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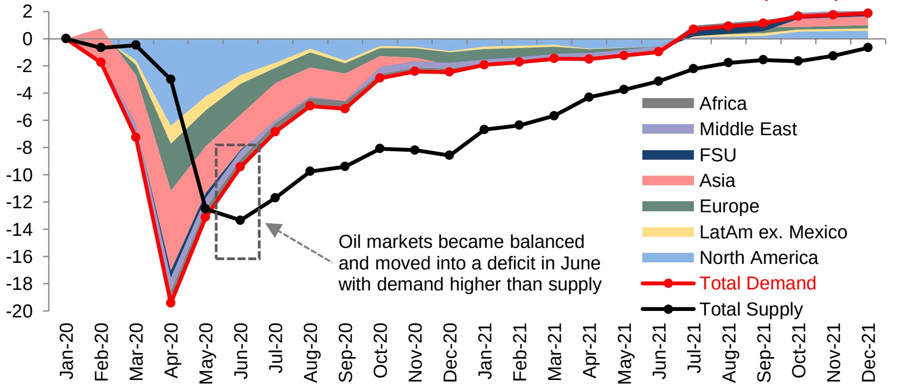
**23 July 2020**

# Taking stock of the oil price transition from relief rally to cyclical tightening

- The global oil market deficit has reached its peak. The robust global oil market rebalancing continues with fundamentals signalling a deficit since early June in line with our expectations. However, the momentum is easing, given both weaker demand progress, and higher supply growth from OPEC+ and US oil production. Our bottom-up country-by-country modelling estimates points to a current global oil market deficit of -3.6m b/d – which is likely to represent the peak deficit levels – given the 2.0m b/d tapering of OPEC+ production cuts from 1 August, a reversal of US output shut-ins and slowing oil demand, with our forecasts pointing to the deficit down to -3.3m b/d by year end.
- A more consolidated and healthier contour for US shale. The recovery in US WTI oil prices north of USD40/b makes some shale output profitable again with larger producers reopening the taps in low-cost plays in Texas as well as more costlier shale basins in North Dakota and Oklahoma. However, a clear distinction is warranted – whilst the current oil market deficit that has carved out a cyclical bottom in prices (Brent ~USD35/b and WTI ~USD30/b) is enough to bring shut-in shale wells back online, it is critically not enough to drill new ones and offset base declines. As such, we view that beyond the return of US shut-in – most of which will be back by September 2020 – US oil supply is set for falls of 1.1m b/d y/y in 2020 and a further 0.6m b/d y/y by 2021. On net, despite this significant shale scale back, we view that the shale industry is to survive in a more consolidated, healthier contour – succinctly put, US shale is down but not out.
- Oil price implications. Oil prices have remained range bound since early June, which is line with our thesis of the transition from relief rally to cyclical tightening. However, as we have recently catalogued (see here and here), oil, like other commodities, are spot (anchored) physical assets – not anticipatory (unanchored) financial assets like equities – and thus must clear the current large inventory overhang (~1bn barrels in excess stocks accumulated year-to-date). This will take time and require patience. From this, we expect the amalgamation of more tepid demand growth and the clearance of the large inventory overhang, to induce an upside cap in oil prices for the rest of 2020 – we forecast Brent ending Q3 and Q4 at USD36/b and USD46/b, respectively.

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




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

# Taking stock of the oil price transition from relief rally to cyclical tightening

The global oil market deficit has reached its peak

The global oil market rebalancing continues to gather speed, driven by both supply and demand improvements which have been running in line with our expectations with fundamentals signalling a deficit since early June. With this market rebalancing firmly in motion, oil prices are transitioning from relief rally to cyclical tightening. However, the momentum is easing, given both weaker demand progress (resurgence of virus in the US, lagging global jet fuel demand growth, slowdown in Chinese imports as well as headwinds to normalising activity in countries where the virus remains under control), and higher supply growth from OPEC+ and US oil production. Our bottom-up country-by-country modelling estimates points to a current global oil market deficit of -3.6m b/d – which is likely to represent the peak deficit levels – given the 2.0m b/d tapering of OPEC+ production cuts from 1 August, a reversal of US production shut-ins and slowing oil demand, with our forecasts pointing to the deficit down to -3.3m b/d by December 2020.

