Crude oil: What's in store for 2018?

We have revised our ICE Brent forecast for the next quarter to $57 per barrel, and also our 2018 forecast to $51 per barrel

Source: iStock

US production set to increase throughout 2018

Geopolitical risk, positive economic data, and expectations of an extension to the OPEC production cut deal have seen ICE Brent trade above US$60/bbl for the first time since 2015. We have revised our 4Q17 ICE Brent forecast from US$52/bbl to US$57/bbl, whilst for 2018 we have raised our forecast from US$46/bbl to US$51/bbl

While global oil inventories have declined over the last year, they still have some distance to go in order to be more aligned with the five year average. OECD inventories (oil and products) fell from a peak of 2,780MMbbls in July 2016 to 2,689MMbbls at the end of August 2017, which still leaves stocks around 200MMbbls above the five-year average.

Despite a slowdown in rig activity, US production is set to continue increasing next year, and output is set to see its highest level on record, surpassing the previous record of 9.6MMbbls/d seen in 1970.

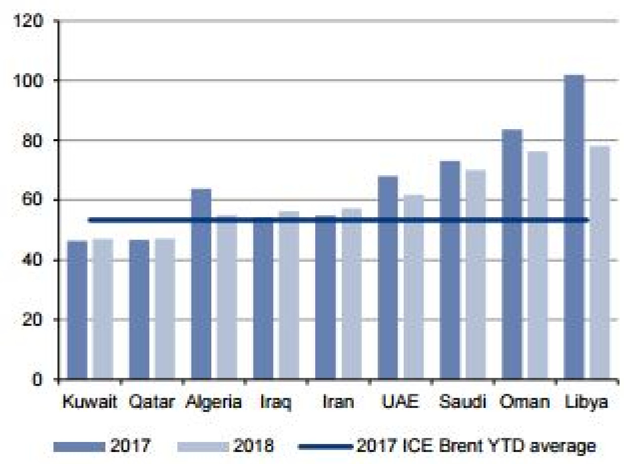
Rising non-OPEC supply, and expectations of slower demand growth over 2018 should see the global market return to a small surplus of around 200Mbbls/d. As a result, we believe that OPEC will continue with its current output deal until the end of 2018. Failing to do so risks pushing the market into a deeper surplus. However the longer the deal does continue, the more likely compliance starts to deteriorate.

What will OPEC do?

OPEC and non-OPEC compliance with the production cut deal implemented in the beginning of 2017 has been much better than initially anticipated. The Joint Ministerial Monitoring Committee (JMMC) reported compliance of 120% within the larger group over the month of September 2017 - the highest level since the production cut deal started.

However, if we take into consideration Libya and Nigeria, which are exempt from the deal, compliance does look more modest. The question the market is asking now is whether OPEC will extend the deal when it expires at the end of March 2018. Recent price action clearly suggests that the market believes the deal will be extended, and with the Saudi Crown Prince supporting an extension, it does look the most likely outcome.

Fiscal breakeven oil price (US$/bbl)



Source: IMF, Bloomberg

Bottlenecks in US production

Looking purely at rig data suggests that the US is experiencing a slowdown in activity. Having increased the number of oil rigs from a low of 328 in June 2016 to a recent high of 768 in August 2017, the count has started to tail off, falling to 729 recently. This is despite the fact that WTI has rallied around 15% over the same period.

There are several reasons behind the slower activity. Firstly there have been media reports of increased shareholder pressure on US producers to improve profitability.

This does mean that the floor for oil prices may not be as low as initially thought.

Adding to this is cost inflation. Daily rig rates in the Permian region have increased by c.10% YoY, while raw material costs have also edged higher. There are also signs of tightness in completion equipment and teams.

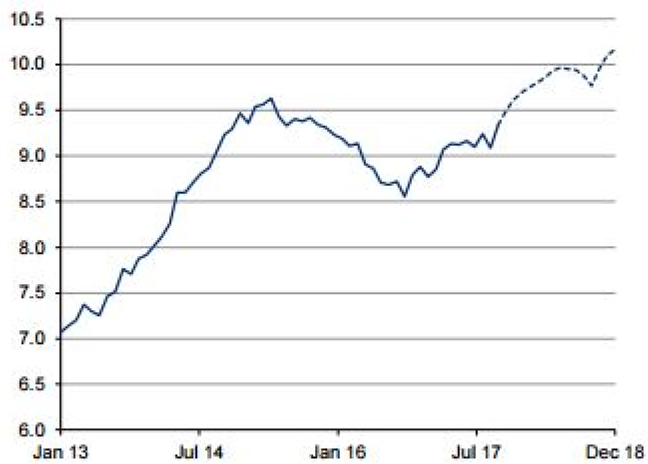
Another factor to focus on when looking at US production is the increase in decline rates in shale oil. These have steadily accelerated over time, and higher well concentration is one of the reasons blamed for this. More wells drilled within close proximity risks reducing well pressure, and as a result, hitting recovery rates.

US oil spills into Asian market

The recovery in US crude oil production has been remarkable over 2017, with output increasing from 8.77MMbbls/d at the end of 2016 to 9.56MMbbls/d at the end of September 2017. The EIA estimates that production for 2017 as a whole will average 9.24MMbbls/d (up from 8.86MMbbls/d in 2016), while for 2018, production is expected to average 9.92MMbbls/d. We do expect to see a recovery in the US rig count, with there usually being a lag between the rig count reacting to prices.

