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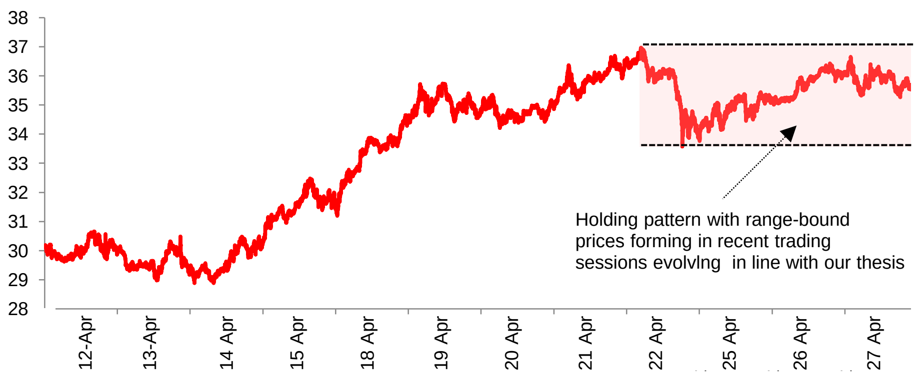
The tug-of-war between re-openings versus macro vulnerabilities and US-Chinese animosities

- A tug-of-war between cautious re-opening of economies (and the promise of a vaccine), versus continued macro vulnerabilities to wade through and escalating US-Chinese tensions, is shaping global oil markets. Investor conviction in recent weeks has emphatically shifted long oil. However, the markets pulse in the near-term would seem more balanced, between hopes associated with ongoing easing of lockdown measures on the one hand, and simmering US-China animosities and a de-synchronised recovery amongst developed and emerging markets on the other hand. It is these two competing forces as to why we advocated last week that prices will enter into a holding pattern with range-bound prices evolving in the next couple of weeks (see here).
- Global oil markets are registering guarded fervour for the post-lockdown phase of the crisis with COVID-19 transitioning from an acute to a chronic issue. In line with our thesis that we have been cataloguing over recent weeks, the sharp rebalancing continues to garner momentum, fundamentally driven by demand improvements through the re-opening of economies across the world (see here and here). In conjunction, the sheer velocity of supply cuts, is driving oil markets to become balanced with the equilibrium of supply equating demand between now and early June (the inflection point), with a deficit by mid-June, in our view.
- Risks to global oil demand abound as we enter an era of heightened geopolitical risk alongside the possibility of a second wave of COVID-19 infections. According to our Washington based political analyst, Hana Rudolph, pre-election anti-China rhetoric from the US will likely only worsen, not only helping President Trump deflect any culpability from the COVID-19 management and economic fallout, but also tap into deteriorating US public opinion against China. Meanwhile, our Hong Kong based analyst, Cliff Tan, believes China may respond to US provocation through moderation and restraint, protecting its national interests, but critically abiding by the Phase One trade deal. Separately, there remains a global bounty on a vaccine. Absent a cure, risks of a sharp reacceleration of new infections as economies begin to reopen could prompt the reimposition of control measures, and with it, hindering the oil demand recovery.

BRENT SPOT PRICES, LAST TWELVE TRADING DAYS (USD/B)



Source: Bloomberg, MUFG MENA Research

The tug-of-war between re-openings versus macro vulnerabilities and US-Chinese animosities

Tug-of-war in global oil markets

Global oil markets remain on edge reflecting two competing forces. On the one hand, the delicate re-opening of economies across the world is driving the recovery in oil demand, which in tandem with deep and impressive supply cuts – voluntary (OPEC+) and involuntary (principally forced production shut-ins in the US, Canada and Norway) – is steering the sharp oil market rebalancing momentum of supply equating demand. On the other hand, an escalating war of words between the US and China alongside continued macro vulnerabilities, is adding headwinds to the nascent global recovery in oil demand. US-China relations have deteriorated materially in recent weeks, with the US considering sanctions to punish China for its crackdown on Hong Kong, whilst Chinese Foreign Minister Wang Yi warned that the US Administration is pushing tensions towards a new Cold War.