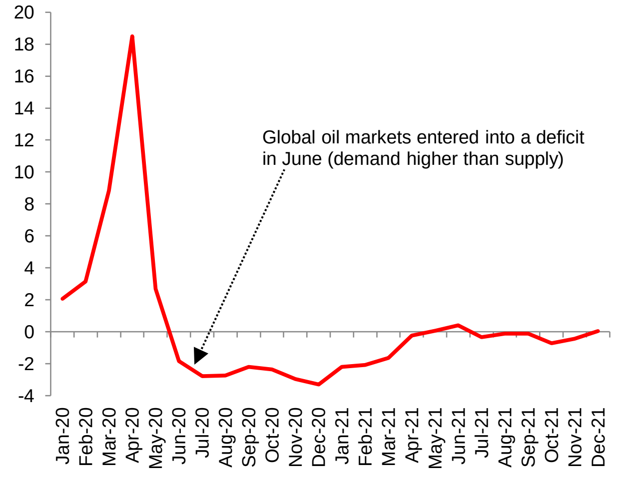
The first real test for OPEC+

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.

OPEC+'s strategy will shift to defending market share over supporting prices

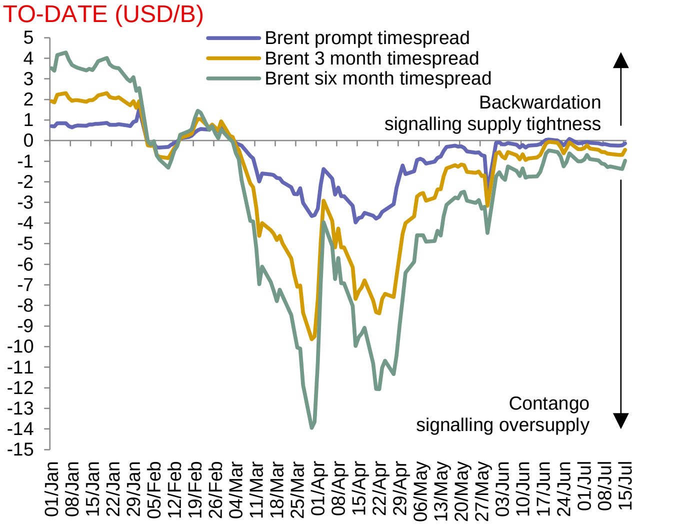
The OPEC+ decision to increase in output staring 1 August is consistent with our expectation that the group will not only focus on normalising excess inventories but also on increasing market share. The joint ministerial monitoring committee's (JMMC)

GLOBAL OIL DEMAND AND SUPPLY BALANCE (M 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

recommendation on 15 July to raise output, is therefore practical, as it keeps the market in deficit but prevents too large an oil price increase that would stimulate US shale activity, with a notable recent increase in the oil horizontal rig count. We expect OPEC+ to remain data dependent, focused on demand and US shale, with an acceleration in production expected in early 2021. Our OPEC+ production forecasts accounts for lower Venezuela production as well as a slower restart in Libya production than previously expected.

**The majority of the US shut-ins will be back online by September**

On US oil production, shuttered production has started to return in response to prices above USD35/b. However, this should not be misinterpreted with the collapse in activity, the effects of which are still to be seen and will last well into 2021. To contextualise the severity of the US shut-ins, the Q2 2020 Dallas Fed survey highlights offers first-hand insights. Whilst 82% of respondents said that they had shut-in or curtailed production in Q2 2020, over 88% of respondents expect to have restarted production by September. Moreover, based on the Dallas Fed survey, the recovery in crude prices and comments from select E&Ps, the amount of shut-in production was at its peak in May and eased in June. A number of companies operating in both the US onshore and the Gulf of Mexico have said they will start bringing back shuttered wells over June, including EOG, Parsley, Fieldwood and Murphy Oil. We estimate that ~2m b/d of US production was shuttered in Q2 2020, bringing aggregating US oil production down to 11.2m b/d to 11.0m b/d in May and June, respectively.

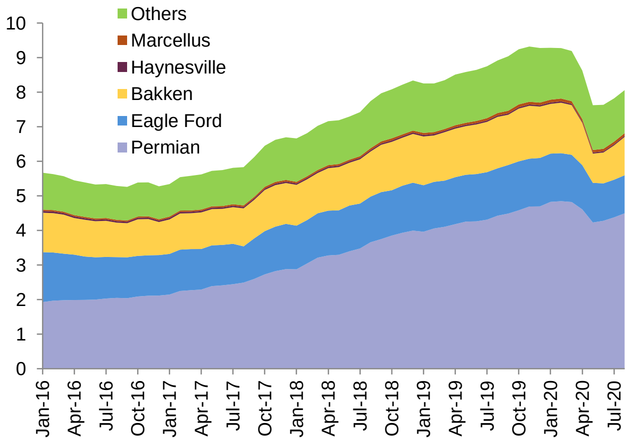
**US supply a key factor for market rebalancing but no longer the growth engine**

The US shale oil industry has been the dominant source of global liquids supply growth over the last three years – growing by 3.8m b/d from 2017 to 2019. Prior to the COVID-19 driven price collapse, while slowing, our expectations was that it would help fill the supply gap left by falling conventional supply. However, this has changed significantly. We now expect total US oil production contracting by 1.1m b/d y/y in 2020 and 0.6m b/d y/y in 2021, owing to supply curtailments and lower new volumes to offset steep base declines. From this, we see US supply bottoming out in Q1 2021 and do not expect the intensity to reach pre-virus levels until 2022.

