RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Oil check:

Key questions facing the oil market in 2019

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Michael Tran

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All values in U.S. dollars and priced as of December 31, 2018, market close, unless otherwise noted.

Wealth Management

Focus
article

Oil check

Key questions facing the oil market in 2019

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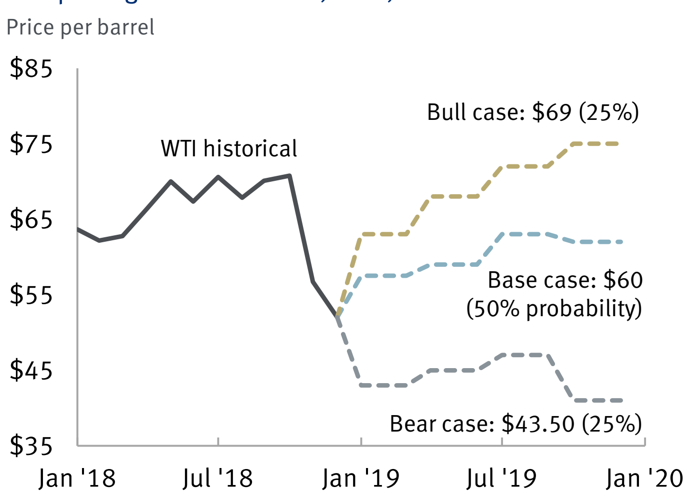
Michael Tran is a Managing Director within the Energy Strategy Research team at RBC Capital Markets, focused on global energy markets including macro supply and demand fundamentals. Mr. Tran's energy views are frequently quoted in media outlets, and he advises various governments on energy policy and budgeting.

With no shortage of captivating subplots for the global oil market as 2019 kicks off, Michael Tran, RBC Capital Markets, LLC's Managing Director and Commodity Strategist, looks at what's in store for oil this year. He explains the risks and catalysts that he expects will drive the market, how he thinks the late stage of the economic cycle will affect demand, and what he thinks the No. 1 threat to the market is.

Q. How do you see the global oil market shaping up for the year ahead?

A. We see global supply and demand in fine balance this year with the market ebbing and flowing on either side of equilibrium. This compares to an extremely volatile period over recent years when the market grappled with bouts of over and undersupply. While there are many moving parts at play, OPEC's resolve, even in the face of unprecedented political pressure, should solidify investor confidence given its commitment to return the market to a balanced state. Whether that is enough to bring apprehensive investors back to the table remains the topic *du jour*. Given the combination of active market management, adequate non-OPEC supply, broad macroeconomic concerns, and dwindling conviction levels among the investor community, we anticipate supportive pricing but far from a runaway market. We see WTI and Brent averaging $60 and $68/barrel this year, respectively. While there is no shortage of captivating subplots ranging from OPEC policy to IMO to the role of U.S. oil exports re-shaping global trade, this year could be one in which prices gyrate over short periods without providing compelling indication on long-term direction.

WTI pricing scenarios: bull, bear, and base cases



We anticipate supportive pricing but far from a runaway market with WTI averaging $60 per barrel in 2019.

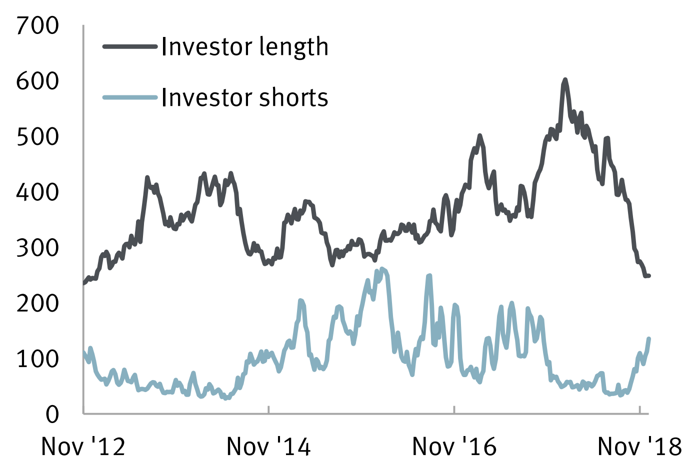
Source - RBC Capital Markets, Bloomberg; data as of 12/13/18

Q. Between OPEC, trade wars, technical trading, and fears for an impending recession, there are plenty of risk factors in the market. Are there any other broad risk factors that should be on the radar?

A. Investor positioning matters! We see the recent retracement in oil prices as oversold and describe our 2019 outlook as a moderately constructive, OPEC-driven view with our eyes wide open toward downside risk. However, the parade of fundamentally driven energy-dedicated traders exiting the space presents a structural issue that muddles how investors interpret the signal-to-noise ratio. As we mentioned, OPEC+ has indicated that it will defend a price floor, but the recent retracement is a keen reminder that investor sentiment, government energy policy, and market fundamentals can all undergo seismic shifts over extremely short lengths of time. Investor long positions in the WTI benchmark remain at multiyear lows and while the shorts have piled up over recent weeks, the aggregate short position is not nearly as high as seen in previous years. This means that short covering will not have as profound an impact as in the past, leaving the bulls to do much of the legwork to muscle prices higher.

WTI managed money futures and options position

Thousands of contracts



Short positions are below prior highs and suggest that oil bulls will be needed to propel crude prices higher.

