Oil Market Weekly

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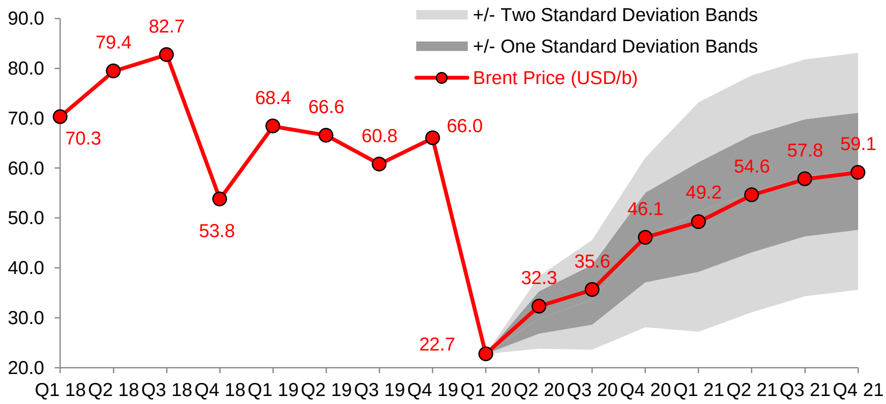
Entering the inflection point in oil markets

- There's tangible credence that normal service is returning to global oil markets. The oil price war, sub-zero oil benchmarks, oil storage capacity distress and staggering oversupply dislocations are now firmly behind us. Chinese oil consumption is almost back to pre-COVID-19 levels, while real-time traffic data continues to signal that gasoline is benefitting with driving activity recovering in the US, Europe and most of Asia, which is supported by the latest weekly US EIA data, with gasoline demand seemingly having bottomed out in April. However, the recovery in the global economy, and with it, global oil demand will be non-linear. Risks abound, especially of a second wave of the pandemic, if policy and social distancing measures are eased prematurely.
- The equilibrium of supply equating demand is in sight. The sharp oil market rebalancing continues to garner momentum, driven by both supply and demand improvements which are progressing in line with our above consensus expectations that we have been advocating in recent weeks (see here and here). The sheer velocity of voluntary (OPEC+) and involuntary (primarily forced production shut-ins in the US and Canada), in conjunction with the ongoing reopening of economies across the world, is driving oil markets to become instantaneously balanced with the equilibrium of supply equating demand by late May – early June (the inflection point), with a deficit by mid-June, in our view.
- Oil price expectations. We remain resolutely bullish on oil prices. A holding pattern with range-bound oil prices could emerge in the next 2-3 weeks, with the next leg higher in prices taking a firm hold once oil markets move into a deficit by mid-June – thus we see firm upside risks to our end Q2 2020 Brent (USD32/b) and WTI (USD28/b) forecasts. The further reopening of economies across the world in the weeks ahead, alongside higher decline rates, lost shut-in capacity and a materially higher cost of capital for oil markets, will set the stage for a global oil market in deficit by mid-June, ultimately leading to higher oil prices. From this, the structural outcome of the ongoing rebalancing leads our models to forecast Brent ending Q3 and Q4 2020 at USD36/b and USD46/b, respectively – with clear upside risks – and rising to average USD55/b in 2021.

BRENT QUARTER END PRICES (USD/B) WITH STANDARD DEVIATION BANDS



Source: Bloomberg, EIA, IEA, OPEC, MUFG MENA Research

Entering the inflection point in oil markets

Past the peak in demand evisceration

The initial phased easing in lockdown restrictions is supporting the increase in oil demand following the nadir in COVID-19-led demand evisceration that was witnessed in April, at -26.1m b/d, according to our econometric models (see here). Our bottom-up country-by-country modelling estimates point to global oil demand printing at -17.2m b/d and -12.1m b/d for May and June, respectively. The largest improvements are being witnessed in gasoline road transportation activity in China, the US and Germany, and to a lesser extent the UK, as recorded by Apple's mobility trends data. Moreover, flight tracking data is demonstrating that aviation activity is rebounding, albeit from a low base. We have already started to see the total number of flights on a global basis begin to rise, suggesting we could be past the worst for global jet fuel demand with the number of flights taken worldwide reaching over 90,000 in mid-May compared to the trough of 46,294 on 12 April.

