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MUFG Bank, Ltd.
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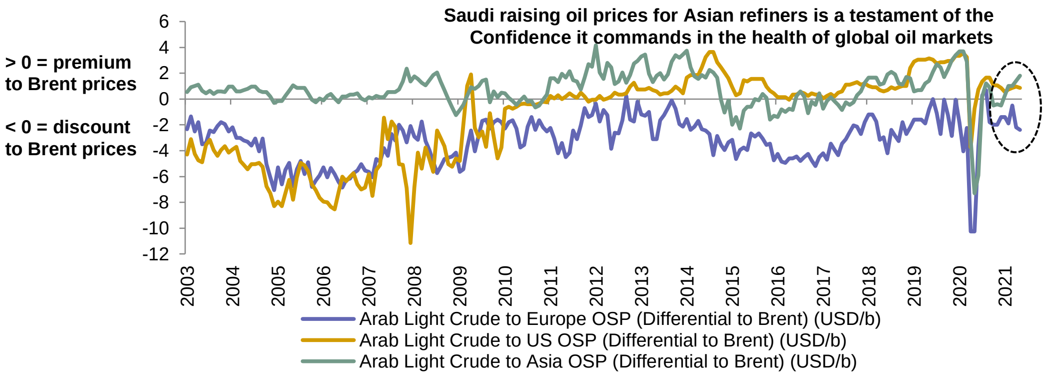
US-Iran sequence management will not significantly impact oil markets

Executive summary

The pulse of global oil markets has shifted from OPEC+ supply management stemming from the surprise decision to gradually ramp-up production on 1 April (see here), to the US-Iran sequencing management with indirect talks this week aimed at carving out the space of reviving the Joint Comprehensive Plan of Action (JCPOA). Our base case scenario continues to remain that a mutual return to the JCPOA in the first half of 2021, and particularly before Iran's own presidential elections on 18 June remains unlikely (20% probability). Bridging the gap will require time and patience but with the spirit of both sides clearly willing to crystallise a rapprochement, our probability of a detailed agreement for a return to mutual compliance in the second half of this year is at 70-80%. From an oil markets perspective, even if an agreement is reached in 2021, additional Iranian barrels will not disrupt the swift market rebalancing that remains in motion given (i) our forecast for robust demand growth with the world appearing to be in the final stages of the pandemic and on the cusp of reopenings (thus markets will remain in a deficit); (ii) the expectation that OPEC+ will help accommodate the return of Iranian crude; and (iii) a return of Iranian barrels is broadly priced in and a consensus expectation.

CHART OF THE WEEK: SAUDI RAISED PRICES FOR ASIAN CLIENTS FOR MAY

OFFICIAL SELLING PRICE (OSP) OF SAUDI ARABIA CRUDE TO ASIA, EUROPE AND US (USD/B)



Source: Bloomberg, MUFG Research

Oil market focus

US-Iran sequence management will not significantly impact oil markets

Reviving the Iranian nuclear deal now front and centre for oil markets

Since the turn of the year, Iran has remained a key uncertainty for global oil markets. With the pulse now shifting from OPEC+ supply management stemming from the surprise decision to gradually ramp-up production on 1 April (see here), to the US-Iran sequencing management with indirect talks this week aimed at carving out the space of reviving the Joint Comprehensive Plan of Action (JCPOA). Negotiations are proceeding in two working groups focused on nuclear and sanctions issues. Talks are slated to continue throughout the week, although US and Iranian negotiators are not expected to talk directly in the coming days. Iran and the remaining nuclear deal participants are expected to hold another meeting on 9 April to take stock of progress.

First mover fallacy – neither side appears over-eager to talk to negotiate from a position of strength

