

OIL, CAUGHT IN ECONOMIC HEADWINDS, TRADES MORE ON FEAR THAN FUNDAMENTALS

Crude limped into 2019 languishing deep in a bear market, barely above the 16-month and 18-month lows plumbed by Brent and WTI on Christmas eve.

The four-year peaks notched on October 3, at \$86.29 for Brent and \$76.41 for WTI, were quickly erased in the weeks that followed, as a surge in fear over a global economic slowdown prompted a sustained sell-off in risky assets, including oil.

The financial markets turmoil, marked by risk aversion and high volatility, remains in control of the oil market as we write this report. That is borne out by the very strong correlation between benchmark US stock indexes and crude prices, both of which are broadly responding to the same data and news events.

Worries over a deceleration in economic growth stem from a confluence of three developments: a bruising tit-for-tat import tariffs battle between the US and China since July 2018, the US Federal Reserve's aggressive quantitative tightening with four interest rate hikes through last year, and emerging economies struggling under capital flight and sharply depreciated currencies against the US dollar.

For the oil market, economic headwinds, especially in China, the world's second-largest oil consumer and biggest contributor to consumption growth, mean lower demand. OPEC and its non-OPEC allies responded by agreeing to a 1.2 million b/d reduction in output from October 2018 levels, which took effect on January 1.

We believe the producers are fully committed to the curbs and will attain high compliance, just as they did with the 1.8 million b/d cuts implemented from January 2017, but it will take some time to mop up the surplus, which has shown up in the form of a continuous rise in OECD oil stocks since last July.

Until the rebalancing becomes evident, and until the economic worries dominate, we expect prices to remain under pressure. That points to Brent in the \$55-65/barrel range and WTI \$8-10/barrel below it. Crude returned into a bull market on January 9, but remains deep below the "death cross", which is when the 50-day moving average of prices slips below the 200-day average. We expect OPEC cuts to support a recovery but only when the economic sentiment is pulling in the same direction.

So far, key macroeconomic data from across the world for December has only brought more gloom to investors. Manufacturing activity was reported to have slowed down not just in China, but across Europe and even the US. Chinese GDP growth for 2018 is expected to come in at 6.5%, the slowest in three decades.

Beijing has begun rolling out fresh stimulus measures this month to inject more cash into its wobbling economy, but will be constrained by its need to contain the ballooning debt burden of the local governments and the corporate sector as well as the shadow banking sector, which it has been trying to clamp down on.

Three days of mid-level trade negotiations between the US and Chinese officials in Beijing over January 7-9 brought the two sides closer to understanding each other's positions and cheered stock markets across the globe. But the positive momentum waned within days, and now awaits higher-level talks, expected to be held in the US later this month. The countries are working to a March 1 deadline under a 90-day truce declared by Presidents Donald Trump and Xi Jinping at the Group of 20 summit in Buenos Aires, Argentina, on December 1.

American iconic brand Apple stunned the markets with an earnings warning for the October-December 2018 quarter on January 2, citing primarily weak sales in China due to its economic woes. Since then, a clutch of big companies in the US as well as Europe, spanning the automotive, airline, consumer retail and even the luxury goods sector, have announced profit downgrades and layoffs for 2019.

The pressure is mounting on both Trump and Xi to break the trade deadlock in order to keep their economies humming. While a full-fledged deal in the new few weeks is hard to fathom, a breakthrough of some sort is likely, which should give an instant boost to the stock markets as well as oil.

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ECONOMIC HEADWINDS IN THE DRIVER'S SEAT

Crude began 2019 with a very strong positive correlation with equities, which is explained by the fact that macroeconomic news and data have been influencing sentiment and risk appetite in the broader financial markets as well as in oil, pushing them in the same direction.

The common impacting elements fall in three key areas:

- The course of the US-China trade dispute and talks to resolve it
- The future path of the US Federal Reserve's interest rate hikes
- Macroeconomic data and projections for 2019