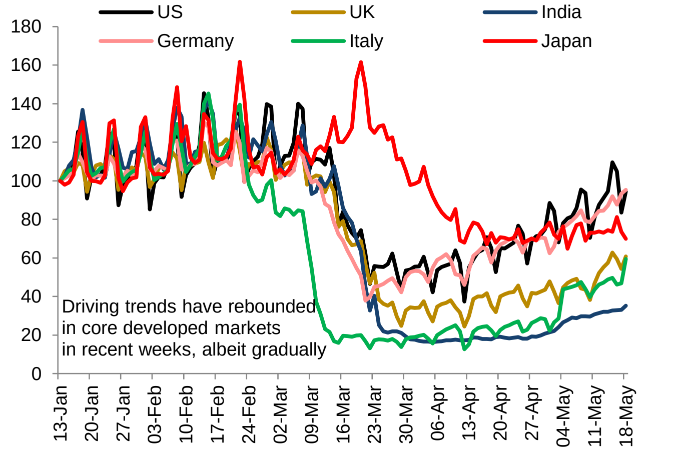
Demand recovery will be gradual

After this initial restart, our expectation is that the rate of improvement will steadily decelerate as a return to normalcy will be gradual, with signs that the initial pent-up rebound in demand is already giving way to a more modest subsequent recovery across developed economies and – with a lag – also amongst emerging markets. As such, our models project global oil demand to register -12.1m b/d in June and then modestly recovering in July and August to -7.6m b/d and -5.8m b/d, respectively.

Pace in demand growth will be de-synchronised across countries

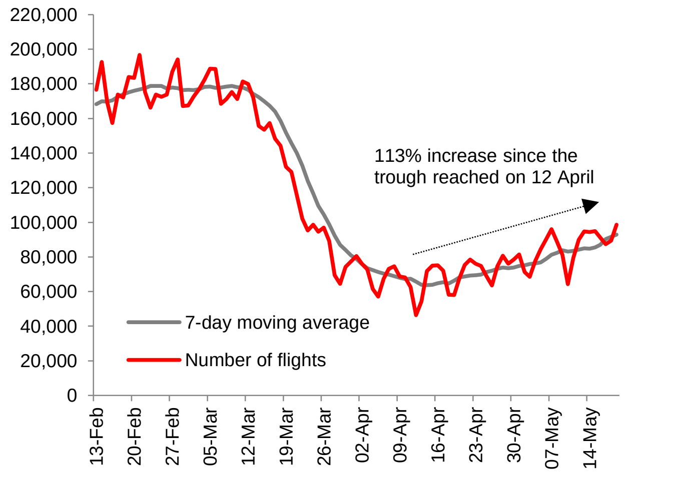
The premise of our estimates are first built on the experience of the Chinese demand recovery – approximately a halving of a demand hit in each month. In addition, we factor in idiosyncratic adjustments for each country accounting for the timing and magnitude of the specific lockdown measures, in order to develop a firm gauge of the pace of the expected demand recovery in each country. Separately, but in similar vein, given the robust normal relationship between global GDP and global oil demand (correlation coefficient 0.768), we also account for the disproportionate hit to oil demand during the current COVID-19 crisis – as oil is central to transportation which is in-turn central for social interactions – hence the global oil demand destruction is more than 2-4x the economic growth hit, in our view. From this, we expect a de-synchronised recovery: (i) between the US and other developed markets, where the latter is likely to experience a more gradual recovery; and (ii) between China and other EMs, where the latter is likely to face the headwinds of high urban population

APPLE MOBILITY STATISTICS – DRIVING INDEX (100 = 13 JANUARY 2020)



Source: Apple Mobility Statistics, MUFG MENA Research

TOTAL NUMBER OF FLIGHTS GLOBALLY PER DAY



Source: Flightradar24, MUFG MENA Research density combined with weaker healthcare systems.

