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MUFG Bank, Ltd.
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OPEC+ sticks to the script in a low stakes meeting

Oil market focus: In what was a low stakes meeting, OPEC+ unified around a singular message and maintained its incremental 0.4m b/d monthly production hikes on 1 September. This will uphold the market in deficit over the autumn months, keeping timespreads in backwardation – bullish structure where near-dated contracts trade at a premium to later-dated ones – signalling supply tightness. This strikes at the heart of the OPEC+ optimisation strategy in achieving fiscal stability through higher revenues and market share. In essence, backwardation favours OPEC+ as it eliminates the financial incentive to store oil over time and discourages higher cost producers, such as shale, from locking-in prices for future production (as low “deferred” prices through the backwardation structure can restrain higher cost producer’s ability to secure future cash flows and attract funding).

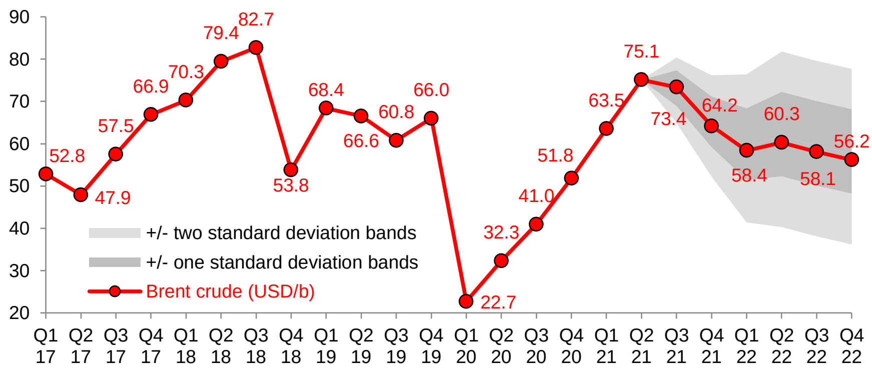
Week in review and week ahead: Oil prices staged a rally earlier this week amid the arrival of Hurricane Ida, causing temporary shutdowns of ~1.7m b/d of oil production in and along the Gulf coast. Prices have since remained directionless with markets digesting a further rise in OPEC+ output as well as in anticipation of the US August nonfarm payrolls reading due today (2 September). We remain tactically neutral for the week ahead given counterbalancing forces – (i) a physically tight oil market; (ii) the global macro momentum navigating the delta variant, whilst mobility easings continue apace; and (iii) how markets steer the Fed’s tapering strategy made during Jackson Hole (see here for our analysis of why global oil markets are less reactionary than financial risk assets to inflation risks and/or interest rates guidance).

Oil price forecast: Oil prices are expected to remain range bound with hesitancy to push the market in either direction for the remainder of this quarter, but near-term volatility may overshoot on both ends temporarily. Looking ahead, the balancing of cyclical demand headwinds with structural supply tailwinds, leads us to remain neutral-to-bearish on oil prices for the rest of 2021. Our quarterly profile remains for Brent to regress lower from USD75/b in Q2 to end Q3 and Q4 2021 at USD73/b and USD64/b, respectively, and to average USD58/b in 2022. Under the weight of higher OPEC+ output, steadily rising shale, the eventual return of Iranian supply, juxtaposed with a more normalised demand profile, we lean short oil further out along the curve.

Core indicators: Prices, market positioning, timespreads, futures, inventories, storage and products performance over the previous week are covered below.

CHART OF THE WEEK: WE LEAN SHORT OIL FURTHER OUT THE CURVE

MUFG’S BRENT PRICE (USD/B) WITH ONE AND TWO STANDARD DEVIATION BANDS



Source: Bloomberg, MUFG Research

Oil market focus

OPEC+ sticks to the script in a low stakes meeting

OPEC+ sticks to script

In what was a low stakes meeting, OPEC+ members unified around a singular message and maintained its incremental 0.4m b/d monthly production hikes on 1 September. A dip in oil prices in August (Brent down -4.4% m/m), with apprehensions that the global economy is struggling to contain the spread of the delta variant of COVID-19 in conjunction with mobility restrictions in core geographies, may have given some OPEC+ members doubts, but analysis presented by the OPEC secretariat to the group's Joint Technical Committee (JTC), signalled no need for a pause. The group's delicate stewardship of the oil market has kept prices high enough to support the revival of the market throughout this year and largely avoided the spike that could stymie the global economic recovery. With OPEC+ staying the course at its latest meeting keeps this rhythm flowing.

