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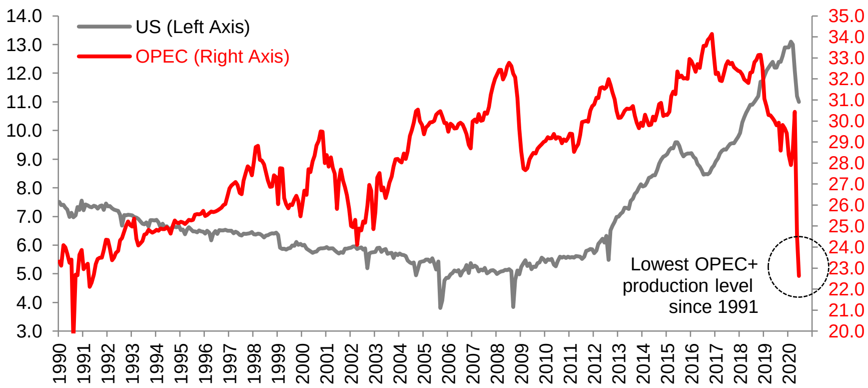
OPEC+ to turn on the taps – the first real test of its strategy begins

- OPEC+ to commence tapering production curbs. Whilst not formal OPEC+ policy, the recommendations by the joint market monitoring committee (JMMC) on 15 July, counts. The JMMC is co-chaired by OPEC+ heavyweights, Saudi Arabia and Russia, and thus proposals by the JMMC are almost certainly likely to endorsed by OPEC+ ministers. As widely expected, the JMMC put forward the proposal that OPEC+ should enter phase 2 of plans to ease output cuts starting 1 August. Managing the transition to higher production levels juxtaposed with lingering macro vulnerabilities and virus concerns (especially following the reimposition of lockdowns in the US) remains front of mind.
- The first test for OPEC+'s strategy commences. With oil prices transitioning from relief rally to cyclical tightening in our view, current spot prices are at levels that could prove self-defeating to the market rebalancing, which in conjunction with the large inventory overhang, creates a real test for OPEC+. Whilst large cuts are needed to normalise excess inventories, the longer OPEC+ keeps its unprecedented barrels off the table, the more it incentivises higher cost US shale producers. Recently, the Saudi Energy Minister, HH Prince Abdulaziz, spoke of OPEC+ adopting "central bank" tactics in its oil market management. Whilst central banks can intervene in financial markets in multiple ways, OPEC+ can either only raise or curb production. It is the lack of economic inflexibility inherent to OPEC+ members that leaves the group with minimal options in its policy toolkit.
- Oil price implications. From an oil price perspective, OPEC+'s sequential shift to targeting higher production levels from 1 August, is now fully priced in. Oil prices have been steadily rising, propped up in large part by a risk-on macro backdrop. However, there remain demand uncertainties due an uptick of COVID-19 cases in parts of the US, and a reversal of shut-in production, while Chinese crude buying is expected to ease. Significant oil receipt declines have taken a toll on OPEC+ balance sheets and they want to use this occasion to bolster revenues through adjusting their output levels for the rest of 2020. Such an approach will likely cap the oil price upside for the rest of 2020 – we forecast Brent ending Q3 and Q4 at USD36/b and USD46/b, respectively – and limiting long-dated prices, facilitating the backwardation that benefits lower cost OPEC+ producers.

OPEC AND US OIL PRODUCTION, MILLION (B/D)



Source: Bloomberg, EIA, OPEC, MUFG MENA Research

OPEC+ to turn on the taps – the first real test of its strategy begins

OPEC+ tapering begins

OPEC+ has had an extraordinary H1 2020. The group's course has swung from price focused cuts, to market share recapture, to internal price war to a historic large cut. The joint market monitoring committee (JMMC) meeting held on 15 July confirmed as widely anticipated, that they will taper output cuts starting 1 August. Saudi Arabia's energy minister, HH Prince Abdulaziz, stated that the easing of production cuts may be narrower than the targeted 7.6m b/d from 9.6m b/d, as countries that did not meet the previously agreed curbs, namely, Iraq, Nigeria, Kazakhstan and Angola, play catch up. This signals the cuts will stand ~8.0m b/d if these countries do not release as many barrels on to the market as they may have otherwise. The targeted easing to 7.7m b/d from August will remain in place until the end of 2020, before entering phase 3 and tapering further to 5.8m b/d between January 2021 and April 2022. Managing the transition to higher production levels juxtaposed with lingering macro vulnerabilities and virus concerns (especially following the reimposition of lockdowns in certain US states) remains front of mind.

