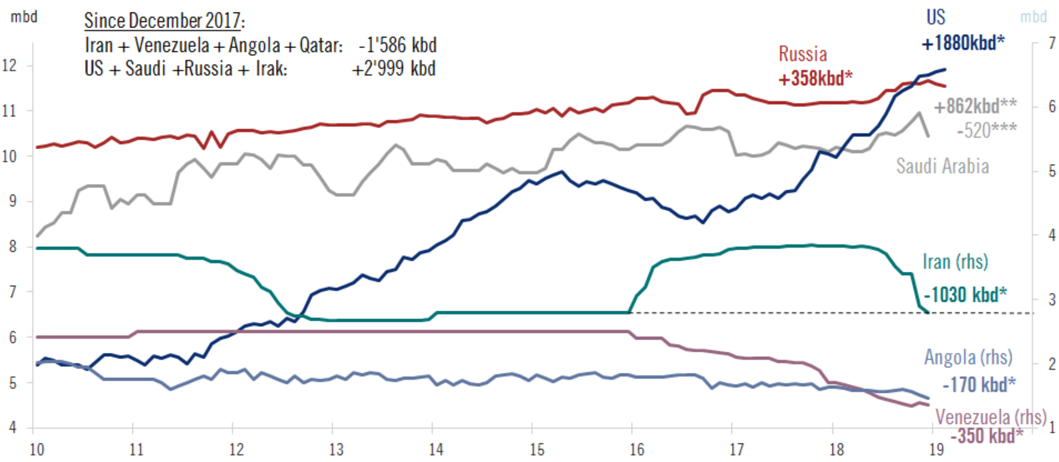
CHART 2: CHANGES IN MAJOR OIL SUPPLIERS' OUTPUT



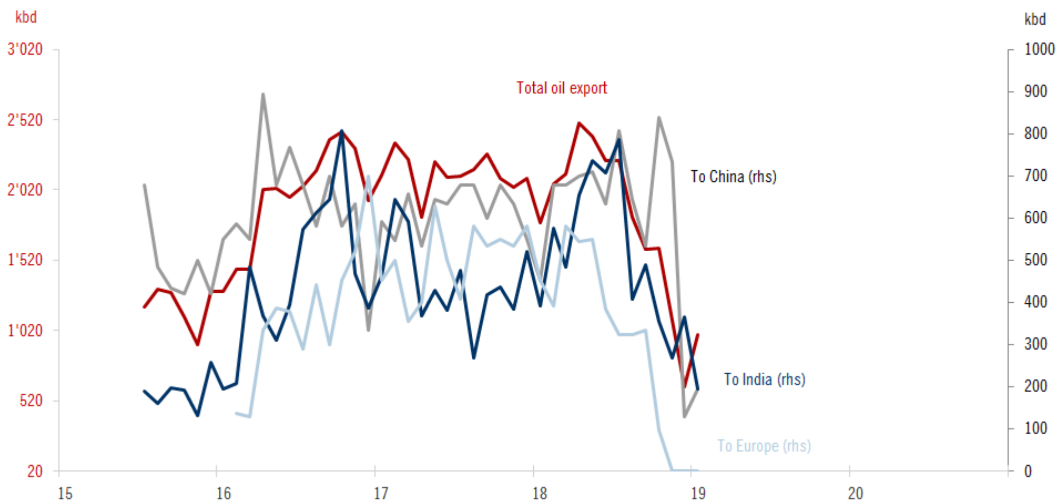
* Since December 2017;
** Until November 2018; *** Between November and December 2018

Source: PWM-AA&MR, US Energy Information Administration, Thomson Reuters

It is worth noting that despite announcements by EU officials that they did not accept renewed US sanctions, Iranian exports to Europe have fallen to zero. Among its major customers, only China seemed to have stood up to US pressure to reduce exchanges with Iran. However, the latest data tend to suggest that even China has capitulated.

Among other troubled producers, Venezuelan output has been declining since early 2016 (although the decline slowed towards end of 2018). Domestic political turmoil could further hurt Venezuela's oil output.

CHART 3: IRANIAN CRUDE EXPORTS



Source: PWM - AA&MR Bloomberg

By contrast, the US oil industry has shown continued dynamism, although Permian basin pipelines have faced capacity issues. The US has become, however briefly, a net exporter