Current OPEC+ strategy to taper production

In what was a tumultuous first two weeks in July, OPEC+ finally reached an agreement after negotiations started, with production targets for H2 2021, a deal extension through end-2022 and higher baselines from May 2022 (see here and here). The agreement had three core outcomes:

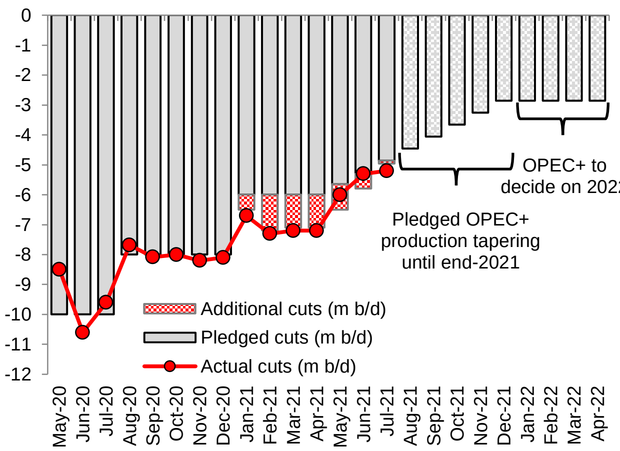
1. An extension of the agreement through to end-2022.
2. Monthly incremental easing of existing curbs by 0.4m b/d through to end-2021, and potentially beyond until the entire 5.8m b/d is phased out (theoretically by September or October 2022).
3. An increase in the baseline from which cuts are allocated of 1.63m b/d in total, spread across Saudi Arabia and Russia (both 0.5m b/d), the UAE (0.33m b/d) Iraq (0.15m b/d) and Kuwait (0.15m b/d).

Important implications of the current OPEC+ strategy

The prevailing OPEC+ agreement has a number of implications. First, it offers those higher baselines to those OPEC+ members which have the available spare capacity, resolving an issue which threatened to destabilise the agreement in July. Second, a steady incremental increase in production will keep the market in deficit in the coming months as 2m b/d of easing between August-December 2021 is not suffice to prevent the market continuing to tighten, according to our models. Third, raising the baseline by a combined 1.63m b/d does not signal 1.63m b/d of higher supply than before –

OPEC+ COMPLIANCE ON ITS LARGEST CUTS IN HISTORY HAS BEEN PRUDENT AND IMPRESSIVE

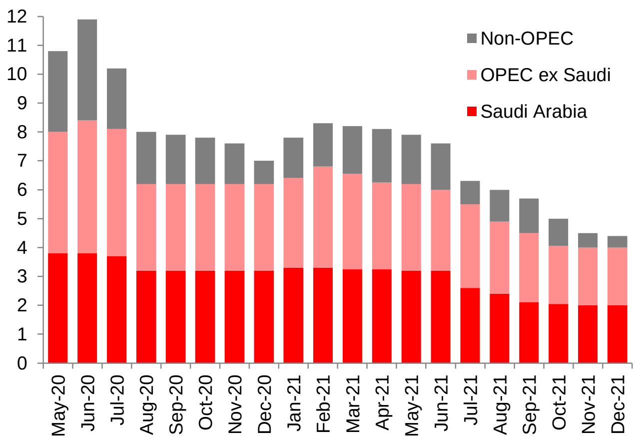
OPEC+ PLEDGED AND ACTUAL OUTPUT CUTS SINCE MAY 2020 (M B/D)



Source: Bloomberg, OPEC, MUFG Research

SAUDI'S IMMENSE SPARE CAPACITY HAS BEEN VITAL IN ENSURING STERN ADHERANCE TO OPEC+ CUTS

OPEC+ SPARE CAPACITY (UNDER PROPOSED ALLOCATIONS) (M B/D)



Source: Bloomberg, OPEC, MUFG Research

the group still plans to unwind the 5.0m b/d of cuts relative to where we are today, and thus the agreement merely acknowledges available capacity in the five countries concerned in higher proportional allocations from May 2022. Finally, guidance for higher capacity will be needed in coming years given growing underinvestment in the oil industry.

OPEC+ compliance rate in July at 108% was the highest so far in 2021

OPEC+ discipline remains resolutely stern. This is primarily driven by the leadership of Saudi Arabia which remains prudent surrounding the demand recovery, alongside its leverage it enjoys by virtue of its immense space capacity. The latest reading suggests that OPEC+ compliance with agreed production cuts reached 108% in July, with monthly compliance rates ranging from 99-108% so far this year, according to secondary sources. Angola and Nigeria have consistently been the key contributors to the group's overcompliance since January. In July, both countries exceeded their supply cut targets by over 0.2m b/d, and OPEC+ collectively overcut production by almost 0.5m b/d. Russia remains the largest overproducers, exceeding its production quota by 0.13m b/d in July, whilst Iraq was one of the largest overproducers in H1 2021, wherein it complied with its output targets in June and July.

