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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

The new rules of the global oil market

OPEC efforts to balance the market, geopolitical tensions, and the economics of refining could shape the market in the second half of 2019.

Michael Tran

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All values in U.S. dollars and priced as of July 31, 2019, market close, unless otherwise noted.

Wealth Management

Focus article

The new rules of the global oil market

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Michael Tran, Managing Director and Commodity Strategist with RBC Capital Markets, LLC, provides his take on what factors could influence crude prices over the rest of 2019. While OPEC remains committed to balancing the market, this will prove more challenging in the years ahead as we transition to a demand-driven market.

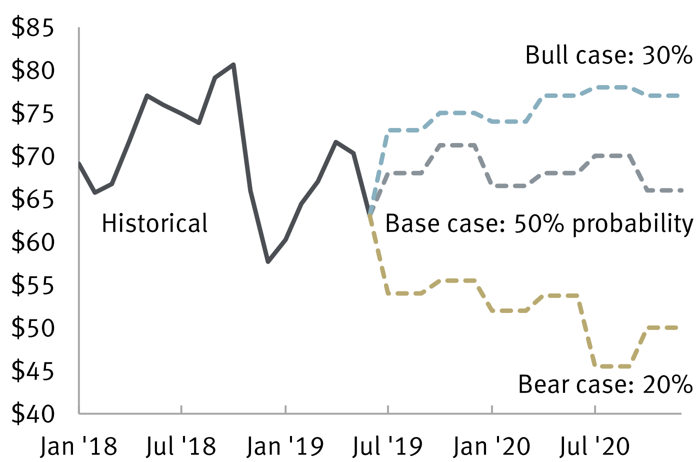
Q. How do you see the global oil market shaping up for the rest of the year?

A. Not all markets are created equal. Rebalancing a supply-driven market is materially easier than finding equilibrium in a market driven by demand weakness. The past five years featured the former, while the years ahead will likely center on the latter. Furthermore, global refinery runs peak in the summer, and while this is bullish for crude demand over the season, refinery utilization rates warrant close attention given that refining margins are weak in many regions, particularly in Asia and the Mediterranean. This signals either softening end-user demand for refined products, a regional excess of supply, or both.

The rules of bullishness are different in a demand-driven market. Production outages are headline bullish, but in a softening-demand market, a major supply outage from a geopolitical hotspot triggering a rally in crude prices could squeeze refining margins from both ends (i.e., higher crude input costs and weak product selling prices) and result in widespread cuts in refinery runs and lower crude demand.

Brent crude pricing scenarios: bull, bear, and base cases

Historical and projected price per barrel



Crude prices will likely remain rangebound in H2 2019, with Brent averaging $69.50/bbl and WTI $63/bbl.

Source - RBC Capital Markets

The market will likely oscillate within a range through the balance of the year, with Brent and WTI prices averaging $69.50/barrel (bbl) and $63/bbl, respectively. We also anticipate that WTI will outperform Brent in Q3 2019 given the weakening demand backdrop for Brent-linked barrels, while firming U.S. exports anchor a tightening North American balance. The opposite is likely to be true in Q4 when rising Permian production is expected to pressure Gulf Coast port capacity and thereby prompt Brent to outpace its North American counterpart.

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

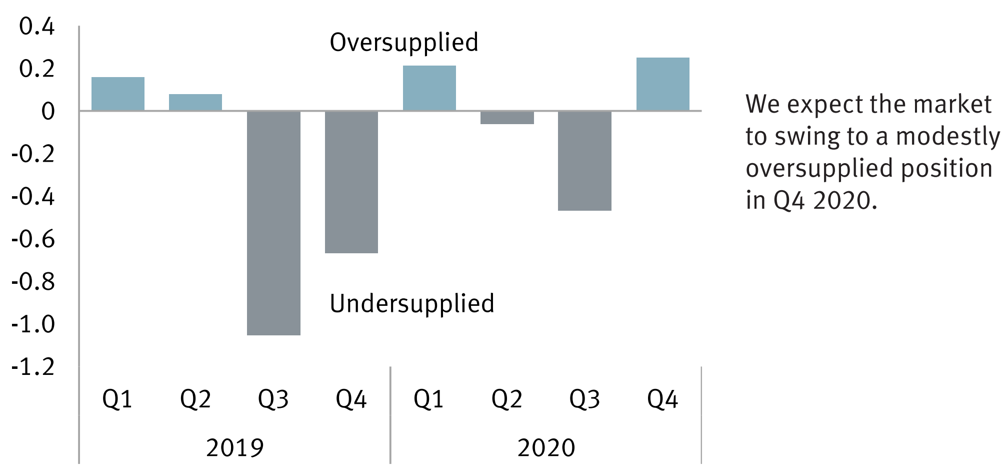
A. The most structurally bullish crude price scenario for the next cycle is one in which poor margins lead to several Asian or European refineries shutting (resulting in an expansion of refining margins and increased global utilization) together with a sizable and sustainable crude production outage in a geopolitically fraught country. In other words, sloppy product balances must be cleaned up before crude can stage a sustainable and material rally. Such a development would be constructive for the entire oil complex, even with a softer crude demand growth backdrop. Ultimately, while we see room for oil prices to improve, underpinned by a plethora of geopolitical risk factors, we anticipate that rallies will be capped unless product demand improves.

Q. What are the forward-looking implications of the most recent OPEC+ meeting?

A. By establishing a clear, tangible, and meaningfully lower target for inventories, OPEC+ (the coalition formed by OPEC and certain non-OPEC partners to manage production volumes) drew a line in the sand for what could prove to be a multi-quarter—but more likely a multi-year—rebalancing process. Given the exogenous factors at play, the path of ridding the market of some 160 million barrels and guiding OECD crude inventories back to 2010–2014 levels will be a long, drawn-out process. One should not question OPEC's resolve or commitment to rebalancing the market, but the path to this goal and the time required remain ambiguous.