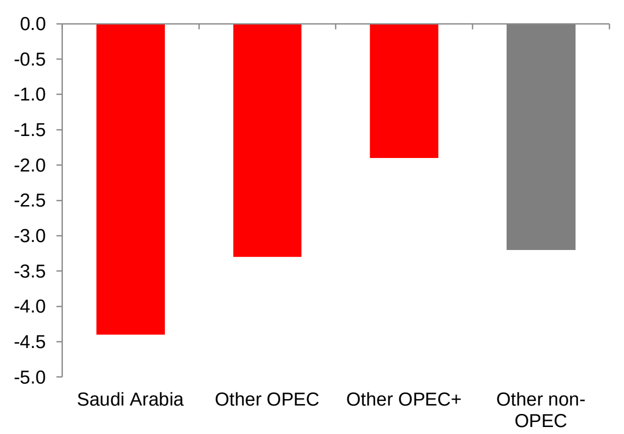
The first real test for OPEC+

With oil prices transitioning from relief rally to cyclical tightening in our view, current spot prices are at levels that could prove self-defeating to the market rebalancing, which in conjunction with the large inventory overhang, creates a real test for OPEC's since it initiated phase 1 of production cuts back on 13 April.. Whilst large cuts are needed to normalise excess inventories, the longer OPEC+ keeps its unprecedented barrels off the table, the more it incentivises higher cost US shale producers. Recently, the Saudi Energy Minister, HH Prince Abdulaziz, spoke of OPEC+ adopting "central bank" tactics in its oil market management. Whilst central banks can intervene in financial markets in multiple ways, OPEC+ can either only raise or curb production. It is the lack of economic inflexibility inherent to OPEC+ members that leaves the group with only minimal tools in its policy toolkit. Their interests are not those of a regulator prioritising a public good, but rather maximising revenues for its members. Should they wrongly time the market and raise production prematurely then their nervousness of downside price action could become a reality.

Compliance adherence has been centre of attention in recent weeks

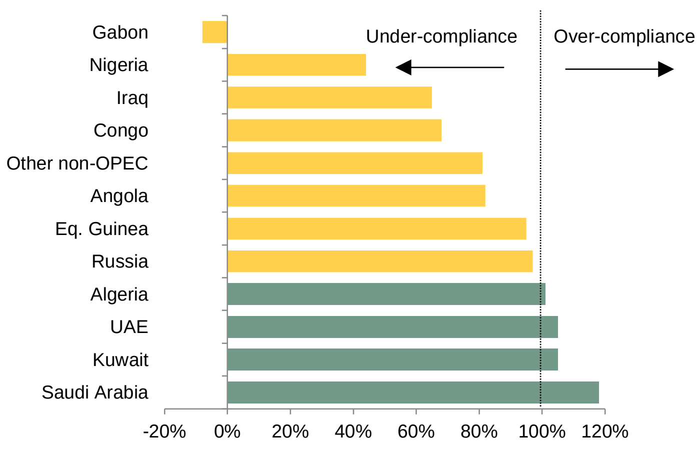
Having moved meetings of the JMMC from quarterly to monthly, JMMC co-chairs, Saudi Arabia and Russia (OPEC+'s two heavyweights), have threatened "non-compliant" countries (primarily, Iraq, Nigeria, Kazakhstan and Angola) to facilitate

OIL SUPPLY CHANGES, APRIL – JUNE 2020 (M B/D)



Source: Bloomberg, EIA, MUFG MENA Research

OPEC COMPLIANCE ADHER ANCE SINCE MAY 2020 (%)



Source: Bloomberg, S&P Global Platts, MUFG MENA Research their ongoing cut obligations. The efforts appear designed to de-politicise from OPEC+ ministerial meetings (typically occurring semi-annually), to provide flexibility in adding or cutting production as deemed necessary to stabilise markets and to consolidate their overarching influence in the group.

Money manager position net long positioning is slowly increasing but well below pre-COVID-19 levels

Trading activity has been skewed toward WTI, with net and relative positioning in Brent significantly lagging the US benchmark. Brent crude oil is hovering choppily in the low USD40/b as trading activity has dropped by one third across the North Sea benchmark this month. Money manager net long positioning is slowly increasing, currently at 199k lots, but remains well below pre-COVID-19 highs of 430k lots. The long-short ratio stands at 4.6x, now quite neutral and no longer overstretched to the short side. By contrast, money manager net long positioning on WTI has extended to a two-year high at 380k lots last month and last week stood at 358k contracts, while relative long/short positioning stands at 6.9x. Overall, combined crude positioning in both Brent and WTI stands at 557k lots and the long/short ratio stands at 5.8x.