The OPEC+ strategy has been working

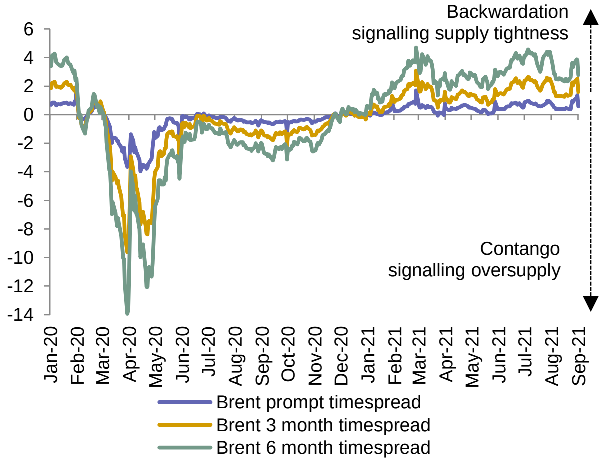
The OPEC+ supply strategy has been working because of its unexpectedness and suddenness. Year-to-date, oil prices are up ~40% and excess inventories continue to be drawn down, meanwhile OPEC+ production is rising and the US oil rig count at 410 still remains ~40% below pre-virus levels. This stands in sharp contrast to the strategy prior to 2020, when OPEC+ viewed itself as the central bank of the oil market, reassuring too much with predictable but never large enough cuts.

OPEC+ optimisation is for backwardation – and it has been successful

With global oil balances remaining in deficit, timespreads remained in backwardation – bullish structure where near-dated contracts trade at a premium to later-dated ones – signalling supply tightness throughout this year. This strikes at the heart of the OPEC+ optimisation strategy in achieving fiscal stability through higher revenues and market share. In essence, backwardation favours OPEC+ as it eliminates the financial incentive to store oil over time and discourages US shale producers from locking-in prices for future production (as low "deferred" prices through the backwardation structure can restrain higher cost producer's ability to secure future cash flows and attract funding). Furthermore, backwardation maximises low cost producers' (namely, OPEC+) revenues relative to higher cost producers (such as shale) that hedge, as they instead sell higher production levels at spot prices. Key to this view is our belief that backwardation can rationalise shale growth by reducing returns expectations and increasing leverage expectations, both of which drive

BRENT TIMESPREADS SHOW MARKET CONTINUES TO REBALANCE WITH ONGOING BACKWARDATION LEVELS

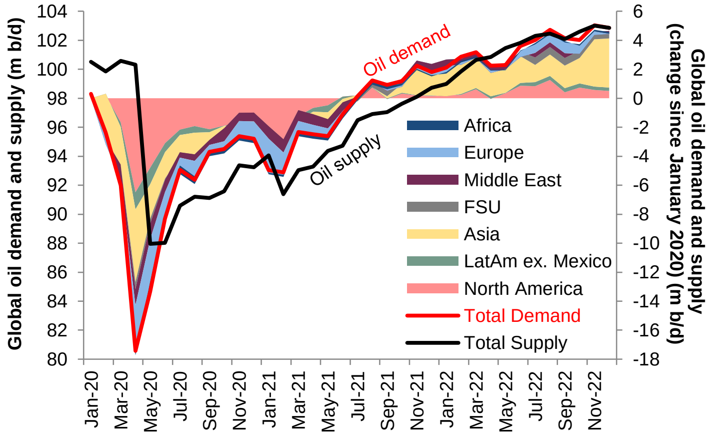
BRENT TIMESPREADS – FRONT, 3 AND 6 MONTHS (USD/B)



Source: Bloomberg, MUFG Research

OUR CONSTRUCTIVE DEMAND OUTLOOK LEADS US TO FORECAST A TIGHT OIL MARKET UNTIL Q1 2022

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



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

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funding costs higher and slow capital allocation.

2022 oil market surplus looms

The oil market outlook for 2022 looks precariously uncertain. Oil demand, projected by the IEA, is set to get close to pre-virus levels and consumption growth will slow substantially by H2 2022, to just 2m b/d on average compared with more than 5.3m b/d expected for this year. Our own estimate put global oil demand at 101.7m b/d on average in 2022 from 97.1m b/d in 2021 – in fact, we forecast demand to reach the pre-virus run rate in Q4 2021 (100.1m b/d). Beyond a more normalised demand profile, it is however on the supply-side that we see market's attention being geared towards in 2022. We, alongside OPEC, IEA and EIA, believe the market will tilt from a market deficit that has remained the case since June 2020 towards oversupply next year. This stems from a confluence of higher OPEC+ output, steadily rising shale, the steady build-up of oil inventories and – perhaps the most contentious upside supply risk – the return of Iranian supply. Specifically, non-OPEC+ supply will recover all its lost output by the end of 2022 with the IEA projecting supply of 67.4m b/d by Q4 2022 (our estimates are slightly below that at 67.0m b/d), higher than pre-virus run rate of 66.8m b/d registered in Q4 2019.