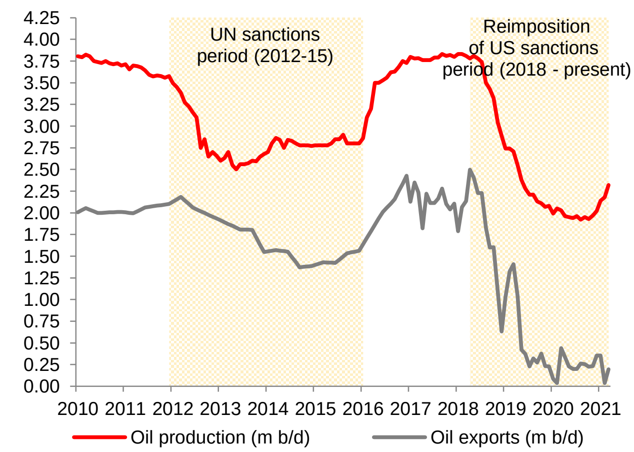
Early comments from participants this week pointed to the hardening of opening gambits, especially on the Iranian side. The Iranian negotiating position has oscillated since President Biden took office, with Iran's current position being that the US must remove all sanctions, allow Iran to verify that step, and only then would Iran roll back advances in its nuclear programme beyond JCPOA limits. Absent this, there "there will be no possibility for Iran entering the talks more than the JCPOA under any circumstances", according to the Secretary of Iran's National Security Council, Ali Shamkhani. Taken at face value, Iran's opening positon is unworkable as President Biden does not have the space to lift sanctions and wait for Iran to reverse its nuclear programme. Securing from Iran a commitment to some form of new JCPOA terms will be pivotal for a US return to the JCPOA and pass muster among US Democrats.

Our base case remains that a deal will require time and patience

Our base case scenario continues to remain that a mutual return to the JCPOA in the first half of 2021, and particularly before Iran's own presidential elections on 18 June remains unlikely (20% probability). Practically both sides have until 11-15 May (end of the Iranian presidential candidate registration period) to secure a re-entry to the JCPOA, or else talks would likely be put on hold until a new Iranian president is sworn in on 7 August. Bridging the gap will require time and patience but with the spirit of both sides clearly willing to crystallise a rapprochement, our probability of a detailed agreement for returning to mutual compliance in the second half of this year

IRANIAN BOUNCE BACK IN PRODUCTION AND EXPORTS WAS SWIFT THE LAST TIME SANCTIONS WERE EASED

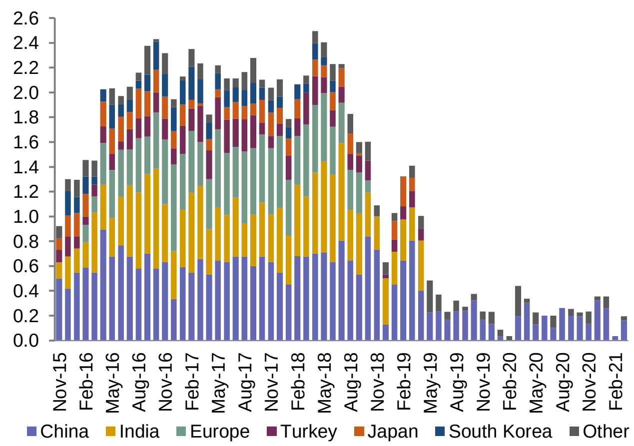
IRAN OIL PRODUCTION AND EXPORTS (M B/D)



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

OFFICIAL DATA SIGNALS THAT IRANIAN OIL EXPORTS REMAINS MUTED BUT THIS IS NOT REPRESENTATIVE

IRAN OIL EXPORTS BY DESTINATION (M B/D)



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

is at 70-80%, with key signposts being (i) a pivot from indirect to direct US-Iran talks; and (ii) negotiations raised to the foreign ministerial and/or presidential levels.

Iran is targeting 1.5m b/d in exports in its new fiscal budget

Digging into the details, Iranian oil exports are not formally mentioned in the fiscal budget though the Ministry of Economic Affairs and Finance in charge of budget management said the government revised estimated exports to 1.5m b/d sold at USD50/b, yielding USD27.4bn in the current fiscal year (April 2021 to March 2022). Whilst this is ambitious it is not unreasonable in the absence of sanctions relief, given higher oil prices, increased Chinese crude imports from Iran as well as adjustments to the governments methodology to accounting (that assumes a strong exchange rate and a smaller allocation of oil revenues to the sovereign wealth fund). Shipping data show Iranian oil supply has gradually increased since the start of 2020, rising from 300k b/d on average during Q1 2020 to 435k b/d in Q1 2021. The data signals that most of this increase made its way to China after being blended with other grades in oil trading hubs. This data, however, masks Iranian oil that is shipped on tankers that switch off their satellite transponders to mask their origins – which several tanker tracking entities estimate total Iranian exports to be as high as 1m b/d, with the majority going to China – reflective of an unexpected tolerance for risk by independent refineries on the assumption that the US administration will be a more relaxed enforcer of US oil sanctions.