**US shale economics requires USD45+/b for activity to recover**

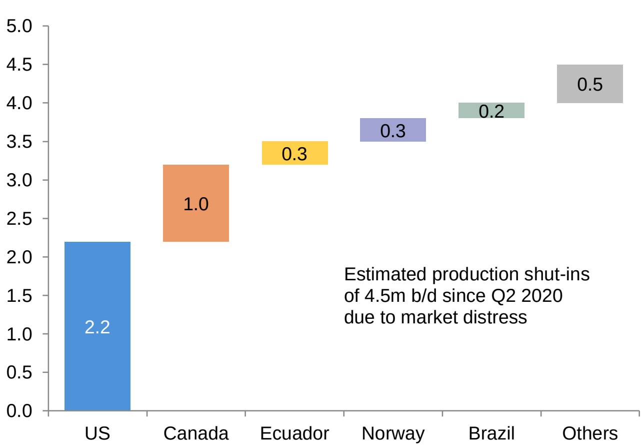
The current price environment of USD35-40/b is leading to shut-in production being brought back on, but it is not nearly high enough to stimulate a meaningful recovery in new activity in the majority of US shale acreage. A select few E&Ps can profitably drill a new well at these prices but the average E&P requires USD45/b+ to breakeven at the well level and even higher prices to break even on a full-cycle and corporate level. Of noteworthy importance, the Dallas Fed Survey provides a good insight into the price levels underpinning economics of the US shale basins. It shows that WTI prices below USD50/b are not enough for the average US E&P to break even on a

US SHALE PRODUCTION (M B/D)




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

ESTIMATED NON-OPEC+ PRODUCTION SHUT-INS (M B/D)




*Source: Bloomberg, EIA, IEA, MUFG MENA Research* new well. According to the March survey, the average price required to profitably drill a new well is around USD50/b , ~USD10/b above current prices levels. With the average operating cost (cash cost) breakeven for shale wells is USD25-30/b, this explains why so much US supply was forced to shut in over Q2 2020 as those operators with little or no hedging protection were producing below cash costs, but much of this output is now returning.

Global oil demand continues to push higher but moderation in growth is likely in coming months

The rebound in global oil demand since the April nadir has been a central part of the market rebalancing. The release of further data provides visibility of how demand has performed with April data signalling that global demand in April fell 19.4m b/d y/y to 79.2m b/d, not as severe as our forecast of the 26.1m d/d y/y contraction that we had projected back in March this year. While the demand improvements surprised to the upside in May, for instance in China and with US demand restarting ahead of lockdowns being lifted, this is no longer the case. This is driven by a sharp slowing in the US due to the resurgence, an only negligible increase in global jet fuel demand and finally the headwinds in normalising activity even in countries where the virus remains broadly under control. As of this month, we estimate that global oil demand has swiftly recovered to 91.9m b/d as lockdown measures ease but, crucially we expect the next stage of demand recovery to be more moderate, with demand not reaching pre-COVID-19 levels of ~100m b/d until Q3 2021.

We expect oil price pullback in the coming weeks

From an oil price perspective, oil prices have remained range bound since early June, which is line with our thesis of the transition from relief rally to cyclical tightening. However, as we have recently catalogued (see here and here), oil, like other commodities, are spot (anchored) physical assets – not anticipatory (unanchored) financial assets like equities – and thus must clear the current large inventory overhang (~1bn barrels in excess stocks accumulated year-to-date). This will take time and require patience. Now that we have transitioned from the relief rally to the cyclical tightening stage of the global oil market recovery, the inventory normalisation process has been driving a flattening in the Brent forward curve but spot upside should be capped by excess stocks with the rolling of inventory hedges weighing on deferred contracts, effectively reducing the incentive to drill for unnecessary new barrels. From this, we expect the amalgamation of slowing demand and the clearance of the large inventory overhang, to induce an upside cap in oil prices for the rest of 2020 – we forecast Brent ending Q3 and Q4 at USD36/b and USD46/b, respectively.

## Ranges & Outlook for the week ahead

### BRENT – NEUTRAL BIAS – (39.00-48.00)

### WTI – NEUTRAL BIAS – (37.00-46.00)

| | Spot close 23.07.20 | Q3 2020 | Q4 2020 | Q1 2021 | Q2 2021 |
|---|---|---|---|---|---|
| Brent | 44.42 | 35.60 | 46.10 | 49.20 | 54.60 |
| NYMEX | 42.05 | 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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