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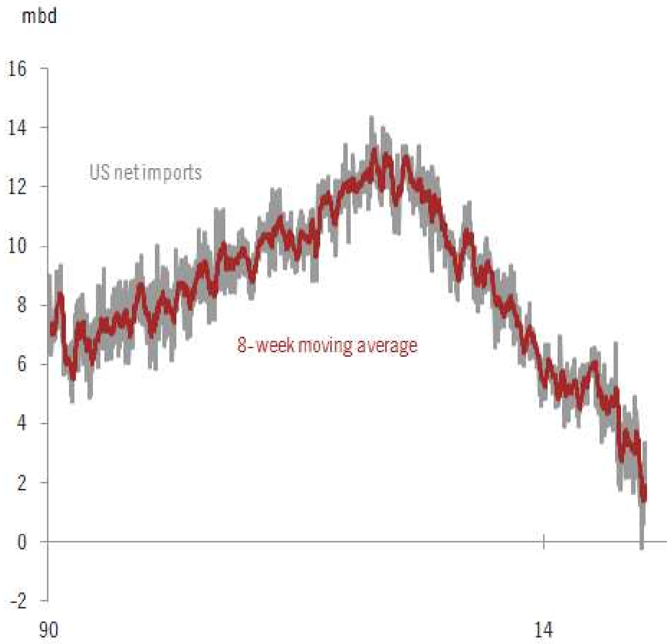
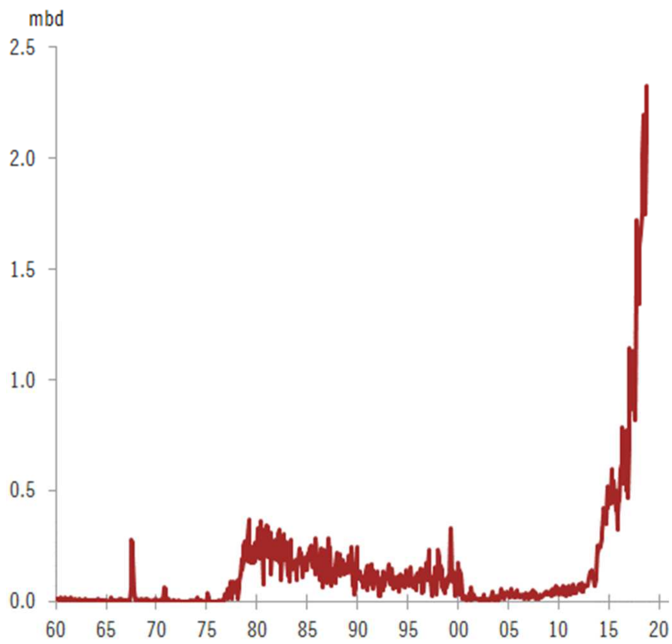
of petroleum for the first time in 75 years. With crude oil exports reaching 2mbd, the US has become a major global producer. This is clearly a disruptive development for OPEC.

CHART 4: US GROSS OIL TOTAL IMPORTS



Source: PWM - AA&MR, US Department of Energy, Bloomberg.

CHART 5: US EXPORTS OF CRUDE OIL



Source: PWM - AA&MR, EIA, Bloomberg.

The lack of pipeline capacity for shale oil from the Permian basin to the Gulf coast was a major concern for US shale oil producers, leading to higher discounts on Midland oil from April on. The discount has fallen since September, but we will have to wait until H2 2019 before significant new pipeline capacity comes on stream and discounts fall again.

