جدوى للإستثمار
Jadwa Investment

November 2017

Quarterly Oil Market Update

OPEC's big decision

Summary

- In its latest monthly oil report, OPEC raised global oil demand forecasts for the third consecutive month, underlining the bullish tone towards oil prices in recent months.

- These revisions combined with geopolitical developments in Iraq helped push Brent oil prices up 6 percent quarter-on-quarter in Q3 2017, to an average of $52 per barrel (pb).

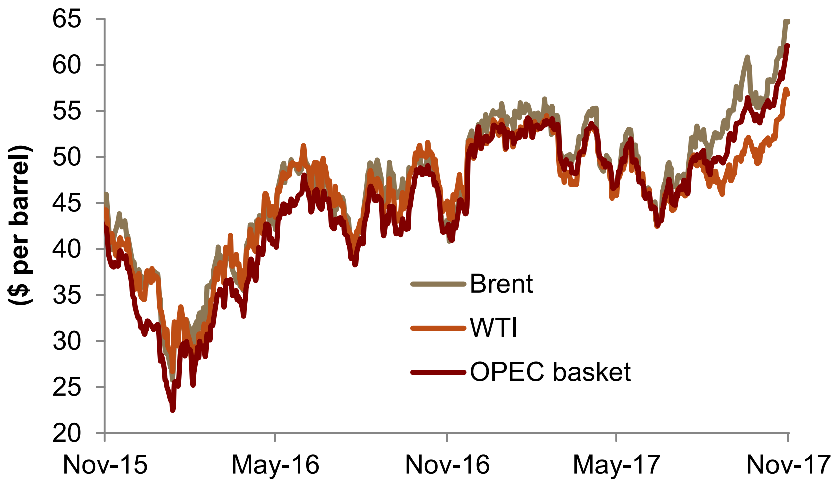
- More recently, rising expectations related to OPEC rolling over cuts in an upcoming meeting and regional geopolitical tensions have pushed Brent crude oil prices back above $60 pb. Prices are likely to remain elevated in the near term due to continued regional geopolitical tensions.

- Despite this, risks to oil prices are still apparent, with a lack of an agreement over cuts in OPEC's upcoming meeting could see prices falling back to below $60 pb.

- Looking into 2018, the outlook for prices hinges on what OPEC and non-OPEC countries, engaged in production cuts, choose to do after the agreement to cut production expires in March 2018.

- Meanwhile, as a result of Saudi Arabia's highly disciplined observance to OPEC's cut agreement in 2017, and taking into account the year-to-date Saudi crude oil output, we have revised our full year crude oil production forecast down to 10 mbpd for 2017 and to 10.1 for 2018, from 10.2 mbpd for both years previously.

Figure 1: Improving oil demand, optimism over extension in OPEC cuts and geopolitics have pushed oil prices up recently



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Brent oil prices were up 6 percent quarter-on-quarter in Q3 2017, to an average of $52 per barrel (pb).

Overview

Upward projections in global oil demand and geopolitical developments helped push Brent oil prices up 6 percent quarter-on-quarter in Q3 2017, to an average of $52 per barrel (pb). In its latest monthly oil report, OPEC raised global oil demand up for the third consecutive month, underlining the bullish tone towards oil prices in recent months. Back in January 2017, OPEC's monthly oil report forecasted global oil demand would rise by around 1.16 million barrels per day (mbpd) year-on-year in 2017, but this was raised to 1.45 mbpd in its October report (Figure 2). Three countries alone are expected to contribute to almost half of the yearly rise in demand in 2017, with China contributing 26 percent, US 11 percent and India 10 percent year-on-year. In addition to stronger demand, regional geopolitical developments have also pushed up Brent oil prices.

Growing Optimism Over Global Oil Demand

US commercial oil and gasoline stocks have been consistently falling since reaching record levels during Q2 2017…

In the **US** (21 percent of global oil demand), data shows that commercial oil and gasoline stocks have been consistently falling since reaching record levels during Q2 2017. Whilst declines in stocks were related to a seasonal summer pattern, gasoline stocks in particular were affected by a hurricane. Around the end of August, parts of the US were hit by hurricane Harvey which led to a number of US refineries being temporarily closed. These closures, in turn, resulted in a decline in supply petroleum products (including gasoline) and therefore led to a faster depletion of gasoline stocks during Q3 2017 (Figure 3). Looking ahead, according to latest US Energy Information Administration's (EIA) forecasts, gasoline consumption (comprising 46 percent of total US liquid consumption) is expected to rise by 0.7 percent in Q4 2017, and by 0.5 percent in 2018, compared to 1.5 percent in 2016. The risk is that lower than previously forecasted gasoline demand could lead to a rebound in both oil and gasoline stocks resulting in further pressure on WTI oil prices and, in turn, lead to higher levels of US oil/gasoline exports (see Box 1 in supply section).

