

# Commodities Strategy

## Oil Enters Either/Or Territory—Near-Term Oil Prices on a Rebound

- **When Citi revised down its forecast for Brent crude oil prices through 2014 and 2015 (from \$105/bbl to \$97.5) a month ago, we noted that that market risk was to the downside.** (See [Commodities 4Q'14: Risk Suppression – Fundamentals Smother Geopolitics](#).) Subsequently, global benchmark Brent crude fell through \$100 and \$90 levels without pausing and after bottoming in the low \$80s staged a bit of a comeback, which we expect to continue over the next couple of months. **We are now again reducing our outlook for Brent to \$92 for 4Q'14 and 1Q'15 and for WTI to \$83 and \$84, respectively.**
- **Undoubtedly, this year's persistent market weakness begins on the demand side: a sputtering global economy means significantly lower petroleum product demand growth.** Reduced prospects for the Chinese economy have weighed especially heavily on the recent oil price slide. The IEA now sees global incremental supply growing a mere 700-k b/d. In 2013, Citi had forecast global GDP growth of 3.2% (exchange rate basis) for this year, consistent with petroleum product demand growth of around 1.2-m b/d. Now after 3Q, global oil demand appears to be growing by only 700-k b/d, also consistent with global GDP at 2.8% (Citi's current estimate for 2014). If global oil demand had grown an incremental 500-k b/d as expected, oil prices would have softened but nothing like the way they actually did. A rebound in global growth would help tighten oil markets.
- **The supply side has also contributed significantly, both from OPEC and non-OPEC sources.** If Libya had not seen a 500- to 700-k b/d rise in output recently, current OPEC production would have more closely matched global demand requirements for the year and Brent would probably be trading at least \$10 a barrel higher.
- **Lower prices have placed pressure on Saudi Arabia and other OPEC producers to reduce production.** But the Saudis have two problems: they do not wish to unilaterally reduce production and market share for fear that they will be on an unending spiral down, making a contribution that others don't match. They also recognize that just as in 2011 in response to the Libyan disruption when they increased production barrel for barrel with the Libyan loss and they couldn't stop a \$25 increase in Brent prices, so now if they reduce production of heavier sourer crudes, they won't impact Brent supply-demand balances. What's required is a cut as well from OPEC's light crude producers in West and North Africa. The Kingdom might also want to test the price at which US oil production growth falters and might have some geopolitical objectives vis-à-vis Russia and Iran, concerned largely with Middle East events. (See last week's [Energy Weekly](#) and also [Energy Weekly: the Saudis Could Win A Price War with US Shale](#).)

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- **Two years ago Citi published a long-range projection, indicating that the then-perceived floor price of Brent at \$90 a barrel was likely to become a ceiling price within the second half of this decade.** Short-term factors intervened and brought prices down – at least temporarily – faster than we had then projected, largely due to macro global conditions. (See [Zeroing In On Long-Term Oil Prices](#))
- **Citi has also persistently noted that the more oil supply there is in disruption for domestic and international political reasons, the more likely some of it could come back on line and bring prices down quickly.** When the first Libyan disruption occurred in February 2011, only some 400-k b/d of oil was then offline. Since then, the level of disrupted supply has risen at times to over 3.5-m b/d, including sanctioned Iranian output. The surge in Libyan production last month from 200-k b/d to over 900-k b/d before falling back a bit is living proof that this bearish overhang can persist even as governance problems in petroleum economies have become a significant bullish feature of markets.
- **US production growth has been particularly impactful on Brent prices.** The US supply revolution consists of light, sweet crude, as does the production of OPEC members Algeria and Libya in North Africa, Nigeria and Angola in West Africa. When Libyan production was cut by 1.5-m b/d in 2011, it represented 11% of light crude supply, and refiners buying it couldn't process adequately the 1.5-m b/d of increased production of other quality crudes from Saudi Arabia and the GCC. Since then, US oil production has increased by 3-m b/d of light sweet crude oil, Nigerian and Algerian flows are lower, and total light sweet crude by end-2013 was 14.65-m b/d, creating a glut of this kind of oil in the Atlantic Basin.
- **As US production growth has increased, North America has rejected around 2.4-m b/d of similar crude supply it used to import from Europe, the Mediterranean, and West Africa.** The result of the glut of light crude in the Atlantic Basin has pushed Brent crude from being a tight to a relatively soft market, as seen in the Brent forward curve moving from tightness in the front (backwardation) to softness in the front (contango) with prompt prices lower than forward curve prices. And now West African crude differentials have to price ever cheaper to clear loading schedules with both Nigerian and Angolan crude differentials touching multi-year lows in 3Q'14. November loadings in Angola and particularly Nigeria have struggled to clear, but refinery demand in Europe and Asia (the key markets for West African producers) is firming. But with barrels persistently struggling to clear and prices moving to a lower base, West African crudes should continue to be a dampener on light sweet grades in the region. This will weigh on light sweet North Sea marker Brent, which is in direct competition with the West African grades. (See also [Energy Weekly: The Atlantic Basin Light Sweet Surplus May Be Here to Stay](#).)
- **Saudi Arabia's recent staking out of a market share strategy has been another trigger of lower prices:** since early Sept, the Saudis indicated they wouldn't cut production much. Ironically, if they let production and exports slide by 500-k b/d it would go a long way to balance markets and raise Brent back toward if not over \$100/bbl, which is why projecting oil prices now is so difficult.
- **Other OPEC countries on the other hand believe that Saudi Arabia and the GCC countries should cut on their own since they increased output and market share when other countries – notably Libya and Iran recently, Iraq and Venezuela at other times – were forced to produce less than they otherwise might have.** As in 1998, when OPEC last agreed to pro-ration production, it will take a great deal of pain to forge an OPEC agreement. Last