We continue to lean neutral-to-bearish on oil

From an oil price perspective, there appears to be hesitancy to push the market in either direction, leaving the front-end likely in a holding pattern in the weeks ahead given two counterbalancing forces. First, fundamentals remain supportive of a tight global oil market in the near-term, owing to the marked velocity of the vaccine-induced demand acceleration (notably across developed markets), alongside inelastic supply (tepid shale growth, delayed Iranian barrels to market and only steady OPEC+ production increases). Second, there remains downside risks to emerging markets demand (where vaccination rates lag) stemming from the still highly contagious delta-variant, alongside steadily rising US shale, the prospect of (eventual) higher Iranian supply and potential weaker OPEC+ compliance (or higher production pledges in line with US pressure – see here). On net, as we have recently catalogued (see here and here) we continue to lean neutral-to-bearish on oil, with Brent to regress lower and end Q3 and Q4 2021 at USD73/b and USD64/b, respectively. Key behind our bearish oil price narrative is that the focus will shift from demand to supply which will increasingly become a source of negative impulses.

Week in review and week ahead

Volatile week due to Hurricane Ida and OPEC+ meeting; we remain tactically neutral for the week ahead

Oil prices staged a rally earlier this week amid the arrival of Hurricane Ida, causing temporary shutdowns of ~1.7m b/d of oil production in and along the Gulf coast. Prices have since remained directionless with markets digesting a further rise in OPEC+ output as well as in anticipation of the US August nonfarm payrolls reading due today (2 September). We remain tactically neutral for the week ahead given counterbalancing forces – (i) a physically tight oil market; (ii) the global macro momentum navigating the delta variant, whilst mobility easings continue apace; and (iii) how markets steer the Fed's tapering strategy made during Jackson Hole (see here for our analysis of why global oil markets are less reactionary than financial risk assets to inflation risks and/or interest rates guidance).

Global oil markets are not reactionary to inflation risks

As we recently catalogued (see here), oil markets do not respond to inflation risks and/or Central Bank forward guidance. As spot physical (anchored) assets, oil only depends on the prevailing level of demand and supply and thus oil's trajectory is driven by scarcity and physical demand. Thus, oil markets are mostly void of expectations and so talk of potential rate hikes two years from now are, by and large, insignificant. Furthermore, the US Federal Reserve (Fed) continues to make it clear that that it would continue to purchase bonds at an unprecedented rate and has articulated that it would taper only towards the end of this year. This signals that the Fed would, in effect, be buying bonds at a marginally slower rate.

Oil markets vs financial markets responses to rate hikes

The pandemic recovery has been characterised by a stop-start pattern, interrupted by labour and capital shortages, supply chain issues as well as the availability of vaccines all of which impact the rate of growth. However, the level of demand remains above the level of supply which is supporting cyclical commodities, notably oil. That explains why as spot assets, oil is not impacted by discussions of interest rate hikes – in the context of the construed Fed hawkish pivot – in the same way that forward-looking financial assets like equities, bonds and credit (see here). In essence, oil is an attractive asset class to protect against short-term unanticipated inflation that is created in response to a rapidly expanding global economy, where the level of demand for key inputs (predominantly capital and labour), is exceeding the level of supply – which is what global markets are currently experiencing. Hence, as spot assets, oil is not vulnerable to rising rates so long as demand remains above supply (which we foresee until Q1 2022).

Oil will remain a central pillar of the global economy until its share of energy mix materially diminishes

The confluence of accommodative monetary and fiscal policy, inflation and our FX house view of a still weaker trade weighted USD over the medium-term, has set up a strong macro backdrop, supportive of commodities, notably, oil. As we have catalogued previously (see here), large-scale infrastructure spending and green capex plans will only strengthen the strong outlook for oil markets in the near-term. In other words, green initiatives helps near-term oil demand, long before it hurts oil demand, and thus from an oil price perspective, until we reach a point in the market wherein oil's importance as a feedstock source of energy for the global economy becomes diminished to the extent that it is alternative and renewable sources of energy become increasingly utilised, we view the near to medium term impact of the energy transition as in fact oil price supportive.