...although lower than previously forecasted gasoline demand could lead to a rebound in stocks.

European oil demand (15 percent of global oil demand) was effectively flat in Q3 2017 year-on-year. Despite a pick up in economic activity in most major European countries, structural factors such as high taxation polices on oil use and continued fuel substitution remains a dampener on oil demand. Meanwhile, there

Figure 2: OPEC global oil demand forecasts for 2017 revised upwards in recent months

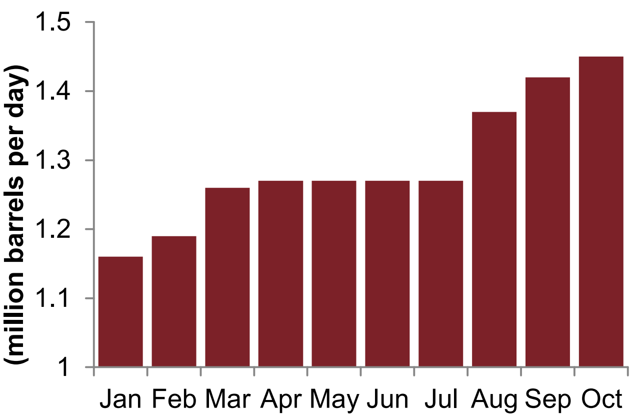
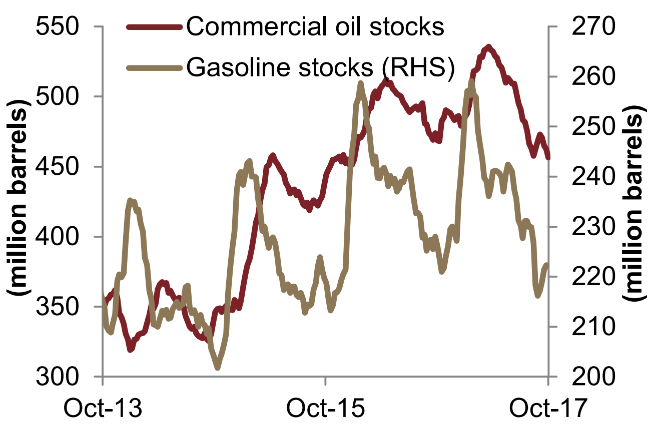


Figure 3: US commercial oil and gasoline stocks have retreated from record levels



UK economic activity has slowed markedly, although the impact on crude oil demand should not be huge.

seems to have been minimal progress in Brexit negotiations so far, but the UK's economy has slowed markedly, with economic growth at around 0.3 percent year-to-date. That said, the impact on crude oil demand should not be huge. The UK only consumes around 1.6 mbpd, of which 0.7 mbpd is imported, with oil demand growth being flat for more than a decade. Overall therefore, European oil demand should continue to show minimal growth in Q4 2017 and in 2018, as a whole.

Year-to-September Chinese oil imports were up 9 percent year-on-year…

...and higher refinery intake, oil for storage purposes, and lower domestic oil production will support oil import growth in 2018.

China (12 percent of global oil demand) crude oil imports, whilst slowing slightly quarter-on-quarter during Q3 2017, are still close to record levels. Chinese oil imports averaged 8.3 mbpd in Q3 2017 (Figure 4), up 9 percent year-on-year, boosted by addition crude oil for China National Offshore Oil Corp's new refinery and higher demand from a fleet of independent refiners. In fact, year-to-September oil imports were up 12 percent year-on-year, although Q4 2017 is likely to see lower level of imports due to a domestic surplus of refined fuel. Looking ahead into 2018, higher refinery intake, with major refiners having applied for larger crude oil import quotas, additional crude oil for strategic storage purposes, and continued lower domestic crude oil production, which was down 2.9 percent in September year-on-year, will all support Chinese oil import growth in 2018.