Uncertainties surrounding the speed and timeline of the return of Iranian barrels remains highly uncertain

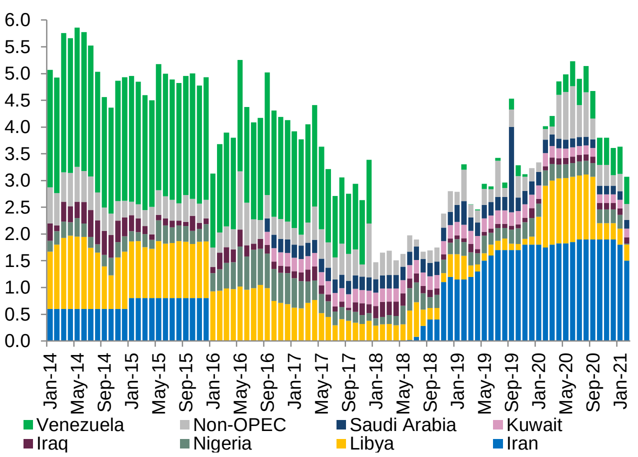
Our own estimates of the magnitude and timeline of the expected ramp-up in Iranian exports remains highly uncertain. We expect that the US could reach an agreement with Iran using a third party, possibly the EU, for marginal sanctions relief, and possibly ~300-500k b/d of legal Iranian crude to re-enter global oil markets in 2021, in the run-up to a full return to the JCPOA. Theoretically, should sanctions on Iran's oil exports be lifted, Iran will be able to resume its previous crude export levels of ~2-2.5m b/d from currently, relatively speedily – as it did so the last time sanctions were eased in 2016. However, uncertainties this time around abound.

Spirit of getting to an agreement is clear, question remains on the process

Overall, both the US and Iran have powerful incentives to make the necessary compromises, but getting to a "yes" from both sides will require time and patience. Succinctly put, our base case is that US-Iran negotiations in the coming weeks will likely yield at least limited benefits that will give policymakers space to start to stabilise macroeconomic conditions and avert a major economic dislocation but a clean return to the full complement of sanctions relief to which Iran was entitled to under the JCPOA is more likely in the second half of 2021. Iranian Supreme Leader Khamenei is permitting talks prior to presidential elections on 18 June, but domestic

IRAN HAS CONSISTENTLY COMPRISED THE LARGEST SHARE OF GLOBAL OIL SUPPLY DISRUPTIONS

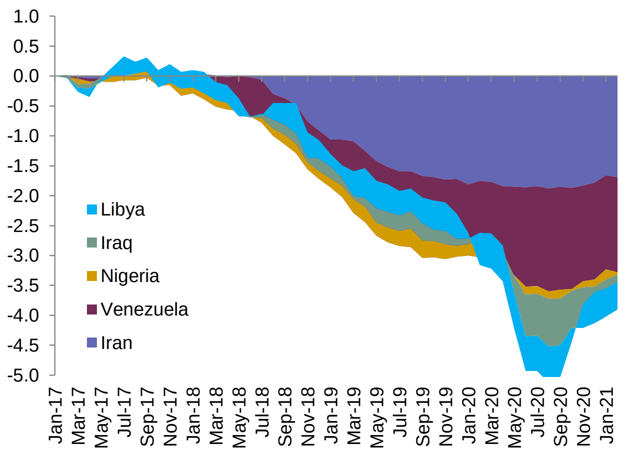
GLOBAL OIL SUPPLY DISRUPTIONS BY DESTINATION (M B/D)



Source: Bloomberg, EIA, MUFG Research

WITH LIBYA MOSTLY COMING BACK, IRAN'S OIL RAMP-UP WILL EASE THE FRAGILE FIVE CONCERNS

LOSS OF OIL PRODUCTION (M B/D) – FRAGILE FIVE COUNTRIES



Source: Bloomberg, MUFG Research

political considerations will probably stand in the way of an early deal, despite the clear economic need. All said, bridging the sequence gap is surmountable and will be achieved.

Muted global oil markets response

From an oil markets perspective, even if an agreement is reached in 2021, additional Iranian barrels will not disrupt the swift market rebalancing that remains in motion given (i) our forecast for robust demand growth with the world appearing to be in the final stages of the pandemic and on the cusp of reopenings (thus markets will remain in a deficit); (ii) the expectation that OPEC+ will help accommodate the return of Iranian crude; and (iii) a return of Iranian barrels is broadly priced in and a consensus expectation.