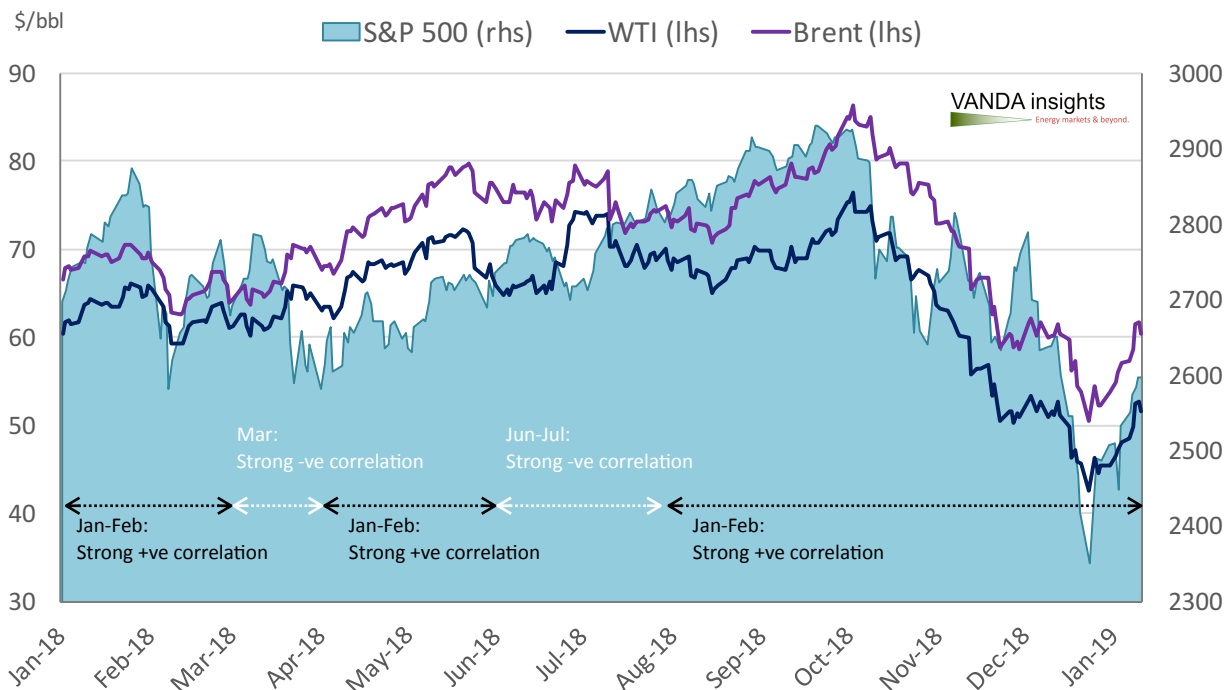
The risk aversion that sparked a sharp and sustained sell-off in the global equity markets at the beginning of last October also battered crude, as capital fled from risky assets and looked for safe havens.

Besides flight of speculative capital from crude futures, a stronger dollar and weaker economic outlook have lent pressure from the fundamentals side, on expectations of a dent in global oil demand.

We calculated the correlation between crude (WTI and Brent futures) and US stock market benchmarks (S&P 500 and the Dow Jones Industrial Average). Results of the two stock market indexes were comparable; we have charted below the movements of S&P 500.

On average, Brent and WTI futures showed a +0.84 correlation with the S&P 500 in the first two weeks of January. The correlation had hit a high of +0.91 in December. The correlation from October to January 11, the duration of the current financial markets turmoil, was also a strong +0.80.

We expect the reduction in physical crude supplies as a result of the 1.2 million b/d of OPEC/non-OPEC cuts from January 1 to gradually start influencing oil market sentiment, but until the fear over economic headwinds prevails, the latter will be the primary influencer.



Source: CME (WTI), ICE (Brent), Yahoo Finance (S&P 500)

FUNDS IN RECORD EXODUS FROM FUTURES

There is an evergreen debate in the oil markets over the role of “money managers”, or speculative traders, by virtue of their substantial positions in the exchange-traded futures and options as well as an ability to add and curtail length quickly.

Our view is that the speculators typically do well in pre-empting sharp bullish or bearish turns in the market. Their trades help amplify up- and downswings in prices and heighten volatility, especially when there is an ongoing or an expected major shift in supply/demand balances. But they are not the main drivers and certainly not solely responsible for setting the direction of the price movements. Over the past months, algorithmic trading is also believed to have boosted volatility.

The first of a long sequence of weekly drops in speculative length — a proxy for bullish bets on prices — was seen in NYMEX WTI and ICE Brent futures in the week to October 2 (the data follows a Wednesday-Tuesday cycle). That was a full week’s head start over the tailspin in crude prices from their four-year highs. NYMEX WTI and ICE Brent futures hit a four-year peak of \$76.41/barrel and \$86.29/barrel respectively on October 3.