Positive feedback loop for oil from EM reserve recycling

Furthermore, oil remains the fundamental link between growing demand, a weaker US dollar and inflation. Oil is mostly produced in emerging markets (EM), leading rising prices to enhance their current account surpluses. These surpluses end up as additional USD reserves at EM central banks, which are then required to diversify these holdings into other developed markets (DM) currencies, selling their excess

USD, which in-turn drives down the USD – i.e. reserve recycling. Moreover, excess reserves raise the availability of credit in EMs, further spurring demand growth, oil prices, and USD depreciation, all of which creates a feedback loop (and thus tailwind) for oil.

Oil price forecasts and ranges

BRENT – NEUTRAL BIAS – (66.00-76.00)

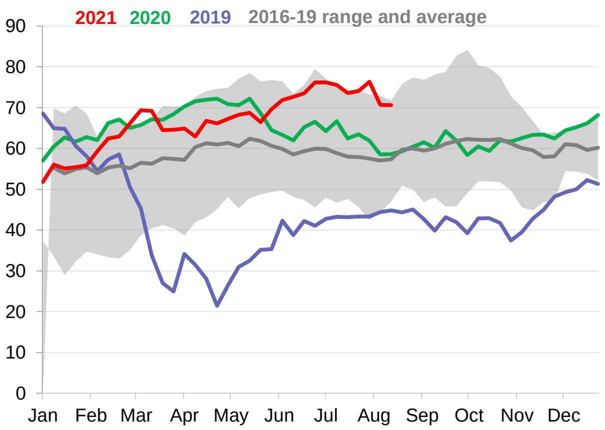
WTI – NEUTRAL BIAS – (62.00-73.00)

Quarter End (USD/b)	Spot close 02.09.21	Q3 2021	Q4 2021	Q1 2022	Q2 2022
Brent	71.30	73.40	64.20	58.40	60.30
NYMEX	68.59	69.10	60.90	55.10	58.40
		Range	Range	Range	Range
Brent		62.90-83.90	50-70-77.70	42.65-74.15	44.55-76.05
NYMEX		55.60-81.60	45.15-75.65	39.35-70.85	42.65-74.15

Core indicators – prices and market positioning

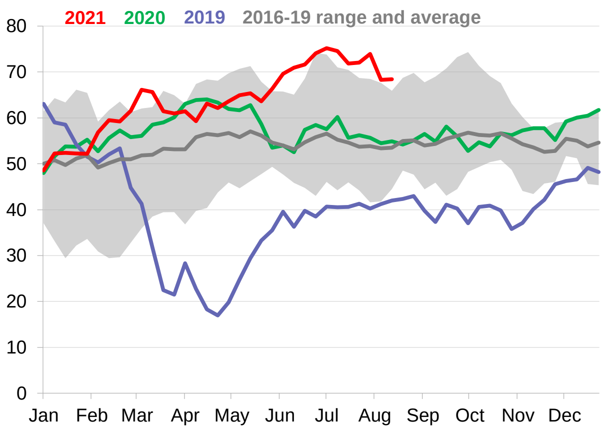
BRENT SPOT

USD/B



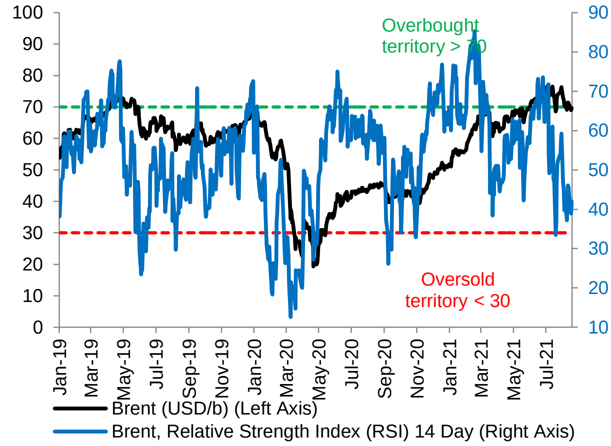
NYMEX WTI SPOT

USD/B



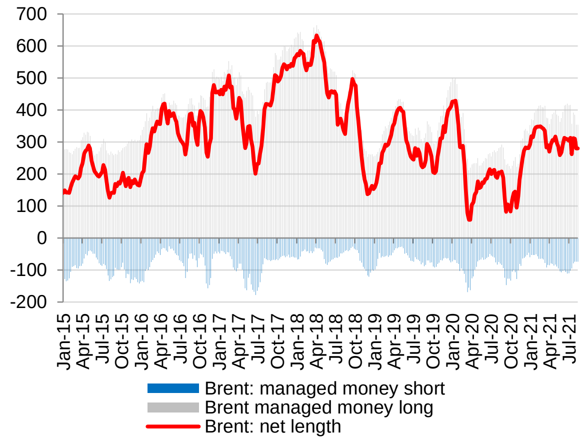
14 DAY RELATIVE STRENGTH INDEX (RSI) AND WTI