India will see continued rises in imports during Q4 2017, with oil consumption expected to grow by 4 percent year-on-year in 2018.

Over the longer term, the IEA sees Indian oil demand rising to 10 mbpd by 2040, compared to around 4 mbpd currently.

Indian oil imports (5 percent of global oil demand) were up by 276 thousand barrels per day (tbpd) or 7.2 percent year-on-year in Q3 2017 (Figure 5). This growth was seen as a result of a rise in refined product consumption on the back of the festival season and receding monsoon rains. India is expected to see continued rise in imports during Q4 2017, with overall oil consumption expected to rise by 4 percent year-on-year in 2018. Moreover, India's long term prospects for oil demand are even brighter, according to a recent report by the International Energy Agency (IEA). The IEA sees Indian oil demand rising to 10 mbpd by 2040, compared to around 4 mbpd currently, with the main driver of this demand growth being a five fold increase in GDP. Given that India currently imports over 80 percent of its oil and, to date, does not have the means to produce large quantities of oil domestically, the country is expected to be one of the key growth markets for oil suppliers in the years ahead.

Figure 4: China's crude oil imports

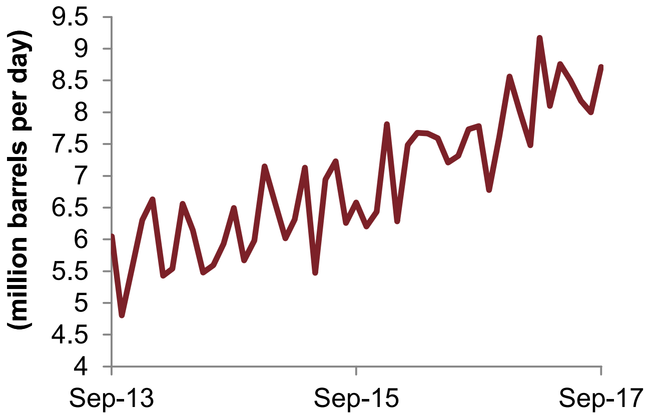
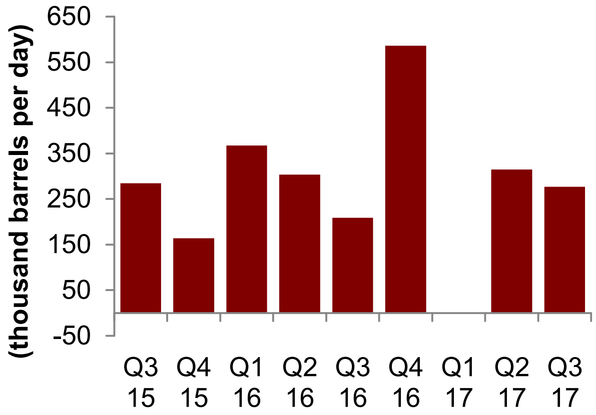


Figure 5: Indian crude oil imports
(year-on-year change)



Japanese crude oil demand is expected to stay in the negative territory in both Q4 2017 and in 2018.

Japanese (3 percent of global oil demand) crude oil imports have been declining consistently, year-on-year, in the last two years due to slower economic growth, rising fuel efficiency, and cuts in refining capacity. Accordingly, year-to-September oil imports were down 3 percent, year-on-year. The Japanese economy is not expected to improve massively in the near future and further closure of refinery capacity will keep crude oil demand in the negative territory in both Q4 2017 and in 2018 as well, with further downward pressure on demand if more nuclear reactors are restarted.

Provisional Q3 2017 data shows Saudi Arabia's domestic demand being down by 7.5 percent year-on-year.

Provisional Q3 2017 data shows **Saudi Arabia's** domestic demand (3 percent of global oil demand) being down by 7.5 percent year-on-year. A notable fall in consumption was seen in diesel, which declined by 19 percent year-on-year, perhaps reflecting a substitution effect and/or subdued activity in the transportation and construction sectors. Despite a fall in direct crude oil burn, which was down 8 percent year-on-year (Figure 6), other oil products consumption rose by 17 percent. We see this rise coming about from higher usage of naphtha. During Q3 2017, Petro Rabigh Phase II and Sadara Chemical complex became fully operational, with both these petrochemical complexes using naphtha as feedstock. Meanwhile, year-on-year consumption was recorded for gasoline and, more notably, fuel oil, with its use rising due to a substitution effect for more expensive products, such as diesel or crude oil (Figure 7). Going forward, slower growth in the economy and the continued effects of higher year-on-year gas output should keep domestic consumption rises to a minimum. That said, an upside risk to demand exists since the government has yet to raise household electricity prices to a reference price, as expected in mid-2017.

