A BEAR MARKET IN CRUDE OIL: HOW LONG WILL IT LAST?

Spotlight

Global Investment Committee

UBP
Union Bancaire Privée

Key points

- *The tailwind of tight supply that characterised the oil market in 2017 has receded in 2018.*
- *The unwind of speculative positions has been a key driver of a 20% decline in crude oil from its October highs.*
- *Concerns about the impact of waivers issued by the US to allow countries to import Iranian crude oil appear overstated.*
- *OPEC excess capacity sits at historically low levels leaving the market now vulnerable to any future supply disruption.*
- *Risk-reward is beginning to tilt back in favour of higher crude oil prices, especially if speculative positions continue to unwind in the weeks to come.*
- *European integrated energy companies are best positioned to benefit from stability in underlying crude prices looking ahead.*

The 20% decline in crude oil from its October highs has prompted market players to claim that a key driver for the sell-off was the issuance of waivers by the United States to allow countries to skirt newly re-imposed sanctions on the purchase of Iranian oil.

However, we view the slide in crude prices as primarily due to the unwinding of speculative positions in futures markets aggravated by a shift in the fundamental supply-demand balance of the underlying crude oil market since mid-2017.

Supply–Demand: From undersupplied to back in balance in 2018

Our bullish outlook on crude oil in late-2017 was largely driven by the meaningful tightness in supply seen in the 2nd half of that year. It is worth recalling that the market was undersupplied by as much as 1.5 million barrels per day in the 3rd quarter of 2017.

Crude oil: Excess demand has eroded in 2018

Sources: Energy Intelligence Group, Bloomberg Finance L.P. and UBP

Since then, the market has rebalanced with supply growth exceeding the growth of demand by over one million barrels per day leaving a relative balance in the market by mid-2018.

The tight supply situation in 2017 also resulted in a dramatic draw on inventories which had been at all-time highs in early 2017 allowing them to move back towards normalised levels by mid-2018. Recent data suggests that inventories have begun building again since August though they still remain within the post-crisis normal ranges.

On balance, with supply–demand now in balance and inventories having shrunk, the previous tailwinds to higher prices in crude have faded.

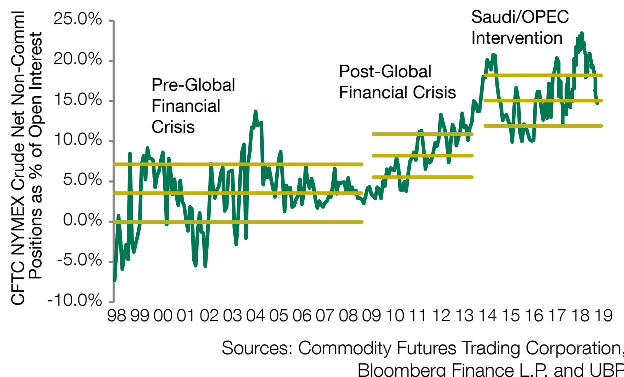
Should the supply–demand balance move more meaningfully to oversupply and/or should inventories continue to build, the risk of a 2014–15-style decline in crude is clear. However, with Saudi Arabia having reportedly announced its intention to withdraw the incremental production that this key producer has delivered into markets in anticipation of the sanctions on Iranian crude (see below) a stabilisation in prices appears likely.

Speculative positioning: Unwinding rapidly

The unwinding of speculative positions in the futures market has also weighed on crude prices in recent months. With supply-demand unusually tight in late-2017, speculators entered the market, driving ‘non-commercial’ (i.e. speculative) buyers to 23% of open interest in crude oil futures according to US Commodity Futures Trading Commission data.

Though some of this speculation eased through the first half of 2018, the prospect of renewed US sanctions on Iran brought speculators back into the market over the summer supporting a move to nearly US$87/barrel by early-October.

Crude oil: Speculative positions unwinding rapidly



Sources: Commodity Futures Trading Corporation, Bloomberg Finance L.P. and UBP

However, autumn saw a rapid unwinding of positioning as the US indicated that it would issue waivers (see below) to allow the temporary continuation of purchases.

With this unwinding of positions, speculators now account for 14% of open interest, just below the average seen since 2014.

Admittedly, further unwinding is possible especially in light of rising US inventories. However, should there be a return to a situation where speculators account for 10-12% of open interest (the lows seen during 2014-15), the overhang for crude looking ahead would be much more meaningfully removed.

Iran sanctions: Import waivers for purchasers

With oil prices having reached three-year highs driven by speculation about the withdrawal of Iranian supplies (appx 2 million barrels per day) following the re-instatement of US sanctions on Iran in early-November, the US issued waivers to major consumers of Iranian crude oil allowing them to continue purchasing from Iran temporarily even with sanctions in place.