After a record 14 consecutive weeks of sell-off, hedge funds and other major speculators were holding net **short** positions equivalent to just over 10 million barrels in Brent futures as of January 8, according to the latest exchange data available.

The last time money managers held a net short position in Brent futures was the second week of January 2016, which corresponded with the benchmark briefly crashing through \$30/barrel to a 13-year low.

Bullish speculative bets in Brent futures had touched an all-time high of 485.14 million barrels over April 11-17, 2018.

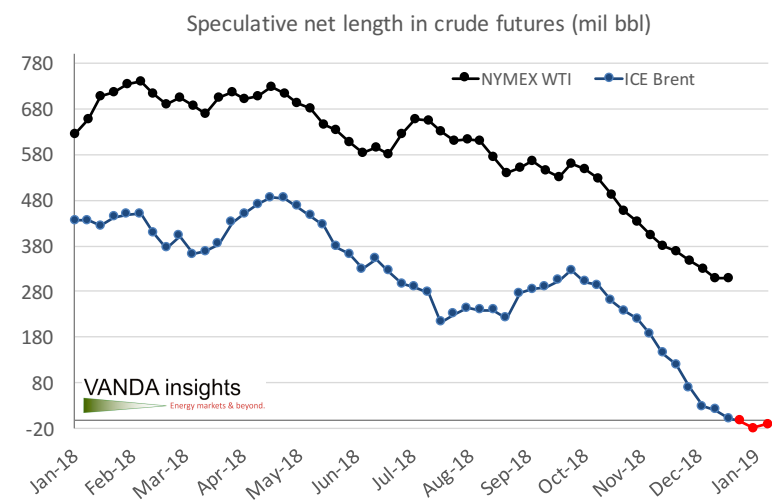
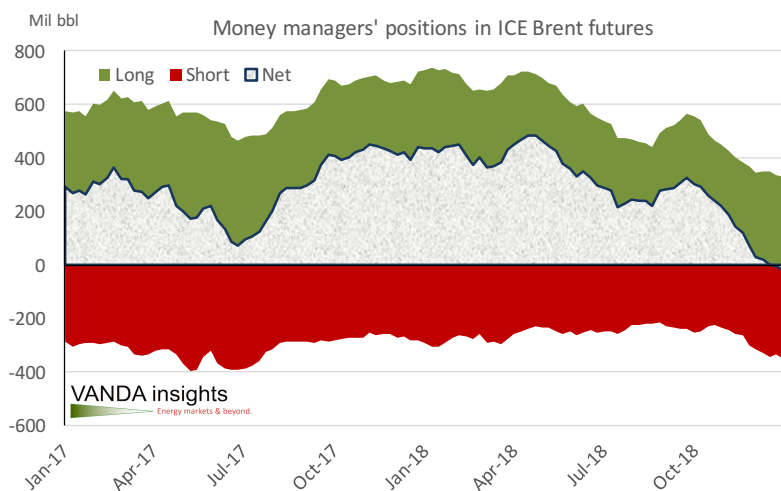
The latest trading positions in NYMEX WTI futures are only available to December 18, owing to the partial US government shutdown since December 22. The Commodity Futures Trading Commission, which issues the weekly Commitment of Traders report, has been affected by the shutdown.

The last data showed speculators were still holding 309.61 million barrels equivalent of net **long** positions in NYMEX WTI futures, albeit the lowest since November 2016. Speculative net length in ICE Brent for the week to December 18

had dwindled to just 2.75 million barrels equivalent. That also helps explain the WTI/Brent futures spread shrinking to minus \$8-9/barrel since late-November, from \$9-10 through September and October.

Though we expect that the longs in WTI have also been unwound since December 18, the sharper swing to the short side in Brent sets the stage for a bigger rebound in the latter vis-a-vis WTI, especially if the turn in sentiment is led by the OPEC/non-OPEC cuts. The producers’ action since 2017 has propped up Brent more relative to WTI.

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Source: CME, ICE

OPEC+ CUTS: A QUESTION OF WHEN, NOT IF

After virtually being ignored by a market in freefall through the end of 2018, the December 7 decision by OPEC and its non-OPEC allies to rein in output by 1.2 million b/d starting January 1 started getting attention this month.

First, it was news agency surveys at the beginning of January showing a surprisingly sharp drop in OPEC output in December, compared with the 2018 peak in November.