year OPEC (excluding Iran) earned \$826 billion, down 7% from 2012 when the group (ex-Iran) earned \$888 billion. Per capita income was \$2,530. A \$25 drop in Brent prices (roughly 23%), which would happen if Brent prices stabilized at today's level, would drop revenue by \$190 billion and per capita income by over \$580 at a time of governance problems and increased pressure to spend. Is that enough pain to induce an OPEC shared cut? Or will OPEC postpone a decision?

- **The stronger US dollar in Q3 and the recent macro sell-off added to the slide in oil prices, but fundamental factors weigh more heavily.** Before stabilizing last week, crude oil prices fell more than twice to three times more rapidly than other commodities and at this point a continued macro sell-off is unlikely to bring crude oil prices much lower, as their recent rise looks sustainable for seasonal and fundamental reasons.
- **Oil market fundamentals should be more constructive over the next 6-8 weeks even in advance of OPEC's November 27th Vienna meeting.** Global refinery demand for crude oil fell seasonally after end-August by about 2.7-m b/d as refiners went into fall maintenance to repair problems emerging in Q3. Refinery maintenance peaks in mid-October, and between now and close to Christmas refinery demand for crude should rise by 3-m b/d, tightening balances.
- **Financial flows have also impacted prompt oil prices and we expect their influence also to ebb around now.** While passive investment in commodity index funds rose especially in 1Q'14, they have fallen since May, with an accelerated exit in Q3 and Q4, putting downward pressures on prompt prices. With AUM in passive funds now at levels similar to where they were pre-commodity super-cycle in 2003, we expect limited further pressures from this end. Additionally, investors moved rapidly from being net long to being net short Brent and WTI crude, also putting pressure on prices in a move that looks like it is ending. Finally, producer hedging at \$85 and \$80 strike prices required banks and other market makers to cover their positions (via delta hedging) at strike price levels that were broken through by prompt and December contracts, accelerating the downward move, and that too seems like it is coming to an end. (See [Commodities Flows: Crude Awakening](#).)
- **Our projections for Brent crude oil prices over this and the next quarter point to an upward bounce close to our more recent forecasts of Brent trading in the mid-\$90 range for the winter.** If that happens, OPEC is likely not to agree to a production cut when the producer group meets toward the end of November. If Saudi Arabia meanwhile lets production slide toward 9-m b/d, the market would look better balanced going into 2015.
- **But that would just postpone the problem of balancing the market by 2Q, and therefore our judgment remains biased to the down side for 2015.** If we have a 60% confidence in our current projection of Brent averaging \$92 for 4Q14 and 1Q15, and of WTI at \$83 this quarter and \$84 next, we believe that should mean the Saudis continue to pump ~9.5-m b/d and should Libya continue to rebound its production, prices would be a good \$5 lower, notwithstanding the seasonal impacts we have pointed out. Pressure would build for an OPEC cut by 2Q. On the other hand, a credible OPEC cut at the November 27<sup>th</sup> meeting could see Brent averaging well above \$95 and perhaps even topping \$100, especially if abetted by a cold winter. And pressure would also be off US shale producers for reining in capex any time soon. (See [Peering Over the Oil Cliff](#) and [The Abyss Stares Back](#) for an in-depth look at US shale costs.)

## Appendix A-1

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