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CHART 6: DISCOUNT ON MIDLAND OIL OVER GULF COAST PRICES

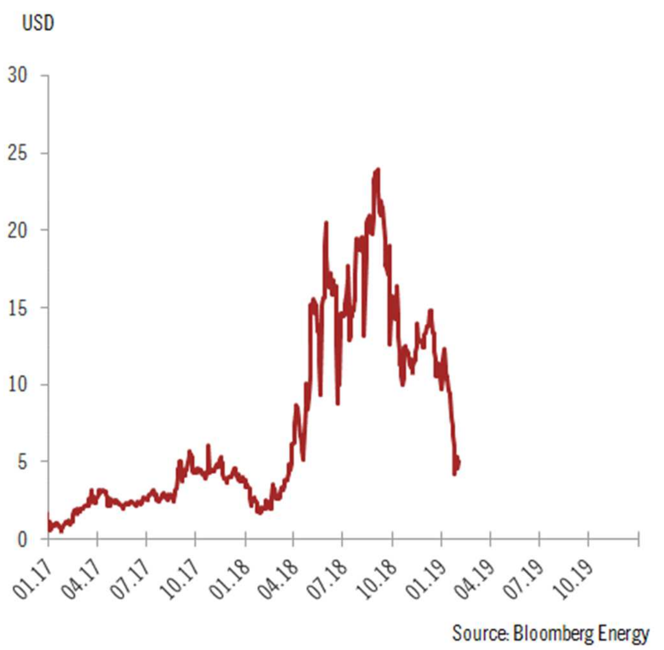
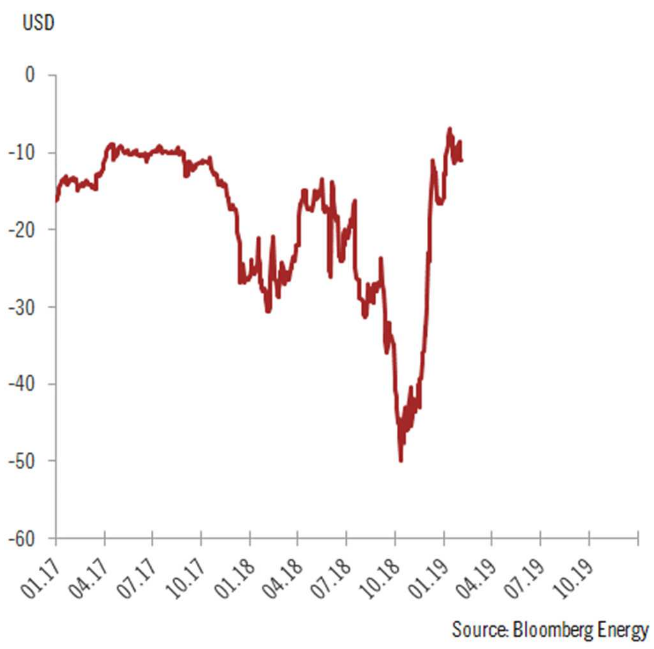
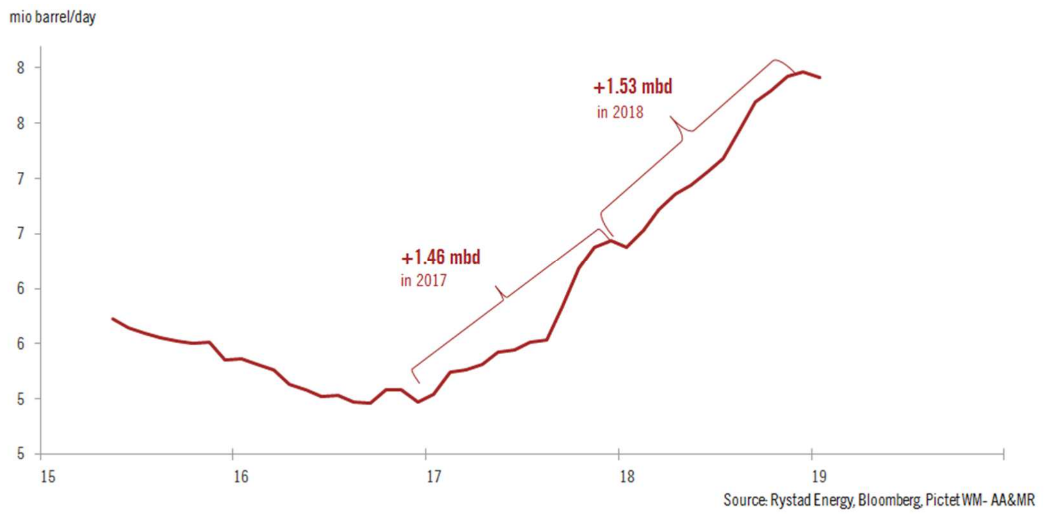


CHART 7: WESTERN CANADIAN DISCOUNT TO US FUTURES



However, pipeline issues only really began to hit in October. Despite them, US shale oil production increased by 1.5mbd in 2018 overall, slightly more than in 2017.

CHART 8: US SHALE OIL PRODUCTION



The new pipeline facilities under construction are expected to enable oil supply to increase by 2mbd in H2 2019, and a further 1.4mbd in 2020. Such an increase in US output will add to the pressure on OPEC.

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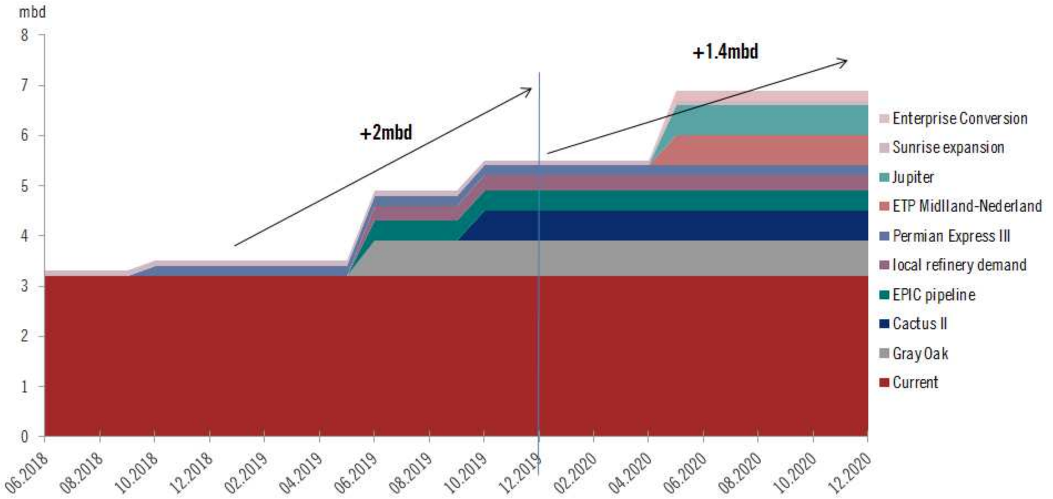
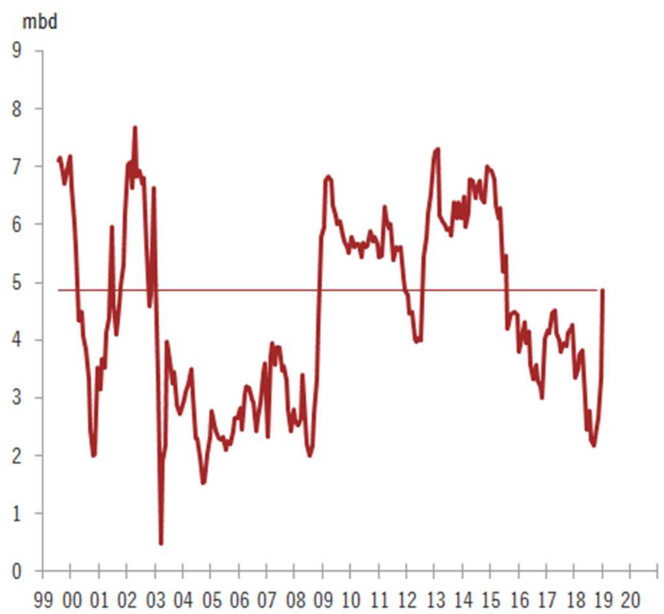
CHART 9: PERMIAN CRUDE TAKEAWAY CAPACITY