Deep and impressive OPEC+ cuts

On the supply-side of the oil equation, deep and impressive OPEC+ supply cuts, alongside forced non-OPEC+ production shut-ins and curtailments, are eroding the supply glut. Whilst official production and export data is yet to be released, vessel tracking data suggests that compliance with the 9.7m b/d in cuts from 1 May, plus the additional 1.2m b/d in further pledged cuts by Saudi Arabia, the UAE and Kuwait, looks promising. Indeed, compliance with the OPEC+ cuts has been a central driver of the tentative recovery in front-end prices.

Non-OPEC+ production cuts have also been robust

Outside of OPEC+, production appears to be falling robustly. The US and Canada could be down ~3.1-m b/d in May. Canadian supply has already declined by more than 1.0m b/d, and domestic prices (Western Canada Select [WCS] crude benchmark) is now recovering from very low levels (currently trading at USD24/b from a trough of a mere USD4/b on 21 April). Separately, our forecasts is for US oil output falling from a peak of 13.1m b/d in March 2020 to 9.9m b/d by August 2020, before recovering thereafter. More broadly, global production curtailments have surged, with some production being permanently shut-in (see here).

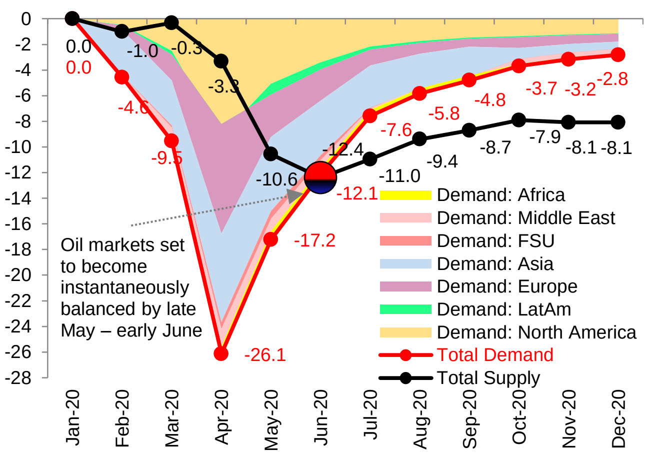
Stronger oil prices will require patience

From an oil price perspective, we remain resolutely bullish. We view that a holding pattern with range-bound oil prices could emerge in the immediate 2-3 weeks, with the next leg higher in prices taking a firm hold once oil markets move into a deficit by June – thus we see firm upside risks to our end Q2 2020 Brent (USD32/b) and WTI (USD28/b) forecasts. Granted, lingering concerns over the economic damage wrought by COVID-19, is countering optimism that deep and impressive OPEC+ supply cuts, alongside forced non-OPEC+ production shut-ins and curtailments, which are eroding the supply glut.

Pause in oil prices followed by another oil price rally once the deficit widens in June

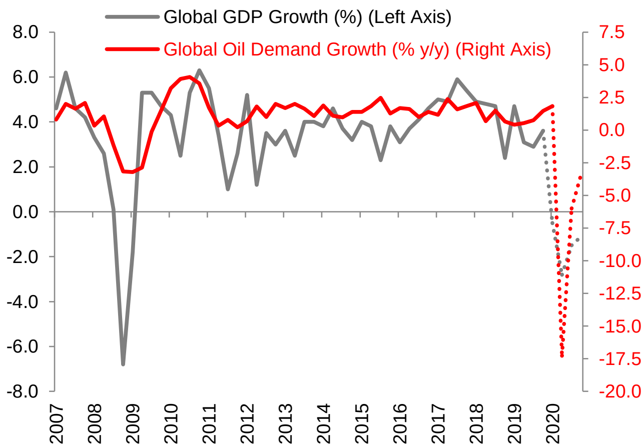
The oil price rally in recent trading sessions appears to be taking a pause fuelled by demand-side apprehensions: (i) reports that Moderna Inc.'s vaccine study has not produced enough critical data to assess its success; and (ii) Federal Reserve Chairman Powell told a Senate Committee that Americans could start losing their homes and warned that long-term unemployment could materially damage the economy. As such, we caution that the relief rally could prove vulnerable in the immediate term, and the most notable shift will likely be a decline in implied volatility, with a firmer leg higher on the front-end of the curve requiring more patience. As the deficit widens, this will be followed by a move higher in spot prices due to a steepening level of backwardation through H1 2021. Higher decline rates, lost shut-in capacity and a materially higher cost of capital for global oil markets will set the stage