Other oil products consumption rose by 17 percent year-on-year, we see this rise coming about from higher usage of naphtha.

Oil Supply

OPEC's Q3 2017 total output equates to 1.1 mpbd less than the organization's October 2016 output.

OPEC data shows that crude oil production from its members averaged 32.6 mbpd in Q3 2017, up 1.4 percent quarter-on-quarter but down 2.1 percent year-on-year. Overall, Q3 2017 total output equates to 1.1 mpbd less than the organization's October 2016 output, the reference point for agreed cuts, therefore exhibiting acceptable levels of compliance. More recently, increasing optimism related to a possible rolling-over of OPEC cuts in an upcoming OPEC meeting have helped propel Brent crude oil prices back above $60 pb. It seems that cuts by OPEC and certain non-OPEC members have helped push daily global oil balances into deficit for a

Increasing optimism related to rolling

Figure 6: Saudi Arabian crude oil burn

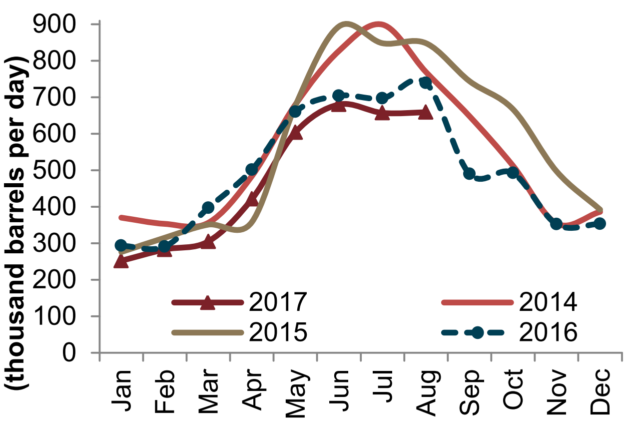
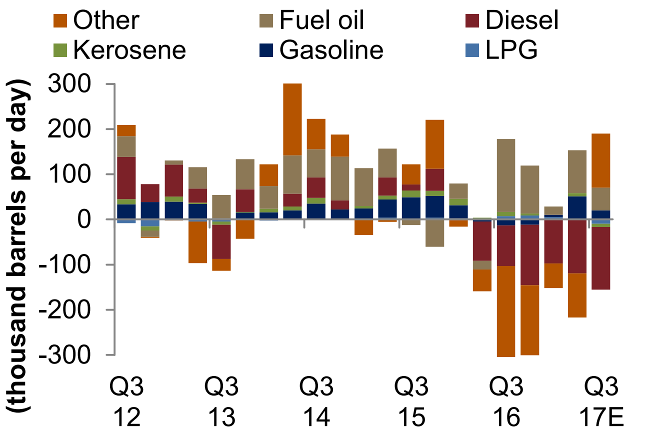


Figure 7: Saudi Arabian refined product demand
(year-on-year change)



-over of OPEC cuts have propelled Brent crude oil prices back above $60 pb.

second consecutive quarter and reduced commercial crude stocks towards the five year average (see oil price section below). Going forward, despite recent market optimism, uncertainly still remains over what OPEC and non-OPEC countries will do after the agreement expires in March 2018. Currently, there seems no real consensus to extend cuts, although Saudi Arabia along with the UAE have stated that they are ready to support an extension (Box 2). Russia, another key player in the agreement, which has so far followed through on its proposed cuts, has not made any definitive statements for or against the agreement. The Russian energy minister did, however, state there was a preference for oil prices not to break above $60 pb, since higher prices would likely lead to ruble appreciation, which would not benefit Russian exporters and hence negatively impact the economy.

Despite recent market optimism, uncertainly still remains over agreement to an extension.

Saudi Arabia and the UAE have supported an extension in cuts…

...Russia, on the other hand, has not made any definitive statements about extensions.