Source: PWM - AA&MR, S&P Global Platts Analytics, Bloomberg

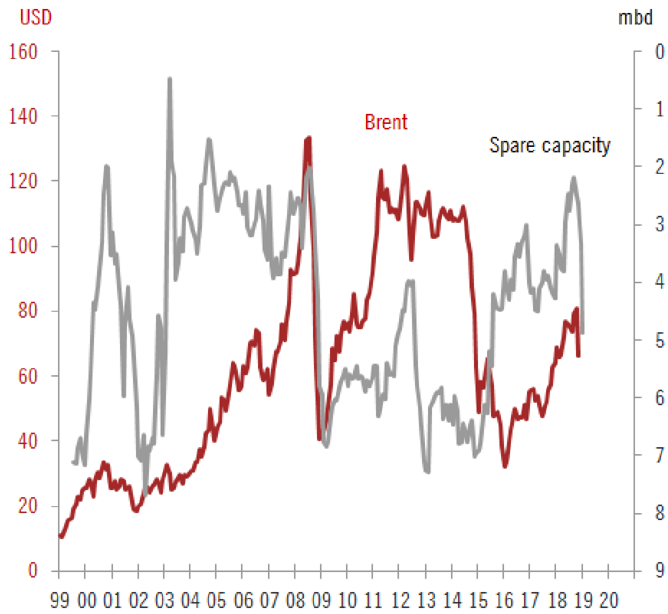
OPEC spare capacity reached a low point of 2.2mbd in September. Even though OPEC's market share has fallen from 51% in 1974 to less than 40% today, stretched capacities when the Northern Hemisphere enters winter increase the risk of further short-term oil price volatility. In the past, declines in OPEC spare capacity tended to push prices higher.

CHART 10: OPEC SPARE CAPACITY



Source: PWM-AA&MR, Bloomberg

CHART 11: OPEC SPARE CAPACITY AND BRENT PRICE



Source: PWM-AA&MR, Bloomberg

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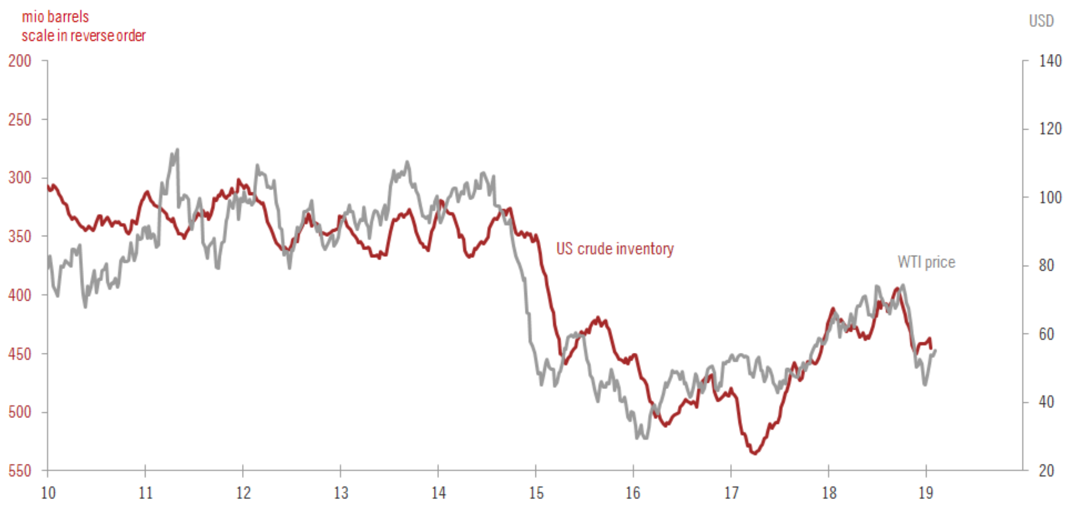
Today, the impact on oil price dynamics is much smaller, possibly reflecting the growing importance of US oil production. However, it would be hazardous to minimise the consequences for prices if there were a major failure in supply in one of the habitual hot spots, such as the Strait of Hormuz, Iraq or Libya in a situation where OPEC's spare capacity is stretched. Nevertheless, since the 7 December OPEC+ decision to cut output by 1.2mbd, the situation appears less tense. With this metric the oil price appears now close to fair value.