GLOBAL OIL DEMAND, MILLION B/D



Source: Bloomberg, EIA, IEA, OPEC, MUFG MENA Research

GLOBAL GDP GROWTH (% Y/Y) AND GLOBAL OIL DEMAND (% Y/Y)



Source: Bloomberg, IMF, MUFG MENA Research

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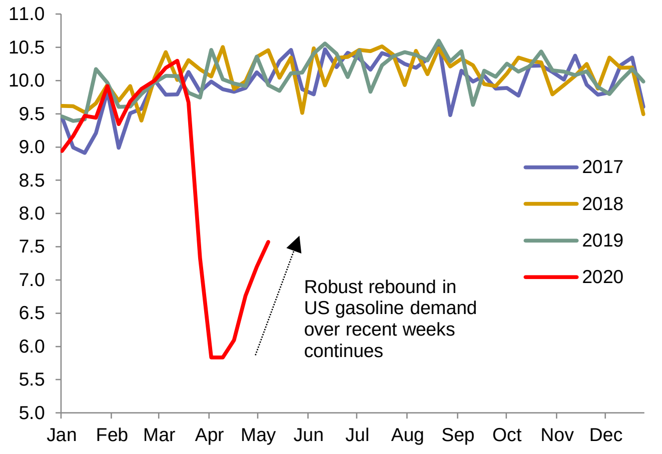
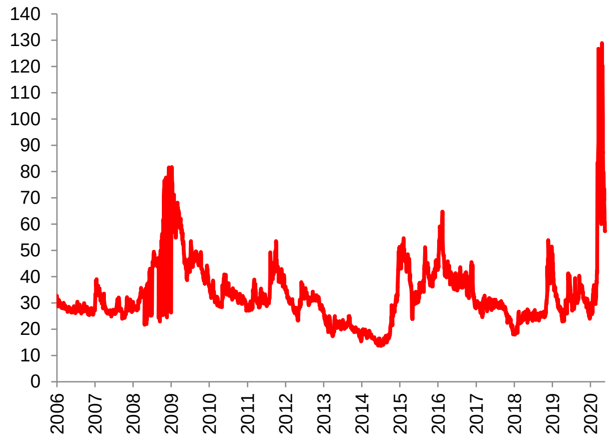
for lower supply and with it higher oil prices, with the structural outcome of the ongoing rebalancing leading our models to forecast Brent ending Q3 and Q4 2020 at USD36/b and USD46/b, respectively, and rising to average USD55/b in 2021.

US GASOLINE DEMAND (MILLION B/D)



Source: Bloomberg, EIA, MUFG MENA Research

3 MONTH OIL IMPLIED VOLATILITY INDEX



Source: Bloomberg, MUFG MENA Research

Ranges & Outlook for the week ahead

BRENT – NEUTRAL BIAS – (28.00-40.00)

WTI – NEUTRAL BIAS – (25.00-37.00)

	Spot close 20.05.20	Q2 2020	Q3 2020	Q4 2020	Q1 2021
Brent	36.09	32.30	35.60	46.10	49.20
NYMEX	33.69	27.80	30.60	41.60	45.20
		Range	Range	Range	Range
Brent		22.80-42.80	24.35-46.85	35.10-57.10	37.70-60.70
NYMEX		18.30-37.30	19.35-41.85	30.60-52.60	33.70-56.70

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