Reuters, Bloomberg and Platts reported a month-on-month slump in output in the range of 460,000-630,000 b/d. OPEC kingpin Saudi Arabia alone slashed output by 400-420,000 b/d, according to the surveys, to around 10.6 million b/d.

Saudi Energy Ministry Khalid al-Falih had said on the day of the OPEC/non-OPEC deal in December that the Kingdom planned to reduce January production to 10.7 million b/d.

But the output could actually be much lower, as we expect the country to at least meet its new quota, if not drop below it, in the first month of implementation.

The new Saudi quota is 10.31 million b/d, a reduction of 322,000 b/d from October, according to the OPEC and non-OPEC member country allocations published by Platts, citing the OPEC secretariat as the source.

OPEC secretary-general Mohammed Barkindo had indicated the detailed quotas would be made public on December 21 in an attempt to bring transparency to the cuts, but that appears to have been delayed.

In the meantime, Saudi Energy Minister Khalid al-Falih has been keeping the media busy so far in January, emphasising the deep cuts in exports being made by the Kingdom, and offering precise numbers.

Saudi exports would fall to 7.2 million b/d in January from a high of 8 million b/d in November, and be trimmed by another 100,000 b/d in February, Al-Falih said on January 9. Data from independent tanker-tracking companies appears to corroborate the steep drop in Saudi exports in December, lending credence to the minister's promises.

In the meantime, Al-Falih remains confident that the OPEC/non-OPEC cuts will work, amid a strong global economy and demand fundamentals. "If a slowdown happens, it will be mild, shallow and short," the Saudi minister told the media in Abu Dhabi on January 14. "The fundamentals of oil demand are sufficiently strong and the oil market will not be impacted."

Meanwhile, on the supply side, OPEC remains "vigilant" and will respond appropriately if it sees any impact on demand, Al-Falih stressed.

As Brent and WTI chalked up nine straight sessions of gains over the year-end until January 10 and bounced back into the bull market, earlier talk of a possible OPEC/non-OPEC emergency meeting to look at deepening the production curbs receded.

The next ministerial meeting remains on schedule for April. The dates, which had not been announced at the December meeting (we understand the participation of 24 countries presents more complicated logistics than when it used to be just OPEC), have been set for April 17-18. The meeting will decide whether to renew the 1.2 million b/d of cuts beyond their expiry on June 30.

The OPEC/non-OPEC Joint Ministerial Monitoring Committee will convene in the Azerbaijan capital of Baku over March 17-18, to take stock of compliance and the market situation and come up with a recommended action for the ministers the following month.

RUSSIA HITS A NEW HIGH BUT AL-FALIH KEEPS HIS COOL

Russia reached a new record high of 48.44 million mt of crude pumped in December, or an average of 11.45 million b/d, according to data from the country’s energy ministry.

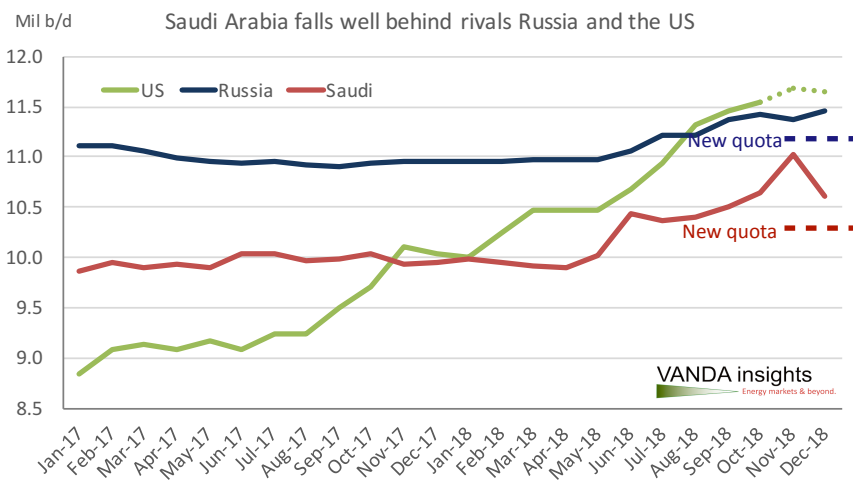
The hike put Russia farther away from its new quota of 11.19 million b/d under the OPEC/non-OPEC cuts. That is a drop of 230,000 b/d from its October output, the baseline used for the December agreement.

Moscow had earlier said it would be paring down to the new level gradually over the first quarter, owing to the harsh winter weather conditions at its oil fields.