Too much oil?

High crude oil stocks were a major factor behind the collapse in oil prices in the final months of 2018, with weekly US oil inventories a particular focus of attention. The steep increase in US oil stocks between September and end November heightened fears of an oil glut. Since the end of November, however, stocks have declined slightly, relaxing the downward pressure on prices. The recent fall in oil prices now looks overdone when compared with US crude inventories.

CHART 12: US CRUDE OIL INVENTORY AND WTI PRICE



Source: PWM - AA&MR, DOE, Bloomberg

Beyond the US, global oil inventories appear also to have normalised. The Organisation for Economic Co-Operation and Development (OECD)'s crude oil inventories are back to the rolling five-year moving average that OPEC had targeted but there are question marks over this target. First, taking an absolute level of stocks as a reference point when global oil consumption is still growing does not appear optimal. It would be more meaningful to consider how many

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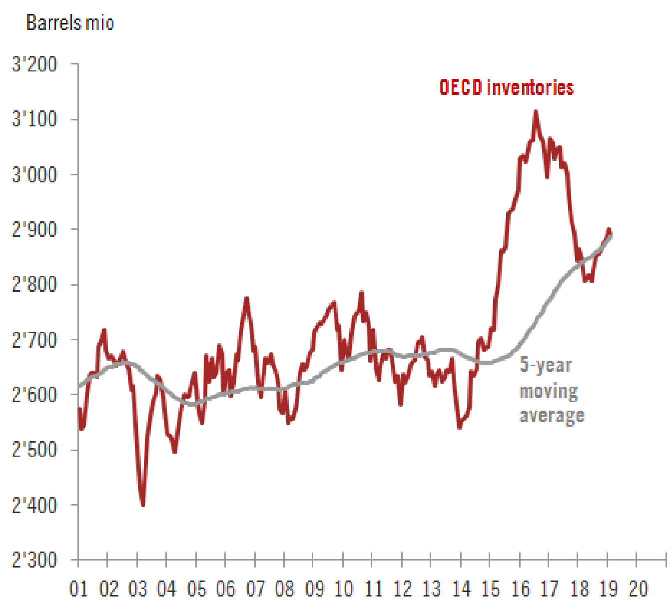
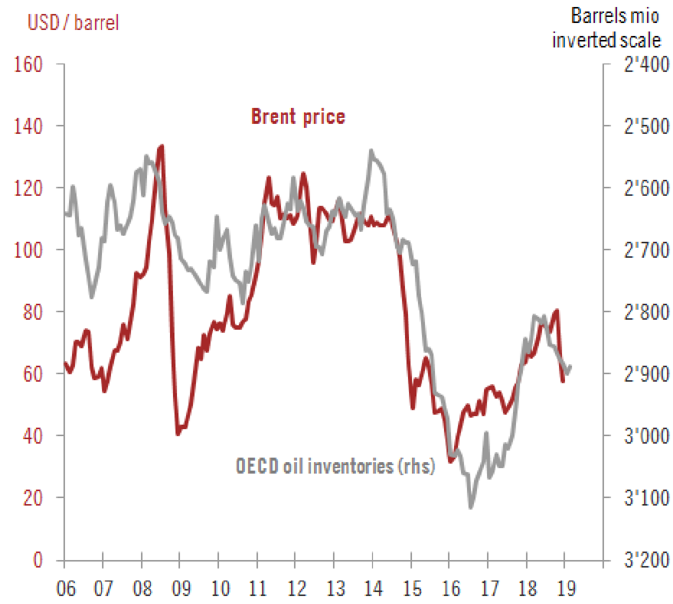
days of consumption current stocks would last. In addition, the moving average is very sensitive to recent history. In periods of large increases in inventories, as in 2016 and 2017, the five-year moving average moves much higher than in more normal times. Leaving aside these technicalities, Brent prices now appear in line with OECD inventory levels.

CHART 13: OECD CRUDE OIL AND LIQUID FUELS INVENTORIES



Source: PWM - AA&MR, EIA, Thomson Reuters

CHART 14: OECD CRUDE OIL INVENTORIES AND BRENT PRICE



Source: PWM - AA&MR, EIA, Thomson Reuters

Global oil demand continues to grow

Despite the ongoing energy transition and the economic slowdown in 2019, global oil demand (based on the International Energy Agency (IEA)'s latest updates) is expected to grow by 1.4mbd this year, a slight acceleration from the 1.3mbd increase recorded in 2018. Based on IEA data, we forecast that growth in demand will slow in advanced economies (from +0.4mbd in 2018 to +0.3mbd) but accelerate in emerging economies (from +0.9mbd to +1.1mbd). Emerging economies' demand for fossil energy has been outpacing demand in advanced economies since 2014. We expect non-OECD demand to top 52.5mbd in 2019, compared with 48.1mbd for OECD economies.