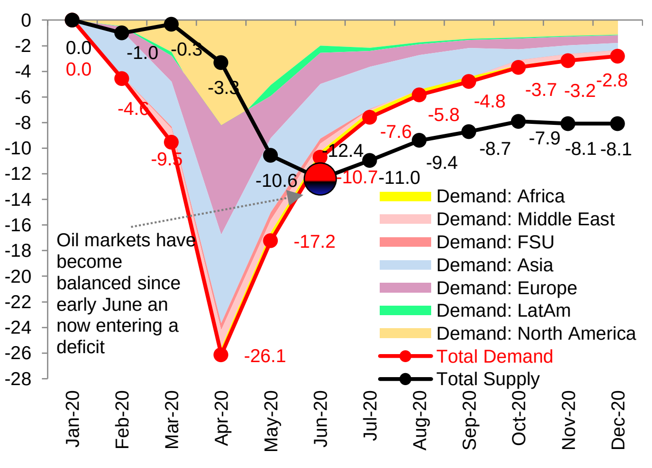
We remain constructive on the front-end of the curve

Brent crude prices have traded mostly range-bound, but we remain constructive over the short term, even if acknowledging that some near-term headwinds could materialise. The oil market is transitioning from a period of record inventory builds to strong multi-quarter stock draws, driven by OPEC+ cuts and a resurgence in demand. As such, we expect the backwardation across the Brent curve to strengthen in the coming months, supporting our moderately constructive view for oil prices in H2 2020.

We expect oil price pullback in the coming weeks

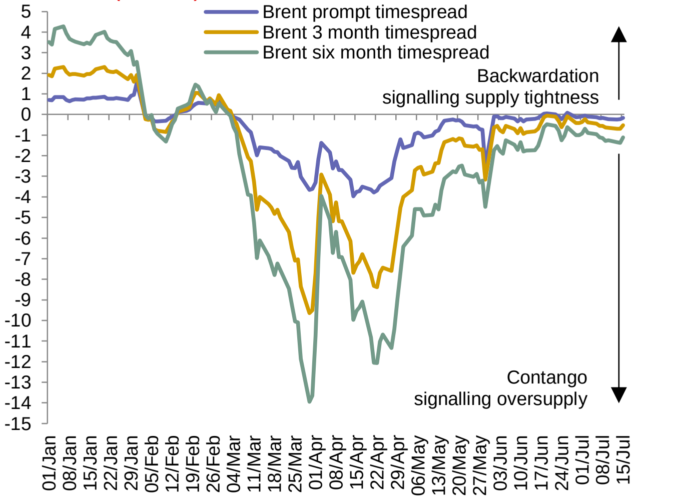
From an oil price perspective, OPEC+'s sequential shift to targeting higher production levels from 1 August, is now fully priced in. Oil prices have been steadily rising, propped up in large part by a risk-on macro backdrop. However, there remain demand uncertainties due an uptick of COVID-19 cases in parts of the US, and a reversal of shut-in production, while Chinese crude buying is expected to ease. Significant oil receipts declines from both the oil price collapse and the historic output cuts have taken a heavy toll on OPEC+ producers balance sheets and it appears they want to use this occasion to bolster revenues through adjusting their production levels for the remainder of 2020. Such an approach will likely cap the oil price upside for the rest of 2020 – we forecast Brent ending Q3 and Q4 at USD36/b and USD46/b, respectively – and limiting long-dated prices, facilitating the backwardation that benefits lower cost OPEC+ producers.

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



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

BRENT TIMESPREADS, FRONT, 3 AND 6 MONTHS, YEAR-TO-DATE (USD/B)



Source: Bloomberg, MUFG MENA Research

Ranges & Outlook for the week ahead

BRENT – NEUTRAL BIAS – (37.00-47.00)

WTI – NEUTRAL BIAS – (34.00-44.00)

	Spot close 15.07.20	Q3 2020	Q4 2020	Q1 2021	Q2 2021
Brent	43.54	35.60	46.10	49.20	54.60
NYMEX	40.89	30.60	41.60	45.20	50.30
		Range	Range	Range	Range
Brent		28.35-54.85	35.10-57.10	37.70-60.70	43.10-66.10
NYMEX		23.35-49.85	30.60-52.60	33.70-56.70	38.80-61.80

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