Global oil supply and demand balances

Millions of barrels per day



Source - RBC Capital Markets, IEA, Petro-Logistics SA, EIA, JODI, company and government sources

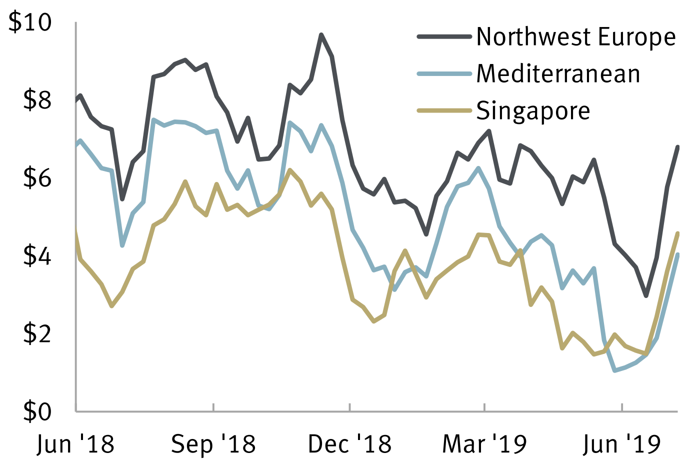
How difficult it will be to return inventories to prior levels also remains an open question, but again one must consider that not all markets are created equal. It is easier for the group to rebalance a market defined by excess supply by reducing output than to rebalance a market driven by demand weakness.

Q. What are the downside risks for the oil market?

A. Outside of the Trump wildcard that could roil many markets, in our opinion, the biggest potential threat to the global oil market for the balance of year is that refining could be drawn into a vicious cycle of falling margins and lower demand. The summer months typically see peak refinery runs as units around the world return from maintenance. This should be bullish for crude demand, but refinery utilization rates bear watching given that margins are weak in many regions, particularly in Asia and Europe. For example, Asian refining margins have weakened over recent months to the point that certain crack spreads have been flirting with negative territory. This means that continuing to produce end-use product is a money-losing proposition.

Regional hydroskimming refinery margins

Dollars per barrel



Refining margins could hold the key to the path of future crude prices.

Source - RBC Capital Markets, Bloomberg, industry reporting, Chinese Customs General Administration

We have been conditioned to assume that production outages are bullish for crude balances, and this is typically the case, but in a softening-demand market, a major outage and a subsequent rally in crude prices could pinch refining margins and result in cuts to refinery runs and lower crude demand. Overall, Asia has added refining capacity over recent quarters and unless product demand improves markedly, the most likely scenario is that regional margins will remain merely firm enough to sustain reasonable run rates. Excess product balances can only be absorbed during the spring and fall refinery maintenance seasons. This is the vicious cycle.

Q. Is there a release valve that can allow gasoline margins to rise?

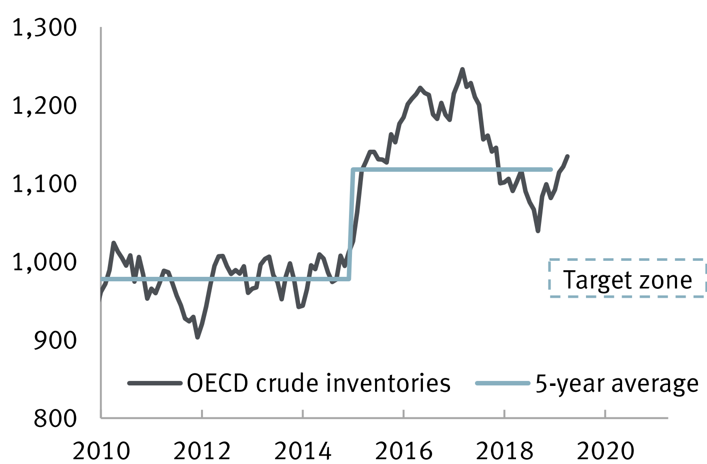
A. The recent closure of the Philadelphia refinery (PES) following a fire is bearish for crude but can be seen as a temporary release valve for a saturated gasoline market. Naturally, shutting a refinery destroys crude demand, and the 235,000 barrels per day (bbl/d) of light crude that PES imported will be left behind in the Atlantic Basin (hence the recent physical weakness and soft Brent spreads). Most of the crude consumed by PES was of a grade typically imported from the North Sea and West Africa. Those barrels will need to find alternative homes. On the bullish front, gasoline makes up nearly 50% of the U.S. East Coast refinery yield; without PES, the region will be left short of gasoline and forced to lean heavily on imports from across the Atlantic. Sourcing additional gasoline domestically is difficult because major pipelines operate near capacity and regulatory requirements make shipping up the East Coast economically undesirable. The region currently imports some 500,000 bbl/d of gasoline, mainly from Europe, a figure set to rise with the PES closure. We believe the East Coast will pull otherwise stranded barrels of gasoline across the Atlantic, temporarily supporting gasoline margins that are generally lackluster on a global basis.

The bottom line

We believe the OPEC+ effort to balance the oil market by guiding global crude inventories down to 2010–2014 levels will take time. It is a welcome and necessary development given that refining economics have weakened in Asia and parts of Europe. The status quo should allow Brent and WTI prices to average $69.50/bbl and $63/bbl, respectively, over the balance of 2019. A truly bullish outcome would require a combination of stronger product demand and a meaningful, sustained disruption in crude production.

OECD crude oil inventories

Millions of barrels



OPEC+ has set a meaningfully lower inventory target, but the path to rebalancing is likely to span years.

Source - RBC Capital Markets, IEA

Research resources

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