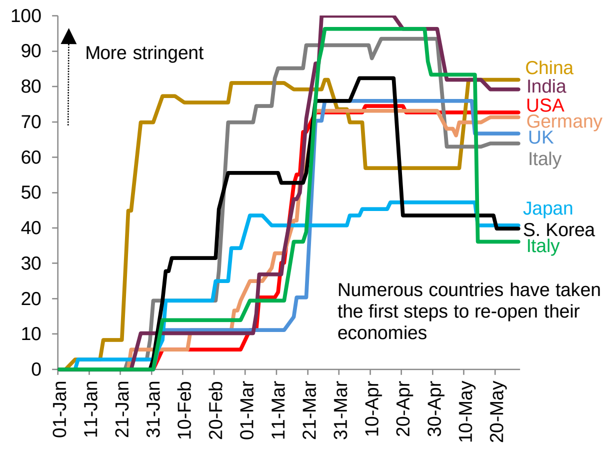
Re-opening of economies gather momentum

Over the past week, numerous countries have taken the first steps to re-open their economies. The largest easing has been witnessed in New Zealand where the Oxford University Policy Stringency Index has fallen 47 points following the relaxation of restrictions on schools, businesses, and internal movements and a sharp rise in mobility. More broadly, European and North American countries continued to ease with a 30 points easing in Italy since the start of May whilst a more muted 9 points easing in the UK over the same period. Meanwhile, we have witnessed a tightening of restrictions in several countries such as in China with a 25 increase since 11 May after new COVID-19 clusters were found in Wuhan and Shulan – two cities hundreds of miles apart.

Leading indicators signal that global oil demand is recovering, albeit at an uneven pace

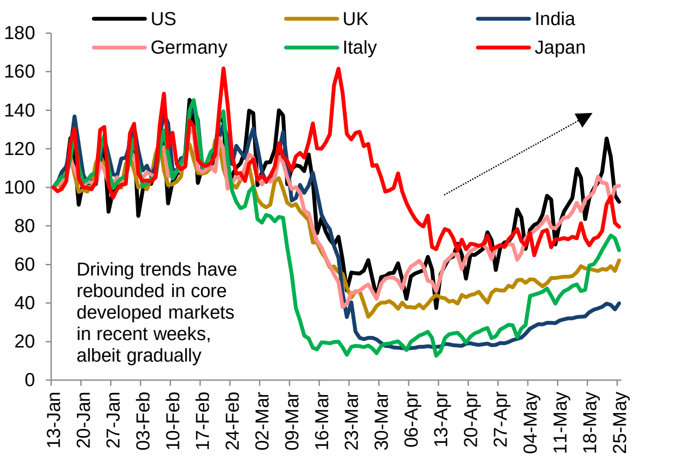
High frequency data indicates that oil consumption is improving in most key regions, and has almost recovered to 2019 levels in mainland China. Apple's mobility trends statistics suggests driving activity continues to demonstrate robust momentum in the US, Europe and most of Asia, although many countries are coming off exceptionally low levels. Our expectations are for these indicators to continue to see improvements over the coming weeks as lockdowns are further eased. We would caution that whilst the rise in mobility data correlates with the rise in gasoline consumption registered in the US, the latest reading was muted over the Memorial Day Weekend – historically the peak period for US fuel demand – signalling the rebound is likely to be tepid and

GLOBAL STRINGENCY INDEX (0-100; 0 = LEAST STRINGENT; 100 = MOST STRINGENT)



Source: Oxford University, MUFG MENA Research

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



Source: Apple Mobility Statistics, MUFG MENA Research indeterminate.

Easing of lockdown restrictions still suggests a gradual demand rebound

Even though we are likely past the worst of the demand destruction, the path to recovery will not be as straightforward as some might expect. Gasoline demand should continue to rebound as mobility restrictions are eased but journey frequency and distance will most likely be lower for many months to come, given the spike in unemployment rates and various work from home measures staying in place. Jet fuel is the most noticeable area where consumption will take a longer time to recover.

Global oil demand will not return back to pre-COVID-19 levels until Q3 2021

On net, whilst we are witnessing greenshoots on global oil demand across various regions and core countries globally, we view that global oil demand will not return back to pre-COVID-19 levels until Q3 2021. As the world emerges from lockdowns, a combination of weaker economic growth and lingering impacts of COVID-19 mobility restrictions will still be a drag on the recovery in oil demand, especially in jet fuel. As such, we forecast the damage will persist into next year, with oil demand only reaching a pre-COVID-19 run-rate by Q3 2021.