Week in review and week ahead

OPEC+ agreed to ramp-up production gradually in the coming months

In the last week, markets have been digesting the surprise decision by OPEC+ to gradually raise production which went against our (and market) expectations. While the increase comes a month sooner than we had expected (May vs. June), the June and July increases are smaller than we had assumed, for a net similar cumulative ramp-up through July. Finally, Saudi Arabia will start reversing its unilateral 1m b/d cut in May by 250k b/d. Taken together, the group is now expected to reach the third phase of its original agreement by July – half a year later than initially projected.

Implications for global oil markets

At face value, an increase in OPEC+ production at a time when the global economy is on the cusp of delicate reopenings could be interpreted as price bearish. However, increasing production by a total 600k b/d, 700k b/d and 841k b/d in May, June and July, respectively, will be more than offset by our expectations of robust demand growth of 605k b/d, 1.2m b/d and 1.7m b/d for May, June and July, respectively. Indeed, from a fundamentals perspective, we forecast a larger rebound in oil demand this summer than OPEC+ and the IEA, requiring an additional 2m b/d increase in OPEC+ production from July to October, in our view. Should the US administration lobby further OPEC+ members (US Secretary of Energy Granholm discussed keeping energy prices affordable ahead of the latest OPEC+ meeting), this is still a tall order for a group of producers that has cut drilling by 50% over the past year. Importantly, we expect a normalisation in excess inventories by July even with such a large ramp-up and, as a result, reiterate our bullish conviction that the recent sell-off is a transient pullback in a larger oil price rally (see here).

Maintain our oil price forecast for a peak “overshoot” in Q2 2021

Whilst the oil price rally has taken a breather, this will prove transitory in our view, and we maintain a strong conviction (see here) that a vaccine-led, spring accelerated, global recovery will spur oil prices “overshooting” in Q2 (Brent USD77/b; WTI USD74/b), buoyed also by accommodative monetary and fiscal policy, pent-up savings and limited scarring effects from the virus. From a fundamentals perspective, we continue to see still rapid rebalancing as the market remains in a large deficit with the normalisation in inventories ongoing and OPEC+ is likely to continue targeting a tight market in the months ahead. From the expected second quarter peak, we see oil prices gradually regressing back in H2 2021 towards the equilibrium price for the oil industry, which we view as being centred on the current anchor near the long-term marginal cost of production and support of ~USD55-65/b for Brent and ~USD50-60/b for WTI. For 2021 as a whole, we now forecast Brent averaging USD68/b (from USD58/b previously) and WTI averaging USD65/b. For 2022, we continue to forecast Brent averaging USD58/b (WTI averaging USD55/b), with lower prices next year being driven by (i) a lower carbon future accelerating the decline in oil intensity of

GDP growth and (ii) an ongoing falling cost structure of the oil industry. Succinctly put, we are cyclically positive an expect an “overshoot” over the near-term prospects but the medium-term outlook for oil is not rosy.

Ranges and outlook for the week ahead

BRENT – BULLISH BIAS – (59.00-69.00)

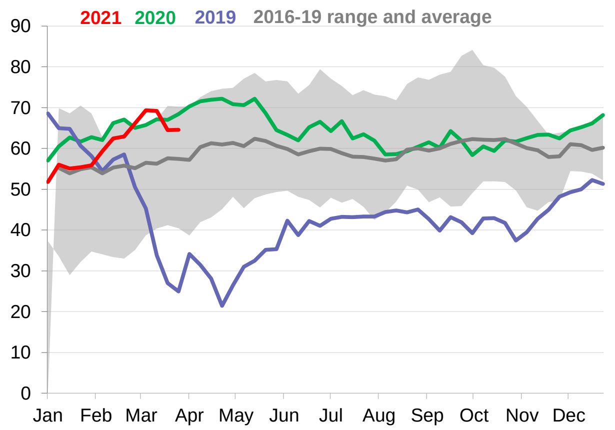
WTI – BULLISH BIAS – (55.00-65.00)

Quarter End (USD/b)	Spot close 07.04.21	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Brent	63.16	77.10	69.40	64.20	58.40
NYMEX	59.77	74.20	66.10	60.90	55.10
		Range	Range	Range	Range
Brent		66.60-87.60	55.90-82.90	50.45-79.95	42.65-74.15
NYMEX		63.70-84.70	52.60-79.60	47.22-76.65	39.35-70.85