Holding all other factors constant, and assuming both OPEC and non-OPEC countries engaged in cuts revert to their October 2016 production levels after the deal expires, a global oil balance surplus of 1.3 mbpd would be expected for the whole of 2018 (Figure 8). Such a situation would be worse than the period of intense OPEC competition and global oil over-supply seen during H2 2015 and H1 2016, where Brent oil prices averaged just above $40 pb.

Latest forecasts from the US based EIA show sizable rises in US crude oil production in both 2017 and 2018…

Meanwhile, latest forecasts from the US based EIA show sizable rises in US crude oil production in both 2017 and 2018 (Figure 9). US oil production is expected to rise by 10 percent year-on-year in 2017 (to 9.8 mbpd), and 3.3 percent in 2018 (to 10.1 mbpd), much slower than average of 14 percent between 2012-15, but a rebound after decline in yearly production in 2016 (at 8.8 mbpd). The rebound, seen since the start of 2017, has come entirely from unconventional (or shale) oil sources and has been encouraged by a recovery in oil prices following an agreement between OPEC and certain non-OPEC countries. After hitting peak production back in February 2015 (at 5.5 mbpd), US shale oil began to decline, as persistent global over supply, helped by record OPEC output, pushed prices downwards. After OPEC cuts and a subsequent oil price increase, from November 2016 onwards, there seems to have been an influx of renewed investment among US shale producers. As a result, US shale oil is expected to achieve an all-time record high of 6 mbpd at the end of 2018.

...with US shale oil expected to reach an all-time record high output of 6 mbpd at the end of 2018.

Figure 8: Global oil balances could slip into surpluses if OPEC does not roll over cuts in 2018

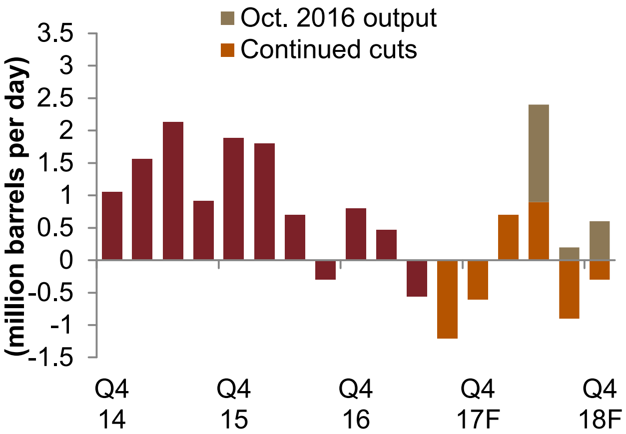
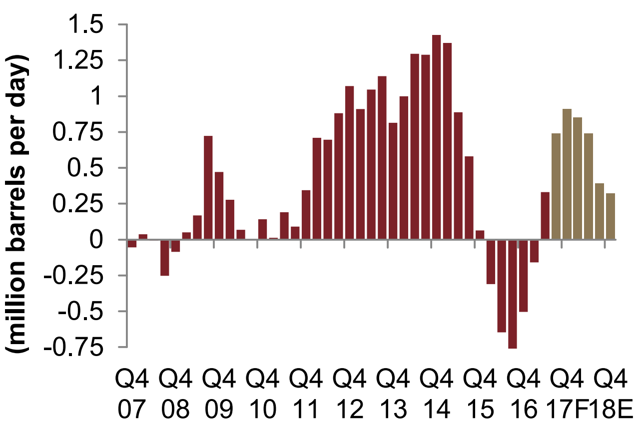


Figure 9: US crude oil production (year-on-year change)



However, a number of factors are expected to push up shale oil breakeven prices for first time in five years...

...including higher borrowing costs and constrained capacity…

...although breakeven prices are still expected to remain 50 percent lower than their peak in 2012.

However, a number of factors are expected to push up breakeven prices of shale oil for first time in five years in 2017, to an average of $36.5 pb, although they are still 50 percent lower than their peak in 2012 ($73 pb).The reason for higher breakeven prices is due to shale oil producers facing higher borrowing costs and constrained capacity, and therefore inflated operating costs. Another reason relates to many US shale oil companies being able to gain access to cheap finance in the past, due to record low US interest rates, all of which played an important role in sustaining US shale oil production throughout the high oil price period of 2010-2014. Going forward, however, low interest rates are not expected to persist with the US Federal Reserve (Fed) having already hiked rates three times in the last two years. In addition, as oil prices dropped to multi-year lows, many shale oil producers pushed oilfield service companies to accept lower priced contracts, which service companies agreed to since they needed cash flow to cover their own expenses. The expiration of such contracts over the coming year should, in turn, allow prices for higher demanded services related to drilling and operating wells to rise (*for more on this please see our report Shale Oil 2.0 published September 2017*).