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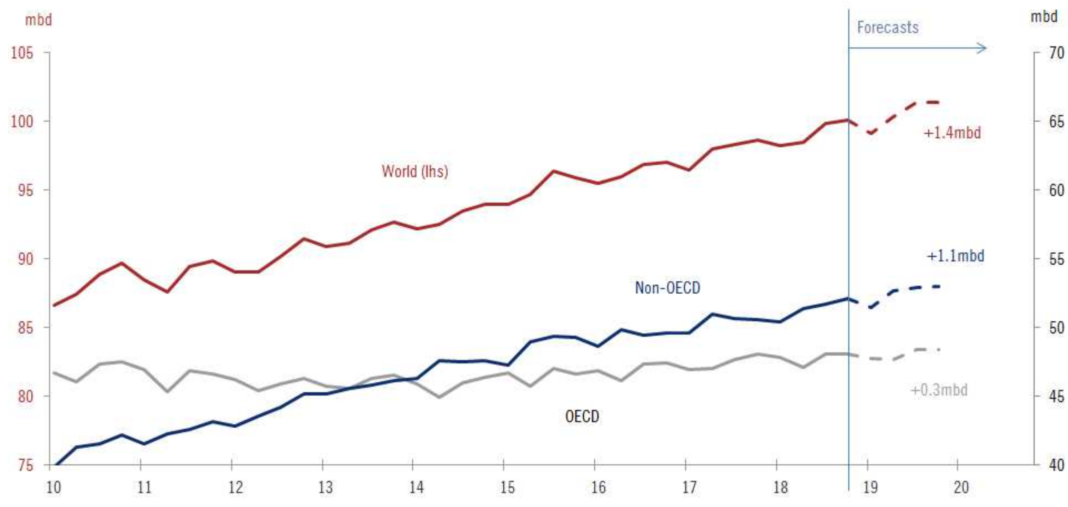
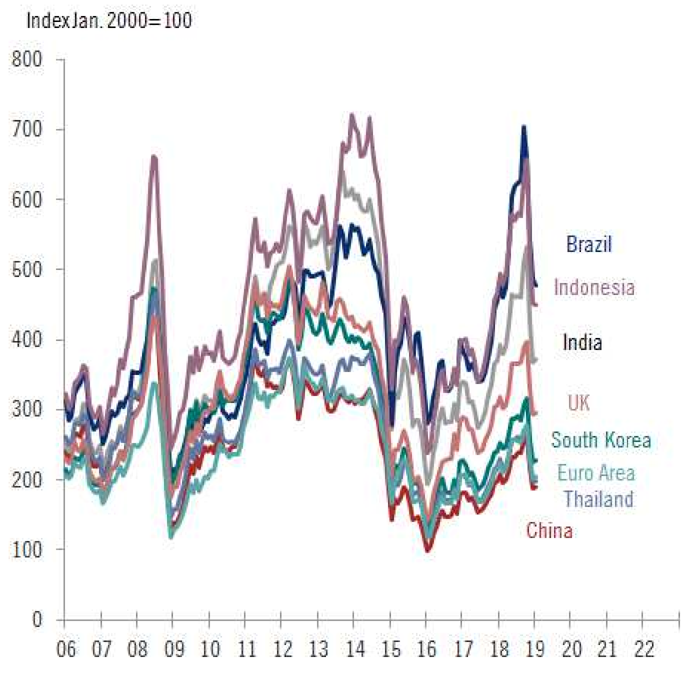
CHART 15: WORLD OIL DEMAND



Source: PWM - AA&MR, International Energy Agency

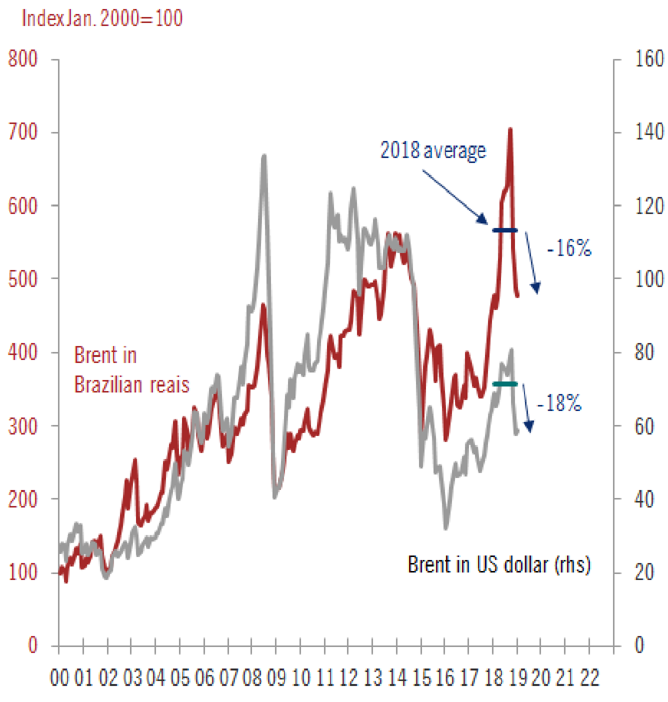
The increase in demand from emerging countries (as a result of the fall in prices) should more than compensate for the loss of economic momentum.