However, press reports suggest that these waivers are somewhat limited in scope and by our estimates do more to stabilise the market rather than necessarily restoring the full extent of Iranian supplies which might drive prices lower.

Reuters reports, for example, that Japan and Korea will each be allowed to import nearly 150,000 barrels per day under the waivers granted to them. This is approximately equal to their average purchases in 2016-17.

With both Japan and Korea having cut their purchases of Iranian crude to zero in October, this means that these two countries can now both purchase from Iran rather than sourcing supply from the broader crude oil market.

However, in contrast, Reuters similarly reports that China was granted a waiver to buy 360,000 barrels of Iranian crude per day - well below the 600,000 per day they purchased in 2016-17 and more than 50% below the 750,000 barrels per day of Iranian crude imported by China in October.

India, another large buyer of Iranian crude will be allowed to import 300,000 barrels per day from Iran, roughly comparable to their import level in October.

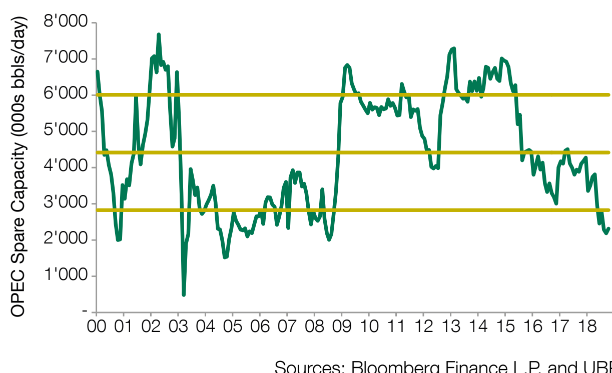
So, on balance, though Japan and Korea will be able to divert their combined 300,000 barrels per day of purchases back towards Iran, China will need to divert a similar level of demand away from Iran into the open market, leaving a modest net impact on the global supply-demand balance.

Key risk – OPEC excess capacity

Although the underlying fundamental drivers of higher prices have eased through much of 2018 and speculative support for crude prices has likewise waned, the key risk for crude oil markets looking into 2019 is the current extra tight excess capacity situation.

Unlike over the past decade, OPEC is no longer in a position to deliver a meaningful offset to any unexpected shock to supply – such as a production outage from a major producer (e.g. Venezuela), or an upside surprise on the demand side resulting from something like a reinvigorated Chinese stimulus.

OPEC spare capacity: Historically tight



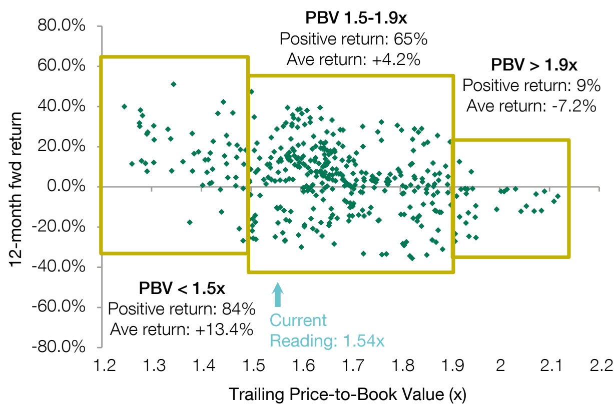
Sources: Bloomberg Finance L.P. and UBP

Outlook for energy prices and energy equities

In a scenario where supply–demand remains balanced and speculative positioning further unwinds in the months ahead, investors should expect crude oil prices to stabilise once again in the USD 65–70 per barrel range, near the levels seen prior to the May announcement reinstating sanctions on Iran.

Against this backdrop, the earnings recovery in the energy sector combined with the near 9% decline in global energy stocks since July leaves energy stocks trading at just above the 1.5x book value level. Historically, valuations below this level have provided a good entry point for investors.

Energy equities: Approaching historical buy triggers



Sources: MSCI, Bloomberg Finance L.P. and UBP

Within the global energy sector, our preference for European integrated energy companies remains intact. Having significantly outperformed the sector year to date, they should continue to do so looking into 2019.

European integrated energy companies have delivered free cash flow of more than four times their 10-year historical average in the third quarter of 2018. While the group delivered record results across almost all key metrics, share price performance was heavily affected by weak underlying crude prices.

Even with the fall in underlying crude prices, we expect the delivery of strong free cash flow will continue among Europe's "Big Oils" in the coming years, which, combined with ongoing capital discipline, will allow for accelerating share buybacks and dividend increases to drive share price performance.

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

Norman Villamin
Chief Investment Officer (CIO)
Private Banking and
Head of Asset Allocation

norman.villamin@ubp.ch

Patrice Gautry
Chief Economist

patrice.gautry@ubp.ch

Yves Cortellini
Deputy Head of Asset Allocation

yves.cortellini@ubp.ch

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Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com

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