Russia would curtail its output by 50-60,000 b/d in January in keeping with its promised reduction schedule, Energy Minister Alexander Novak said on January 11.

For now, Saudi Arabia’s Al-Falih is keeping his cool. Russia was moving “slower than I’d like” on its cuts, he acknowledged on January 11, but added, “I am sure...they will catch up.”

The Kingdom, having accepted a much larger cut than Russia under the December 7 deal and likely to curb its output more than required in a bid to help the group reach its overall compliance levels quickly, is now set to fall to a distant third place (see adjacent chart) among the world’s top three crude producers.



Source: US production from the EIA; November and December (dotted line) figures imputed from actual weekly output data. Saudi Arabia’s figures are as per “secondary sources” cited in OPEC’s monthly oil market reports. Russian data from the country’s energy ministry.

Meanwhile, there are other unavoidable and unplanned production crimps that are being ignored while the market remains preoccupied with demand growth fears, which will likely come into sharper focus as the OPEC/non-OPEC cuts start doing their work.

Libya’s giant Sharara oil field, which pumps about 315,000 b/d of crude, has been shut since December 9, with state-owned National Oil Company declaring a force majeure on crude exports from the Zawiya terminal.

Facilities at the field have been seized by tribesmen, armed protestors and state guards. With no restart date in sight for Sharara, Libyan production is likely to remain well below the recent months’ high of just above 1 million b/d.

In Canada, the government of the oil sands province of Alberta has mandated 325,000 b/d of production cuts since January 1, in the face of high stockpiles and plummeting prices for local crude due to severe pipeline and rail transportation bottlenecks.

Though the discount for heavy Canadian crude to NYMEX WTI has shrunk dramatically in the first two weeks of January, the government has rolled over the cuts to February.

Supply from OPEC members Venezuela and Iran is also expected to drop, though the countries have been exempted from reducing output.

Venezuelan production had plummeted to around 1.2 million b/d by the end of 2018, about 450,000 b/d lower than a year ago. State-owned oil company PDVSA saw 350,000 b/d of production disappear through 2017, the upstream sector a casualty of mismanagement and a crippling lack of funds amid the worst economic crisis in the country's history. Output could slip below 1 million b/d this year.

Iranian production has been hit hard by US sanctions against its oil and shipping sectors, re-imposed on November 5. Crude and condensate exports had slumped to around 1.6 million b/d in December, from a high of 3.2 million b/d in May 2018, according to Reuters estimates.

US TALKS TOUGH ON IRAN: DEJA VU OR CAUSE FOR WORRY?

Meanwhile, the US has renewed its threat to force Iranian oil exports down to zero. "We are in a position now, we think, with a much better-supplied oil market, to accelerate the path to zero," US Special Representative on Iran, Brian Hook, told CNBC on January 12.

However, Hook was mum on the specifics of the renewal of the waivers that Washington granted eight countries last November to enable them to continue buying crude from Iran.

The six-month waivers, granted on condition that the importers reduce their purchase volumes, were given to China, India, Japan, South Korea, Taiwan, Turkey, Italy and Greece. However, only five of those countries are currently importing Iranian oil, Hook said, claiming that Iran's total exports had dropped from a 2018 high of 2.7 million b/d to less than 1 million b/d.

The waivers are due to expire in early May.

Hook's tough talk did not spur an immediate spike in crude prices as similar statements had done in the aftermath of US President Donald Trump announcing a withdrawal from the multilateral Iran nuclear deal and a reimposition of sanctions against the Islamic Republic on May 8 last year. First, sentiment in the crude market is still downbeat on account of the economic gloom-and-doom and demand concerns. Second, market bulls are likely to be more cautious after being wrong-footed on this issue last summer.

When US granted sanction waivers that contrasted in their generosity with the scorched-earth approach Washington had promised against Tehran, it helped swing the world back into oversupply. OPEC and its allies, who had gone full-throttle from June at Trump's request to alleviate market tightness, were also caught off-guard.

Is it just sabre-rattling on Washington's part this time or will it follow through with more meagre waivers after May, especially if the market remains well-supplied? We'll need to keep a close eye on this one.

The sanctions are only a means to an end — Trump could feel the pressure to show progress on the list of demands he has made against Tehran, especially with the approach of 2020 presidential elections appear. That could entail turning up the heat on Iran, and oil is the only tool available to the US to do that.