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



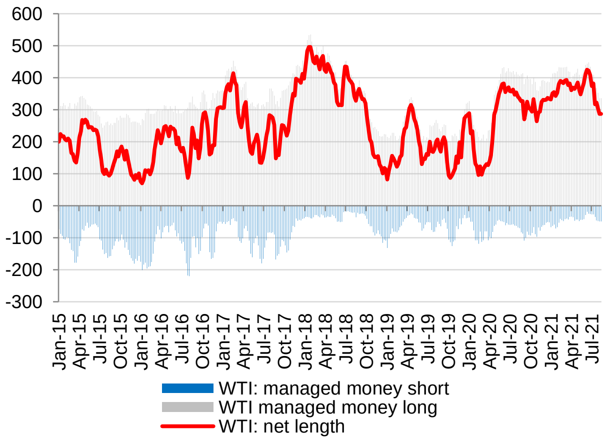
BRENT NET LENGTH MANAGED MONEY

CONTRACTS (THOUSANDS)



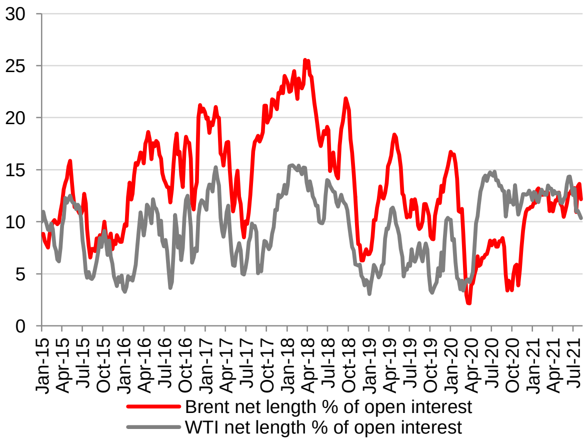
WTI NET LENGTH MANAGED MONEY

CONTRACTS (THOUSANDS)



NET LENGTH MANAGED MONEY / OPEN INTEREST

%

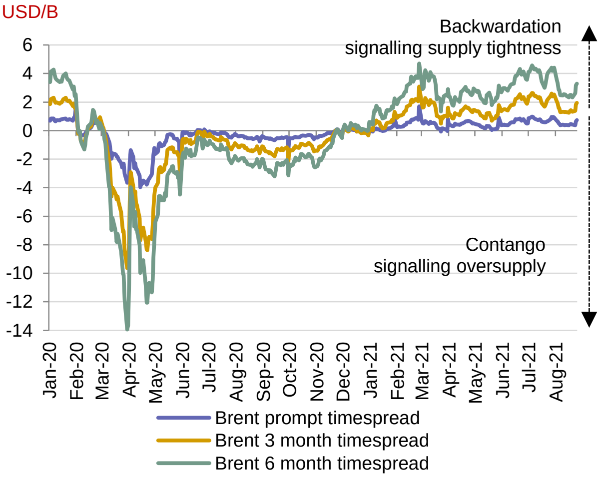


Source: Bloomberg, EIA, IEA, OPEC, MUFG Research

Core indicators – timespreads and futures

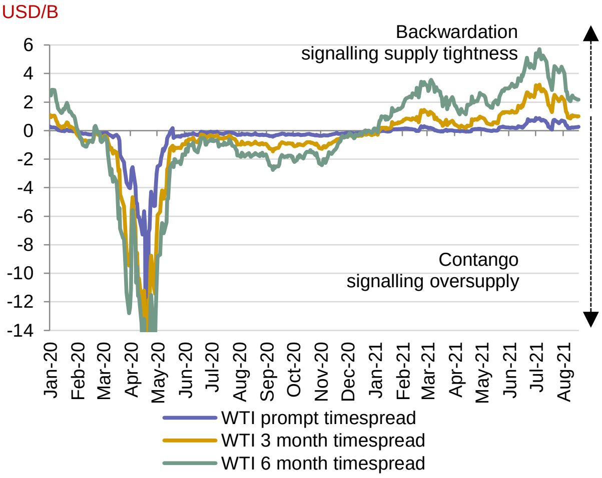
BRENT TIMESPREADS – FRONT, 3 A ND 6 MONTHS