Core indicators – prices and market positioning

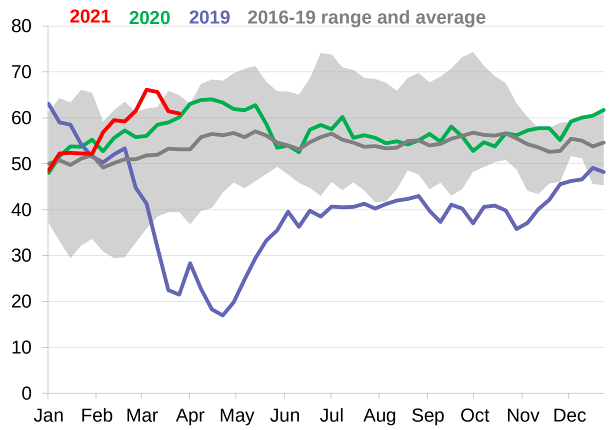
BRENT SPOT

USD/B



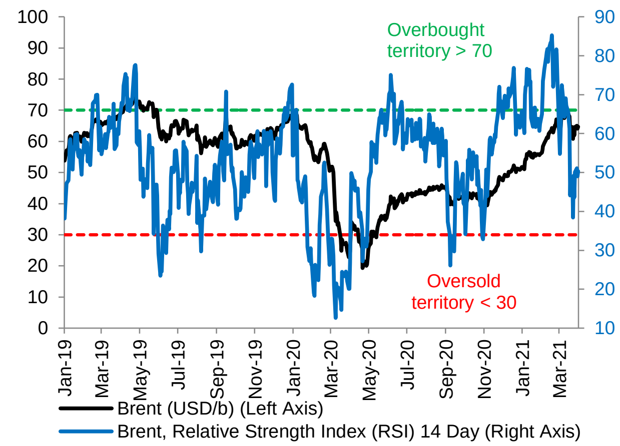
NYMEX WTI SPOT

USD/B



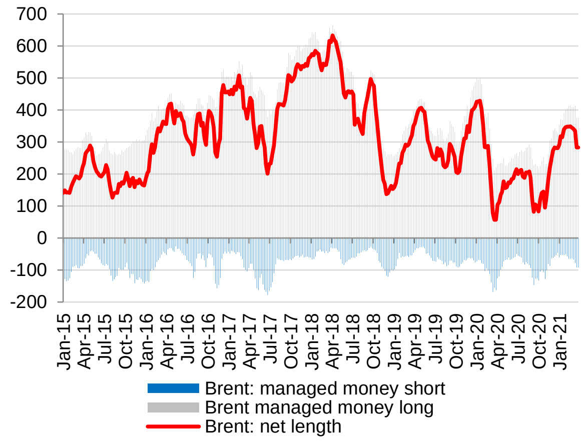
14 DAY RELATIVE STRENGTH INDEX (RSI) AND WTI

USD/B AND 0-100 INDEX (<30 = OVERSOLD; >70 = OVERBOUGHT)



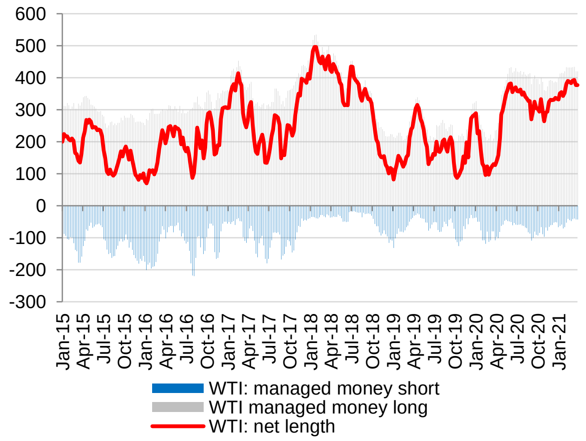
BRENT NET LENGTH MANAGED MONEY

CONTRACTS (THOUSANDS)