OPEC could see more competition from the US, especially so if US oil output expands as forecasted…

...and OPEC agrees to extends its production cuts, and, with it, curtails supply to some customers.

Box 1: US Crude Oil Exports

The US exported 2.13 mbpd of crude oil at the end of October, the first time ever its exports exceeded the 2 million mark. India, a long-term purchaser of OPEC crude oil, received its first ever shipment from the US during the month. Currently, the US oil benchmark, WTI, is being traded at a discount of around $4 pb to OPEC's basket of fourteen crudes, which makes it slightly more attractive to some overseas buyers. Going forward, OPEC, and indeed Russia, could see more competition in their traditional markets from the US, especially so if US oil output expands as forecasted, and OPEC agrees to extends its production cut deal in March 2018, and, with it, curtails some supply to its customers.

Oil Price Outlook

OPEC cuts have helped push daily global oil balances into deficit and reduced commercial crude stocks…

So far, OPEC and certain non-OPEC members' cuts have helped push daily global oil balances into deficit for a second consecutive quarter (Figure 10) and reduced commercial crude stocks towards the five year average (Figure 11). Aside from some uplift from geopolitical events, further optimism over prices has been provided

Figure 10: Consecutive deficits in daily global oil balances for the first time in three years.

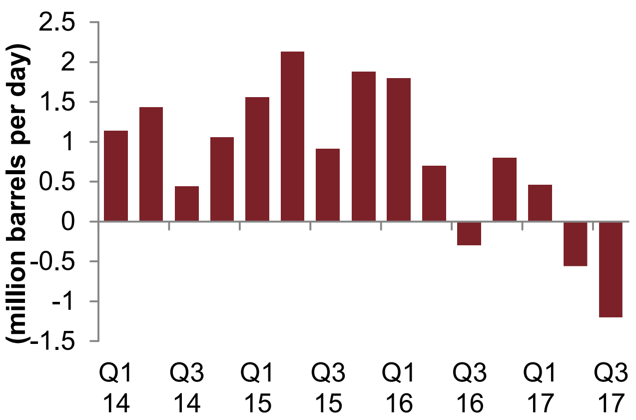
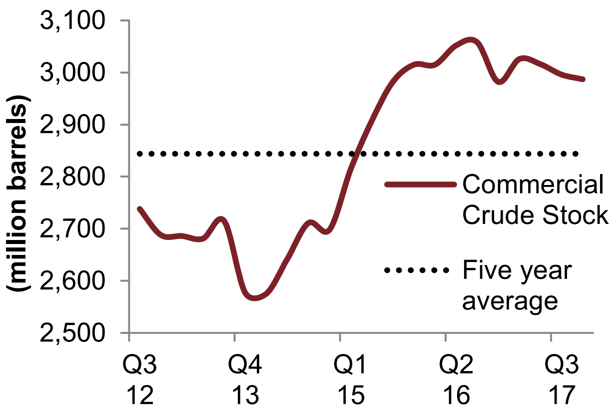


Figure 11: OECD commercial crude stocks dropping closer to five year average



...but year-to-date Brent oil still averages $52 pb, with risks to the downside still apparent.

by expectations of OPEC rolling over cuts in an upcoming OPEC meeting. As a result, Brent crude oil prices have shot back up to above $60 pb recently. Although prices are likely to remain elevated in the near term due to continued regional geopolitical tensions, risks to downside are apparent. Besides the expected recovery in US oil production, a lack of consensus over cuts in OPEC's upcoming meeting could see prices falling back to around $55 pb. Bearing this in mind, we have revised down our Brent oil forecast to $52 pb for full year 2017, from $55 pb previously. Looking into 2018, the outlook for prices hinges on what OPEC and non-OPEC countries decide to do after production cuts expire in March 2018. Nevertheless, we have revised our full year 2018 Brent oil forecast down to $56 pb from $61 pb previously.