CHART 16: BRENT PRICE IN LOCAL CURRENCY



Source: PWM - AA&MR, Thomson Reuters

CHART 17: BRENT PRICE IN BRAZILIAN REAIS AND PRICE IN US DOLLARS



Source: PWM - AA&MR, Thomson Reuters

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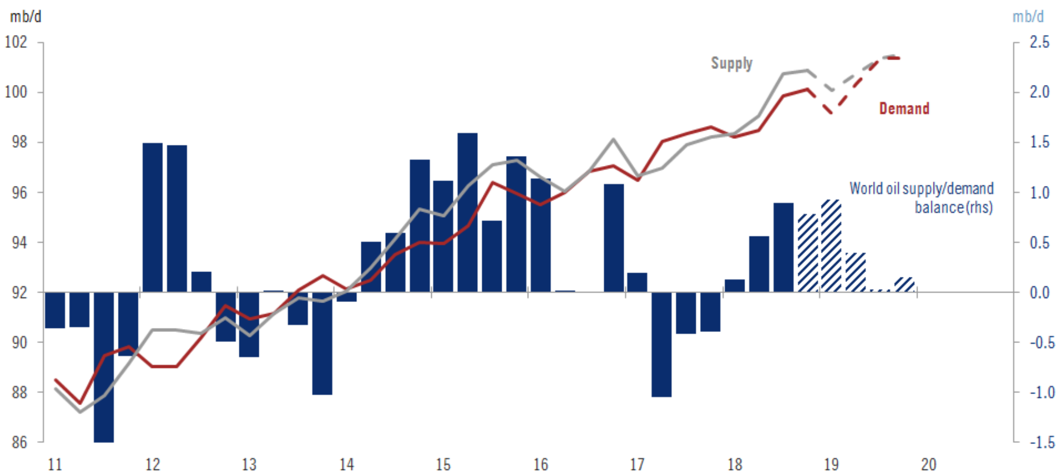
At end January, Brent prices in local currency were between 14% and 18% cheaper than their 2018 average price. This is a huge boost for economic activity and private demand in oil-importing countries, assuming lower oil prices are transmitted to the final consumer.

Towards a balanced market in 2019?

Data show that there was excess oil supply in Q2 and Q3 2018 *(see chart 18)*, justifying the collapse in oil prices that started on 4 October. Data for Q4 2018 and Q1 2019 will also probably show there remain surplus supplies of oil. However, OPEC+'s decision to cut output by 1.2mbd should help reduce surpluses in the following quarters. If there is disciplined adherence to the OPEC+ oil cuts, and if the cuts are extended beyond summer 2019, the surplus is likely to disappear by the end of the year. The 17 April OPEC+ ministerial meeting will be a key event in this regard.

It is still too early to assess to what degree the December decision will be respected by OPEC+ members. The latest data show that Saudi Arabia is taking the agreement very seriously, and the kingdom has already cut production by 500,000 barrels per day since November. By contrast, Russia (not an OPEC member, but a party to the OPEC+ agreement) has not yet reduced output significantly.

CHART 18: WORLD OIL SUPPLY – DEMAND BALANCE



Source: OECD/IEA, PWM AA&MR

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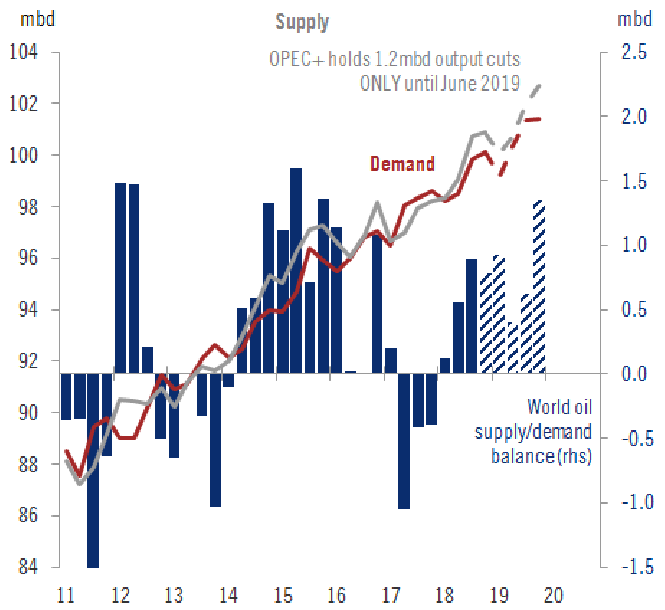
Much depends on OPEC+ compliance with agreed output cuts