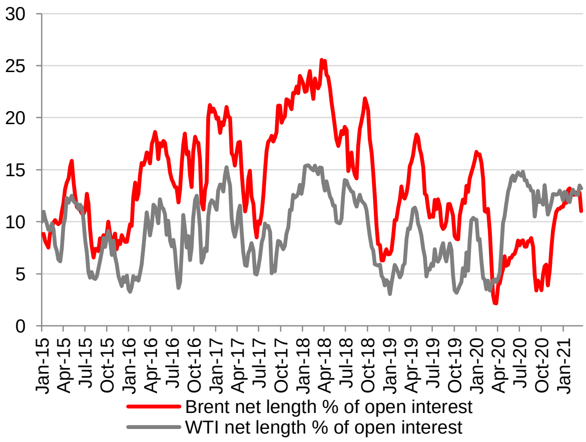
WTI NET LENGTH MANAGED MONEY

CONTRACTS (THOUSANDS)



NET LENGTH MANAGED MONEY / OPEN INTEREST

%

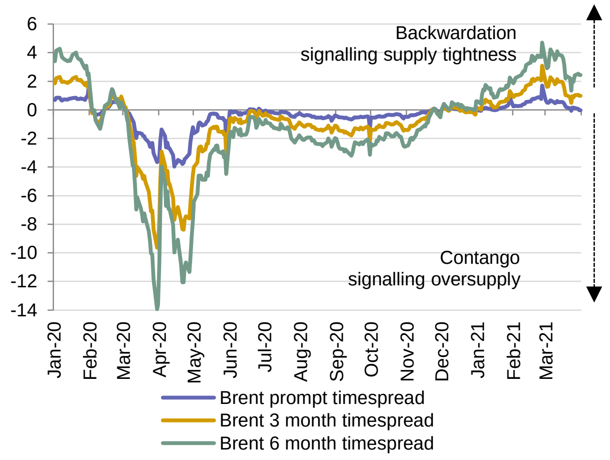


Source: Bloomberg, EIA, IEA, OPEC, MUFG Research

Core indicators – timespreads and futures

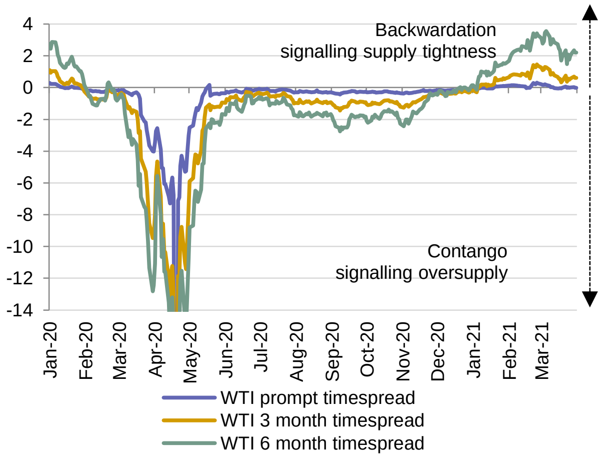
BRENT TIMESPREADS – FRONT, 3 AND 6 MONTHS