As such, we have revised down our Brent oil forecast to $52 pb for full year 2017, and $56 pb in 2018 from $55 pb and $61 pb previously.

Box 2: Saudi Crude Oil Production

Due to highly disciplined observance to cuts by Saudi Arabia…

Saudi Arabia has been one of the most stringent observers to OPEC cuts, with year-to-September secondary sources production at an average of 9.9 mbpd. This corresponds to an average cut of 614 tbpd so far, which is higher than the cut of 486 tbpd initially proposed by OPEC under the current agreement. As result of this highly disciplined observance to the agreement, and taking into account the year-to-date Saudi crude oil output, we have revised our full year crude oil production forecast down to 10 mbpd for 2017 and 10.1 for 2018, from 10.2 mbpd for both years previously.

...we have revised our full year crude oil production forecast down to 10 mbpd for 2017...

...and 10.1 for 2018, from 10.2 mbpd for both years previously.

The recently released Q2 2017 GDP data from the General Authority for Statistics (GaStat) showed overall GDP declining by 1 percent in Q2 2017, compared to -0.5 percent in Q1 2017 and a rise of 0.9 percent in Q2 2016. As was the case in Q1 2017, GDP was dragged down by a sizable decline in the oil sector. Bearing in mind the continued adherence by Saudi Arabia to agreed OPEC cuts going forward, and that Saudi crude oil production averaged 10.6 mbpd in H2 2016, roughly 300 thpd higher than the H1 2016 average, an ever sharper decline in oil sector GDP is likely to occur in H2 2017 (Figure 12). As a result, we now expect oil sector GDP to decline by 2.8 percent for the whole of 2017, compared to -1.2 percent previously. On the non-oil side, whilst we do expect to see some improvement across most sectors during H2 2017, in line with an expected rise in government capital spending, we have revised our non-oil sector growth to 0.7 percent in 2017, compared to 1 percent previously. Overall, therefore, we see the Kingdom's GDP declining by 0.9 percent in 2017, compared to growth of 0.1 percent in our previous forecast (Figure 13).

As a result, we now expect oil sector GDP to decline by 2.8 percent for the whole of 2017, compared to -1.2 percent previously…

...with overall GDP declining by 0.9 percent in 2017, compared to growth of 0.1 previously.

Figure 12: Oil sector GDP and crude oil production (year-on-year change)

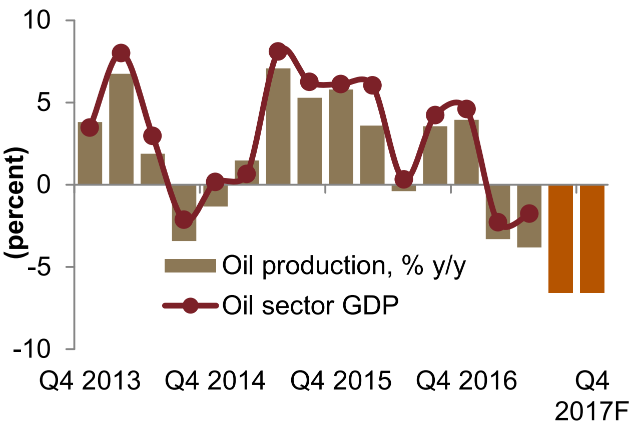
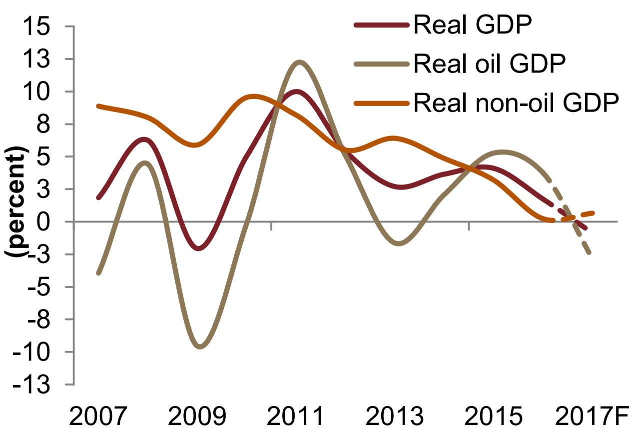


Figure 13: Real GDP growth (year-on-year change)



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