Growing US production has seen the Brent – WTI spread trade out to levels that have supported increased US crude oil exports. Over recent week exports have exceeded 2MMbbls/d, significantly higher than the 485Mbbls/d exported on average in 2016. Unfortunately for OPEC, these exports are competing for market share in Asia. The proportion of Chinese import supply provided from the US has increased from 0% in early 2016 to as much as 4% over periods of 2017. Given that US production is expected to continue growing over 2018, while OPEC is likely to continue with cuts, we could see the share of US crude oil making its way into China increase further.

US crude oil production (MMbbls/d)



Source: EIA STEO, ING estimates

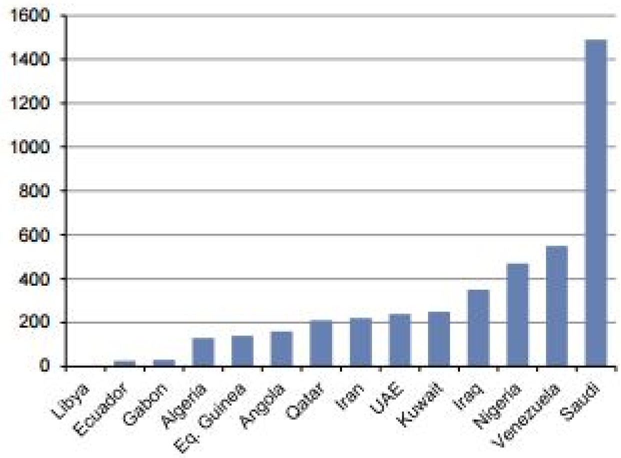
Demand projections and market balance

2017 has been a strong year for oil demand; the IEA estimates that demand growth over the year will total 1.6MMbbls/d. Meanwhile, good GDP data, along with robust factory activity continue to support the view of stronger oil demand.

However, the IEA expects that oil demand growth over 2018 will slow to 1.4MMbbls/d. This number is key for the oil market, as it is less than the 1.5MMbbls/d of non-OPEC supply growth forecast for the year. OPEC supply is estimated to be broadly flat over the year, and so any potential increase in the group's production will see what is currently expected to be a marginal surplus in 2018 grow. Demand growth over 2018 is expected to come almost exclusively from non-OECD nations, with the IEA estimating demand growth from these countries at 1.35MMbbls/d. Almost 50% of this growth is expected to come from China and India, with an increase of 320Mbbls/d each. However, we believe that there is downside risk to these numbers.

Concerns remain around China, where stock building has supported oil demand over 2017, and there are doubts over how long this stronger buying can persist. Over the first nine months of 2017, China produced 3.9MMbbls/d of oil domestically and imported 8.7MMbbls/d, yet refinery throughput was just 11.2MMbbls/d. This suggests a potential surplus of 1.4MMbbls/d, which would have been added to inventory. In India, economic growth has fallen to a three year low of 5.7% in 2Q17, slower growth rates are being attributed to the demonetisation seen at the end of last year, which took out of circulation 86% of cash supply. Meanwhile, the government's tax overhaul, which saw the introduction of the Goods and Services Tax (GST) is also expected to have hit economic growth in the country.

OPEC spare production capacity (Mbbls/d)



Source: Bloomberg

IEA forecasts 2018 surplus

The IEA expects that the global oil market will see a surplus of c.0.2MMbbls/d over 2018 (a surplus of 0.8MMbbls/d in 1Q18 and largely balanced over the rest of the year), assuming that OPEC output remains at current levels.

Growing geopolitical risk

As we move towards the end of 2017, it is clear that geopolitical risk has returned to the oil market, and this is a theme set to continue into 2018.

Firstly we have seen concerns grow over oil supply from Northern Iraq, given the conflict between the Iraqis and the Kurds, following the Kurdish referendum vote for independence. The Kurdish region of Iraq exports around 600Mbbls/d of crude oil, which is exported through the Turkish port of Ceyhan by pipeline. The conflict has already seen operations at oil fields in the region affected, and as a result, oil flows via the pipeline have reportedly fallen to 288Mbbls/d. The Iraqi government is trying to make up for any loss in supply from the North, by increasing export supply from the South. The Iraqis are also looking to repair a government-owned pipeline to transport oil from Kirkuk oil fields.

Secondly, concerns over the future of the Iranian nuclear deal continue to overshadow the market. President Trump is not happy with the deal, and with him having failed to certify it in October, has meant that Congress has 60 days to decide whether to reimpose sanctions. Therefore expect the market to continue pricing in a risk premium for this uncertainty.

The concern for the market is that we see oil exports fall back towards levels when sanctions were last in place. In 2015, Iranian crude oil output averaged 2.84MMbbls/d, while exports averaged 1.19MMbbls/d over 2H15. Meanwhile, 3Q17 production has averaged 3.83MMbbls/d, and exports 2.17MMbbls/d. So if the US impose sanctions once again will we see a loss of almost 1MMbbls/d? For now, we believe this is unlikely; a number of other nations have made it clear that they believe Iran is complying with the nuclear deal, and so see no need to reintroduce sanctions.

There is also increased uncertainty around Saudi Arabia, following the recent crackdown on corruption, which has reportedly led to the arrest of a number of Saudi princes and senior officials.

Conclusion

While there are clear signs of slowing US production growth, US crude oil output is still expected to grow over 2018, while global demand growth is set to slow. We believe OPEC will extend their production cut deal through until the end of 2018, however the risk is that the longer the deal continues, the more likely compliance starts to slip. These factors should see the oil market return to small surplus over 2018 and, as a result, we believe ICE Brent will average US$51/bbl over 2018. The key risk to this view is a worsening of the current geopolitical environment.

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