USD/B



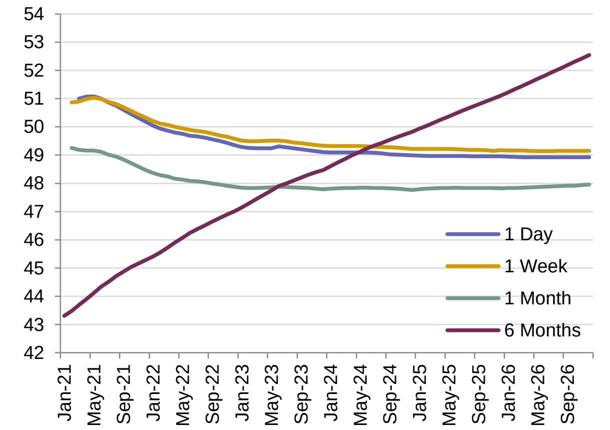
WTI TIMESPREADS – FRONT, 3 AND 6 MONTHS

USD/B



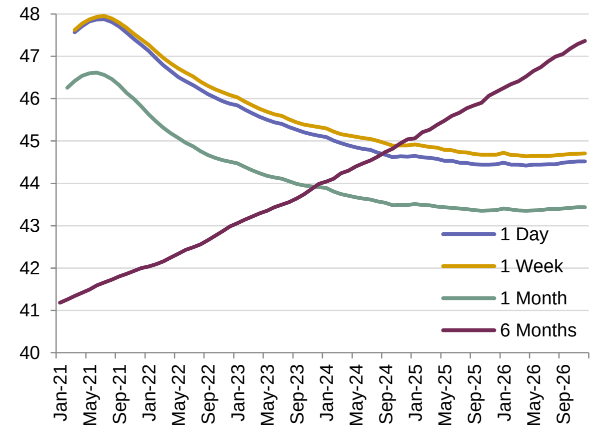
BRENT FUTURES CURVE

USD/B



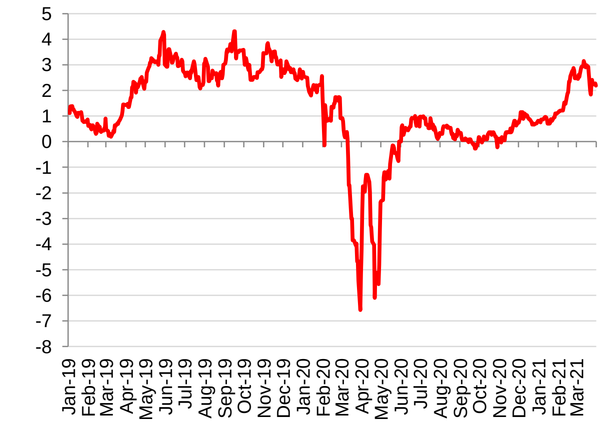
WTI FUTURES CURVE

USD/B



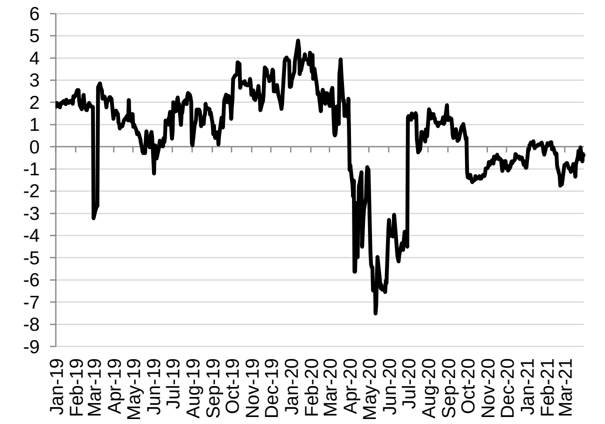
BRENT-DUBAI SPREAD

USD/B



BRENT-MURBAN SPREAD

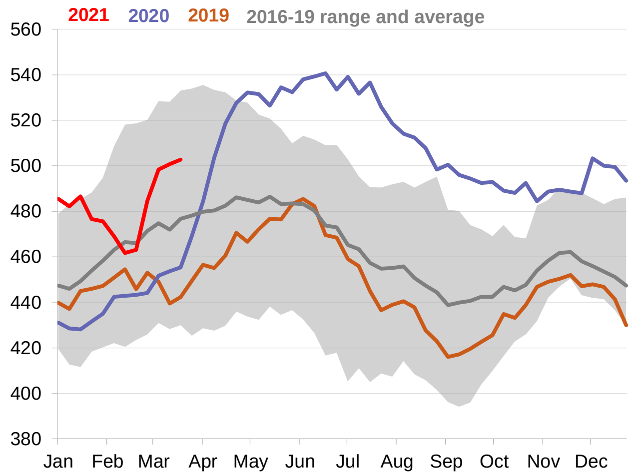
USD/B



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

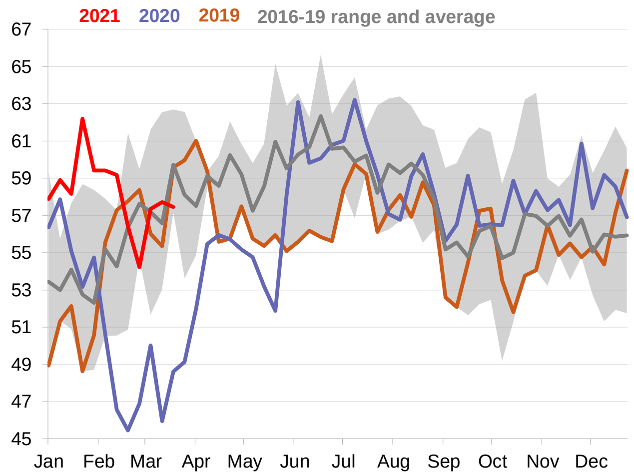
US CRUDE INVENTORIES

MILLION BARRELS