Source - RBC Capital Markets, CFTC, Bloomberg; data through 12/18/18

Q. What are the bullish catalysts to look out for?

A. Supply outages from geopolitical hotspots remain a clear and present danger for a market that has become complacent about disruption risk. Upcoming Nigerian elections and the recent disruptions in Libya are important reminders that we can see acute, episodic issues, while outages in other regions, like Venezuela, remain structural. In a similar vein, the market is pricing as if the worst-case scenario for Iran is already behind us, but it is important to remember that even though Iranian production has already fallen by some 700 thousand barrels per day (kb/d) from spring levels, November 4 marked the start of sanctions, certainly not the end.

With U.S. consumption near full capacity and Europe set for further contractions, the world will soon be left with Emerging Asia as the sole major contributor to oil demand growth.

Q. Given the concerns about how late we are in the economic cycle, how do you factor the broad macroeconomic concerns into your thoughts surrounding oil demand?

A. Despite headlines of a slowing global macro backdrop, we anticipate status quo steady-enough oil consumption growth near 1.2 million barrels per day (mb/d) for this year. Global demand growth has averaged a robust annualized rate of 1.5 mb/d since the oil price collapse of 2014. During that period, OECD oil demand growth contributed an annualized rate of 475 kb/d, accounting for nearly one-third of global growth. This past year, the developed world contributed less than 270 kb/d, and we see little to stem the slowing trend in the years ahead. The years following the oil price collapse saw three pillars for oil consumption growth: the U.S., Europe, and Emerging Asia. With U.S. consumption near full capacity and Europe set for further contractions, we think the world will soon be left with Emerging Asia as the sole major contributor to oil demand growth. The truth is that OECD oil demand peaked a decade ago before the financial crisis and efficiency gains will continue to soften regional oil demand in the OECD region. Broadly speaking, we think the engine of global oil demand growth can ultimately be distilled down to China, India, and the rest of Emerging Asia. This subset of countries accounted for nearly two-thirds of global growth so far this decade. This concentration risk presents an asymmetric risk profile to the downside.

Q. How concerning is the rise of electric vehicles for the future of oil demand?

A. Let's use the example of China. China is both the global leader in oil demand growth and also the world's largest automobile growth market, including the foremost region for electric vehicle (EV) sales. EV sales in China have been on the rise and recently made up some 6% of total Chinese vehicle sales, but while EV sales have been increasing, SUV sales have also increased. SUVs constituted 7% of total Chinese vehicle sales back in 2010, but have since increased to 35%. This means that every incremental mile driven in China has a higher energy intensity than ever before. Simply put, EVs have been on the rise, but so have gas guzzlers.

Broad electrification is certainly a concern for oil demand, but the reach goes beyond cars. For example, there are major cities in China, like Shenzhen, where the entire bus fleet became electrified over a short four-year period. We believe one of the biggest threats to the current trajectory of future Chinese oil demand growth is mass migration to regions with large-scale electrified public transit options. The trajectory of oil demand is being reshaped by Chinese government policy.

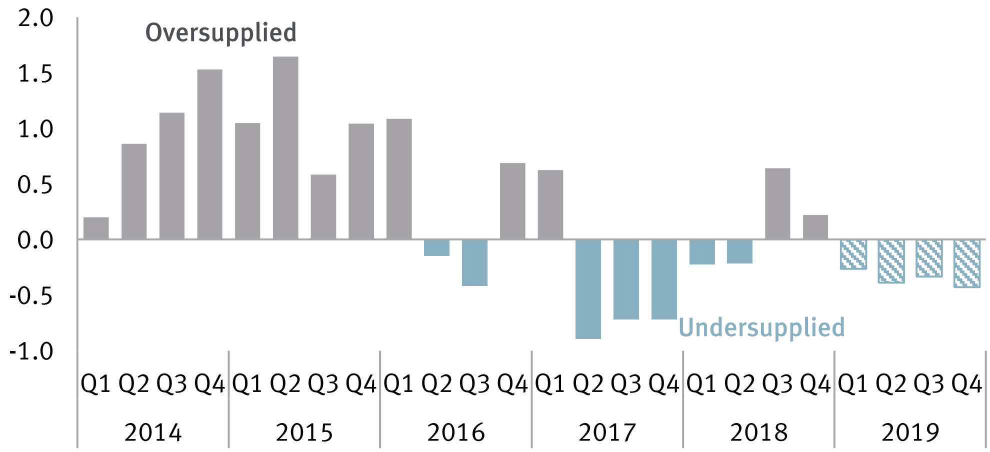
Q. What is the biggest downside threat to the oil market this year?

A. In our opinion, the biggest potential downside threat to the global oil market for this year is not a crude problem, but rather a gasoline issue that begins with China. While we believe the Asian giant will be counted on to once again support the oil market this year, a paradox exists. Chinese refinery throughput is higher by 8% y/y, which has played a major role in absorbing global crude that would otherwise have difficulty clearing the market. On the other hand, the heavy refinery runs have resulted in an oversupplied regional gasoline market. Slowing refinery throughput would clean up the gasoline overhang, but in turn exacerbate an already soggy crude market. Alternatively, continuing down the path of the current elevated refinery run rate would intensify gasoline balances that are already spiraling downward and potentially kick off a domino effect in which a gasoline glut created in the East ultimately reverberates westward and results in an oil market led lower by an oversupply of refined product.

We see supply and demand in a fine balance this year with the market ebbing and flowing on either side of equilibrium.

Global oil supply and demand balances

Millions of barrels per day



Source - RBC Capital Markets, Petro-Logistics SA, International Energy Agency, U.S. Energy Information Administration, Joint Organizations Data Initiative, company and government sources

Research resources

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