USD/B



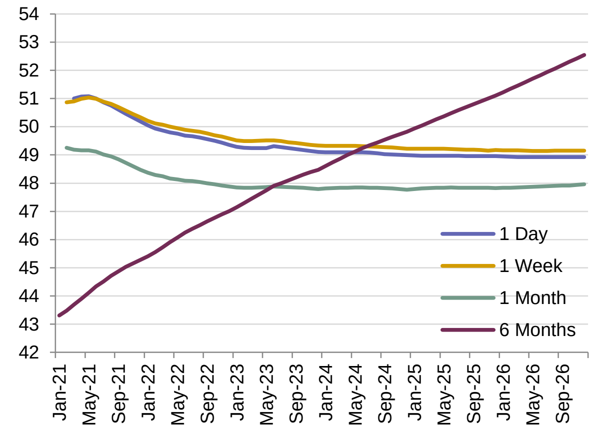
WTI TIMESPREADS – FRONT, 3 AND 6 MONTHS

USD/B



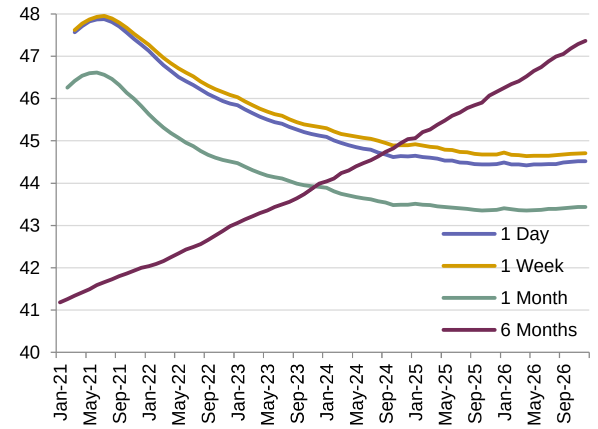
BRENT FUTURES CURVE

USD/B



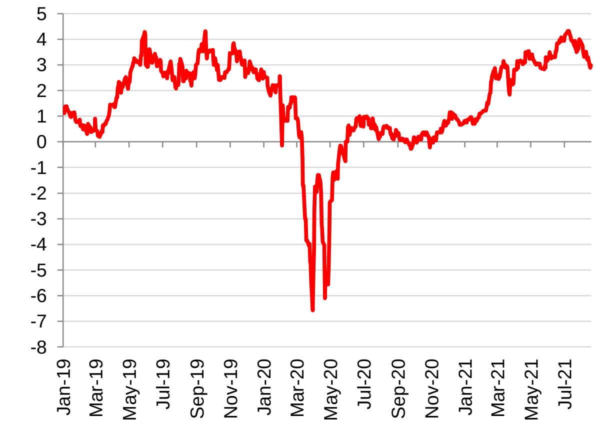
WTI FUTURES CURVE

USD/B



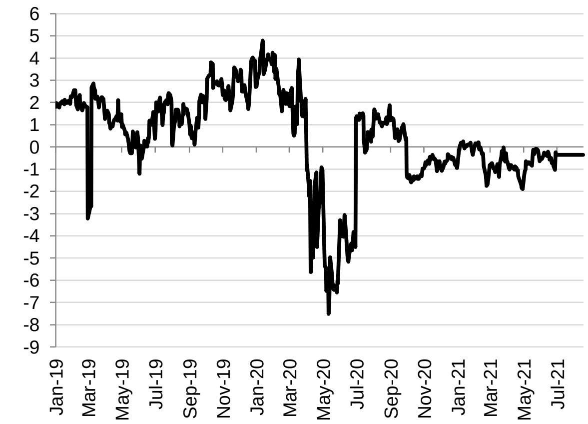
BRENT-DUBAI SPREAD

USD/B



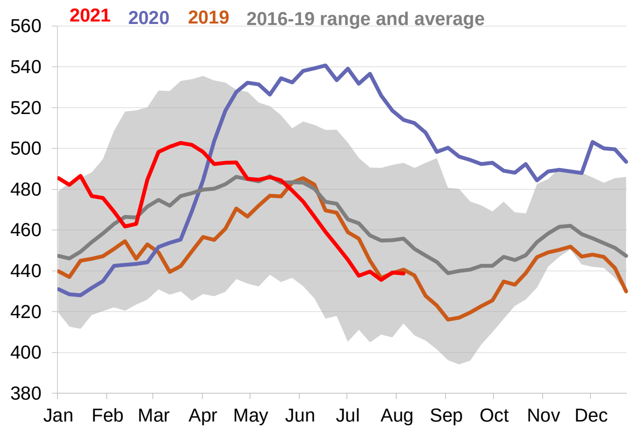
BRENT-MURBAN SPREAD

USD/B

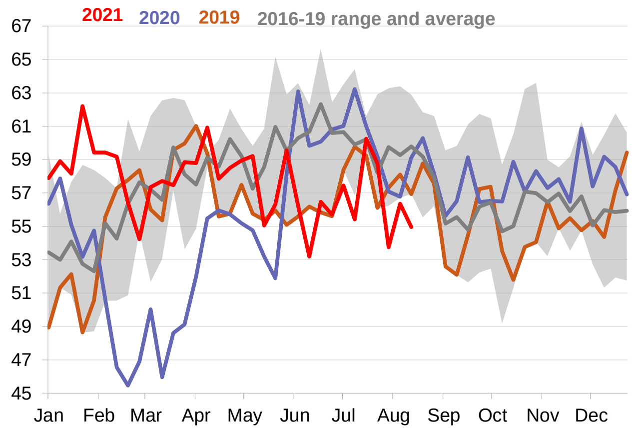


Source: Bloomberg, EIA, IEA, OPEC, MUFG Research