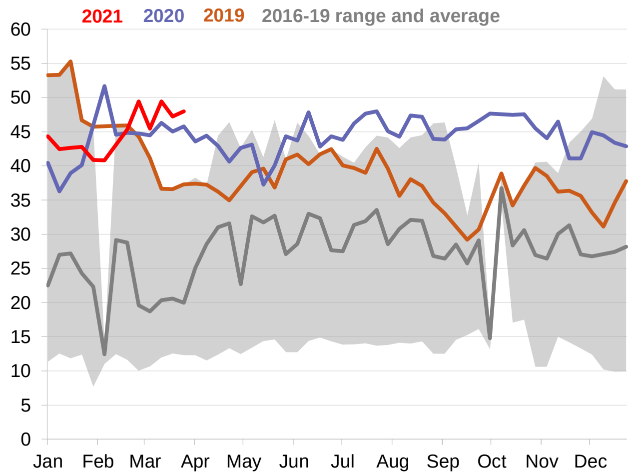
ARA CRUDE INVENTORIES

MILLION BARRELS



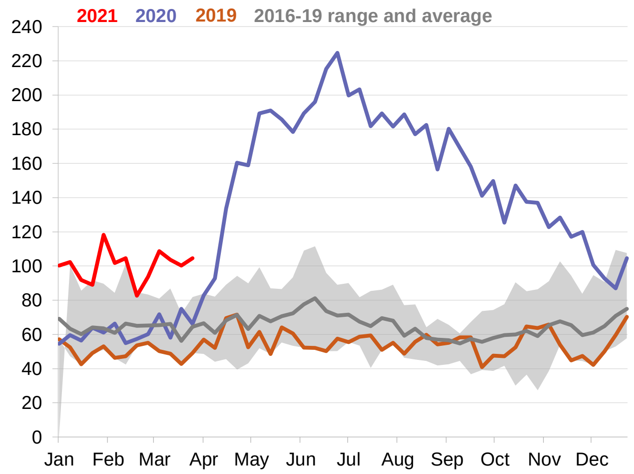
CHINA SHANDONG CRUDE INVENTORIES

MILLION BARRELS



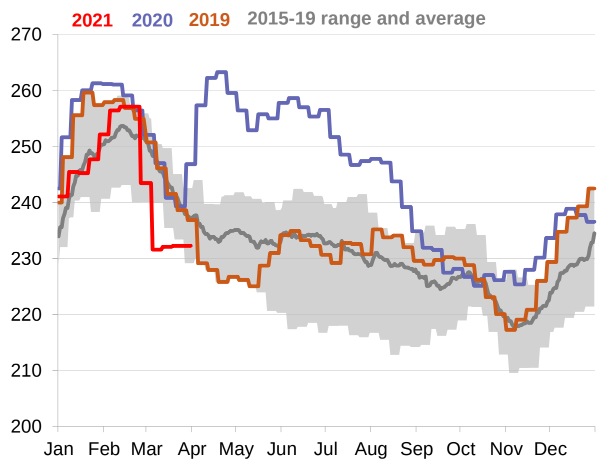
GLOBAL CRUDE FLOATING STORAGE

MILLION BARRELS



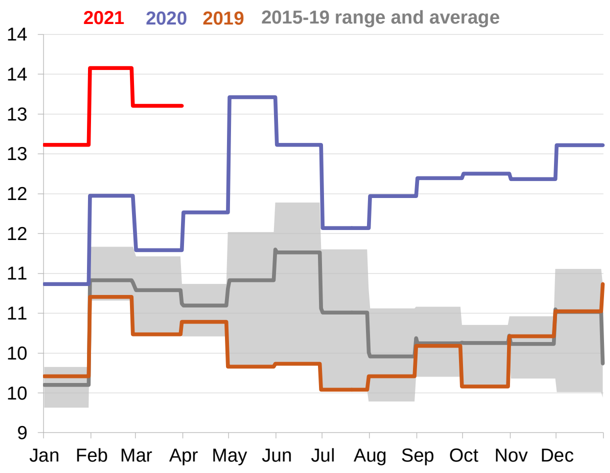
US GASOLINE INVENTORIES

MILLION BARRELS



JAPAN GASOLINE INVENTORIES

MILLION BARRELS



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

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