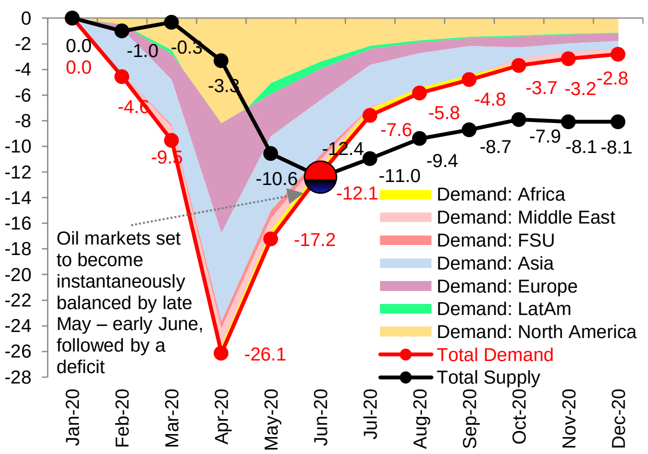
The velocity of supply curbs has been remarkable

On the supply-side of the oil equation, the sheer velocity of supply cuts – voluntary (OPEC+) and involuntary (principally forced production shut-ins in the US, Canada and Norway) – has been nothing short of remarkable. 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. This was formally echoed by the Russian Energy Ministry this week stating that the OPEC+ deal has been "undoubtedly successful" and forecasted that the global oil market balance will be reached between June-July (broadly in line with our view of the equilibrium of demand equating supply between end May – early June). Meanwhile, non-OPEC+ supply has been falling robustly, with our expectations that US and Canadian production could be down 3.1m b/d in May alone.

US-China tensions in the midst of a pandemic

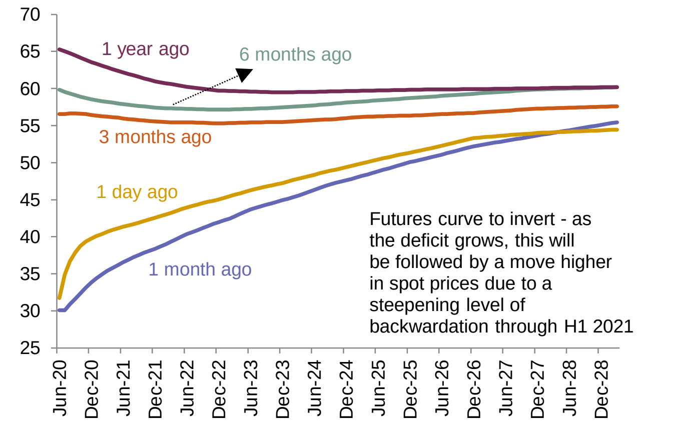
Despite the sharp rebalancing developments in recent weeks, risks to global oil demand abound as we enter an era of heightened geopolitical risk alongside the possibility of a second wave of COVID-19 infections. According to our Washington based political analyst, Hana Rudolph, pre-election anti-China rhetoric from the US will likely only worsen, not only helping President Trump deflect any culpability from the COVID-19 management and economic fallout, but also tap into deteriorating US public opinion against China.

GLOBAL OIL DEMAND AND SUPPLY, CHANGE VS. JANUARY 2020 (MILLION B/D)



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

BRENT FUTURES CURVE, 1 DAY, 1 MONTH, 3 MONTHS, 6 MONTHS AND 1 YEAR AGO (USD/B)



Source: Bloomberg, IMF, MUFG MENA Research

US may begin to shift the narrative

After initially presiding over the longest US expansion in history – with the unemployment rate falling to its lowest level since 1969, and the S&P rising 49% since he assumed office up to the mid-Feb peak – the sudden turnaround for President Trump has come at breakneck speed. The unemployment rate rose to 14.7% in April, and earnings prospects are still clouding equities. President Trump is now shifting gears towards being a wartime President, and since it is probably too risky to declare COVID-19 as the enemy given how precarious the virus has been, China became the easier target. One could argue that President Trump is also tapping into the psyche of the US public, whose views on China have deteriorated sharply, according to various polls.

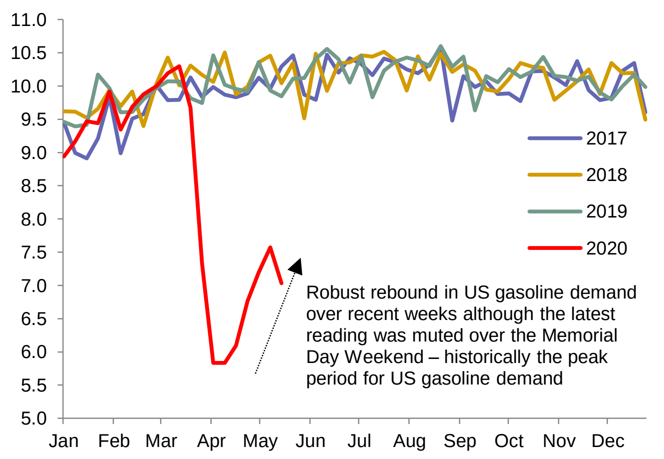
Phase One trade deal is likely to hold for now