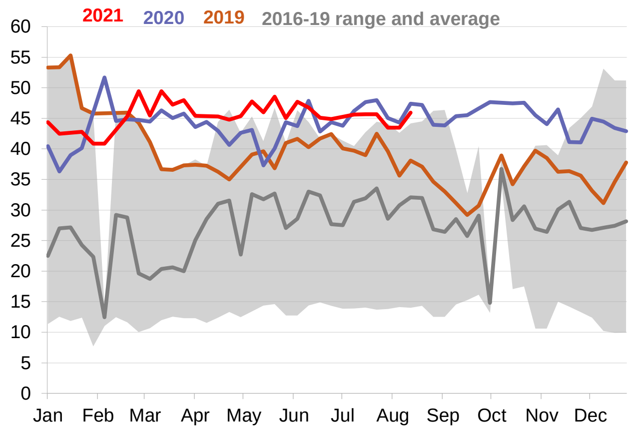
US CRUDE INVENTORIES
MILLION BARRELS



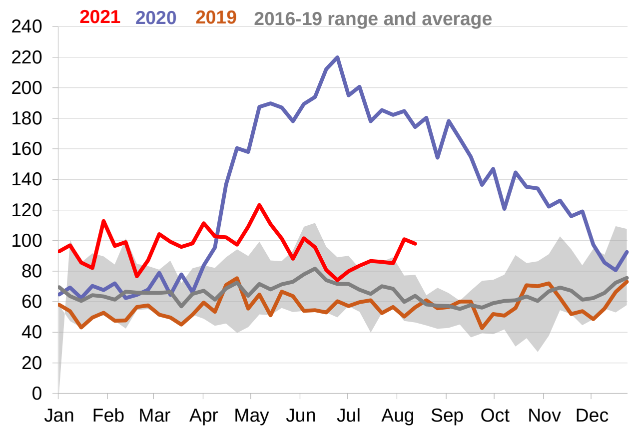
ARA CRUDE INVENTORIES
MILLION BARRELS



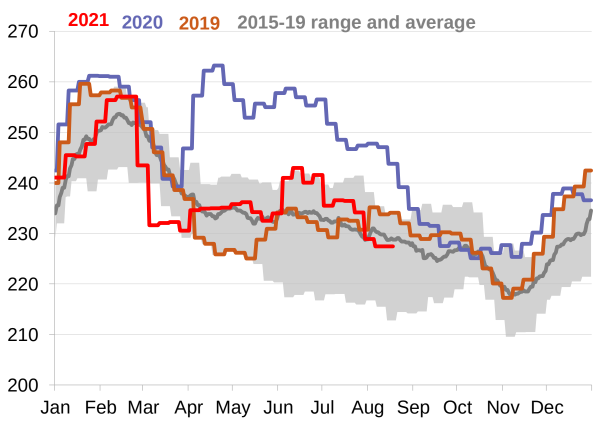
CHINA SHANDONG CRUDE INVENTORIES
MILLION BARRELS



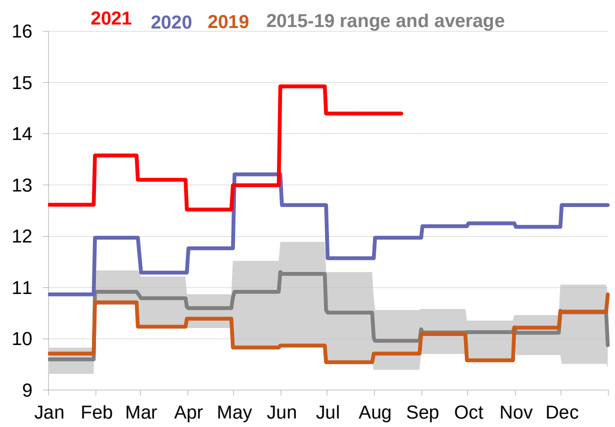
GLOBAL CRUDE FLOATING STORAGE
MILLION BARRELS



US GASOLINE INVENTORIES
MILLION BARRELS



JAPAN GASOLINE INVENTORIES
MILLION BARRELS



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