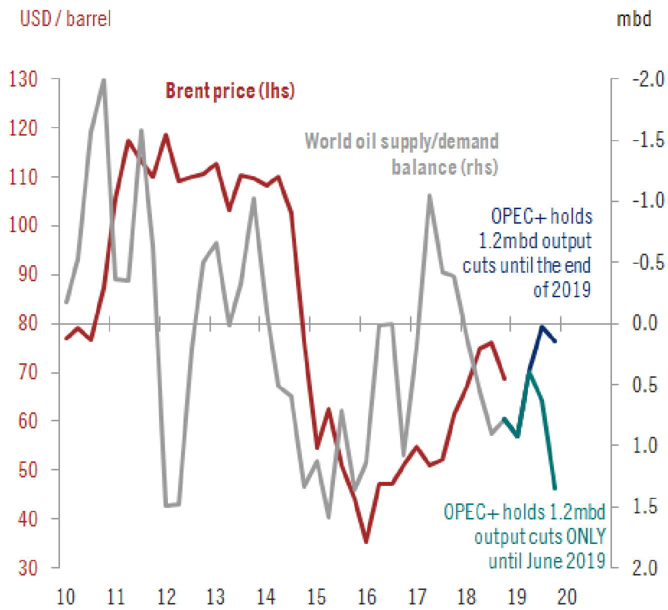
If OPEC+ fails to limit production until the end of the year, a gradual convergence towards pre-agreement levels of production will lead to a significant oil supply surplus (+1.4mbd) at end-2019, with significant consequences for prices. Brent prices could reach USD75 if the supply surplus falls to zero but could be USD40-50 in the case of a 1.4mbd surplus.

CHART 19: WORLD OIL SUPPLY/DEMAND BALANCE



Source: OECD/IEA, PWM AA&MR

CHART 20: WORLD OIL SUPPLY/DEMAND BALANCE AND BRENT PRICE



Source: OECD/IEA, Thomson Reuters, PWM AA&MR

Long-term fundamental equilibrium

In the face of much geopolitical uncertainty, it could be useful to focus on fundamental forces. Our long-term fundamental equilibrium proved again in 2018 to be a valid attractor toward which the spot price converges after a while, even in times of significant geopolitical events.

With the WTI at USD54, we are very close to the current equilibrium price (USD53). So, the discrepancies that dominated in 2018 (with oil prices moving well above equilibrium up to October) have been corrected. Upward or downward economic forces are cancelling themselves out for the moment.

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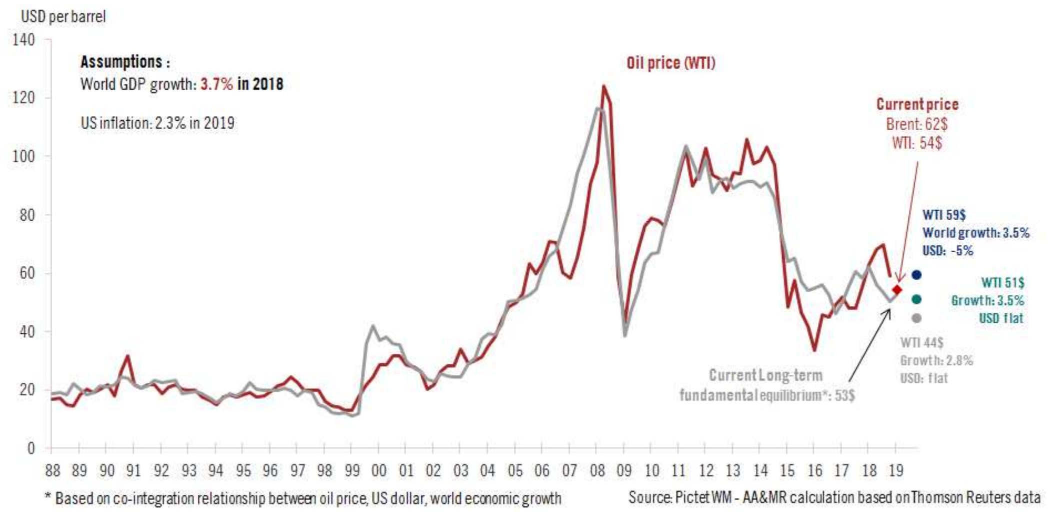
On a 12-month horizon, if the world economy grows at 3.5% in 2019 (as per our central scenario) and if the USD remains at its current level, the equilibrium price for WTI oil could remain very close (USD51) to where it is now.

However, since our core scenario posits a weaker US dollar in 2019, the equilibrium price is expected to be higher (USD60 for WTI and USD70 for Brent by end-2019 if the dollar weakens by 5%).

Based on this analysis, our year-end forecast remains unchanged at USD70 for Brent and USD60 for WTI.

CHART 21: WTI PRICE, LONG-TERM FUNDAMENTAL EQUILIBRIUM



Source: PWM - AA&MR

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