Our Hong Kong based analyst, Cliff Tan, believes China may respond to US provocation through moderation and restraint, protecting its national interests, but critically abiding by the Phase One trade deal and averting tariff escalation. While China appears to be complying with the non-import related conditions of the deal, it is questionable if China can achieve the aggressive import purchase targets, given how far behind it is thus far. Nonetheless, President Trump may see a strategic advantage to keeping Phase One intact as a means to extract high profile Chinese purchases of US goods from key swing states in the run up to the election. Separately, the US may pursue other non-tariff related actions against China. The focus here will be on an expanded entity list on Chinese corporates for both human rights and national security issues, sanction risks on individuals and institutions. For its part, it is expected that China will likely respond to US provocation with moderation and restraint, protect national interests, and plan for decoupling. Technology decoupling will take time and will likely restrain how China responds to the US given its reliance on US technology, but China will likely continue to push for Renminbi (RMB internationalisation, and thus would argue for RMB stability, and could also diversify its portfolio investments away from USD assets, with some EM economies standing to benefit over time.

Concerns of a second COVID-19 wave absent a vaccine

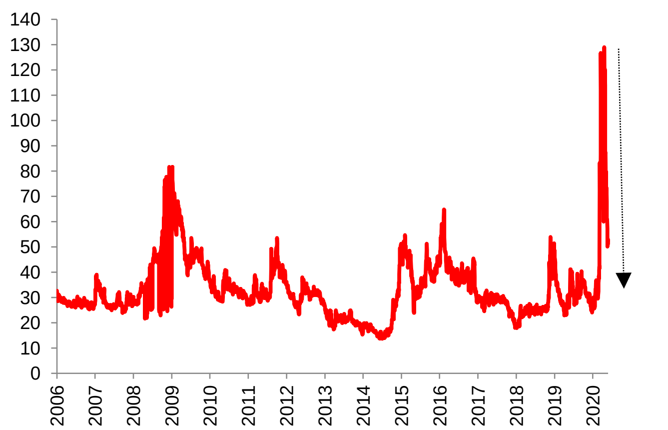
Separately, there remains a global bounty on a vaccine. We remain cautious on the timeline for any breakthrough of vaccine to combat COVID-19 from a deliveries perspective – with the broad consensus suggesting that vaccines will not be widely available until H2 2021. Reports suggest that the US Administration is looking to fast track the vaccine approval process, suggesting some upside risk to the outlook. However, absent a cure, significant risks of a sharp reacceleration of new infections as economies begin to reopen could prompt the reimposition of control measures,

US GASOLINE DEMAND (MILLION B/D)



Source: Bloomberg, EIA, MUFG MENA Research

3 MONTH OIL IMPLIED VOLATILITY INDEX



Source: Bloomberg, MUFG MENA Research

and with it, hampering the global oil demand recovery.

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

We advocated last week that oil prices appear oversold and will likely enter into a holding pattern with range-bound oil prices emerging in the next couple of weeks (see here). Indeed, the oil price rally has taken a pause in recent trading sessions fuelled by demand-side apprehensions and simmering US-China tensions and macro vulnerabilities. As such, we continue to recommend that the most notable shift will likely be a decline in implied volatility, with a firmer leg higher on the front-end of the curve likely taking hold once the deficit widens in mid-June, At this point, the stage is set for structurally higher oil prices heading into H2 2020 with our current Brent price forecasts of USD36/b and USD46/b in Q3 and Q4 2020, respectively – with upside risks to these forecasts. Thereafter, as the deficit grows, 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 much higher cost of capital for the industry will set the stage for higher oil prices, with the structural outcome of the ongoing rebalancing leading our models to forecast Brent averaging USD43/b and USD55/b in 2020 and 2021, respectively.

Ranges & Outlook for the week ahead

BRENT – NEUTRAL BIAS – (29.00-40.00)

WTI – NEUTRAL BIAS – (26.00-37.00)

	Spot close 27.05.20	Q2 2020	Q3 2020	Q4 2020	Q1 2021
Brent	34.26	32.30	35.60	46.10	49.20
NYMEX	32.01	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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