OBSERVATION

TD Economics

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AS OIL PRICES SCRAPE THE BOTTOM OF THE BARREL, WHAT LIES AHEAD?

Highlights

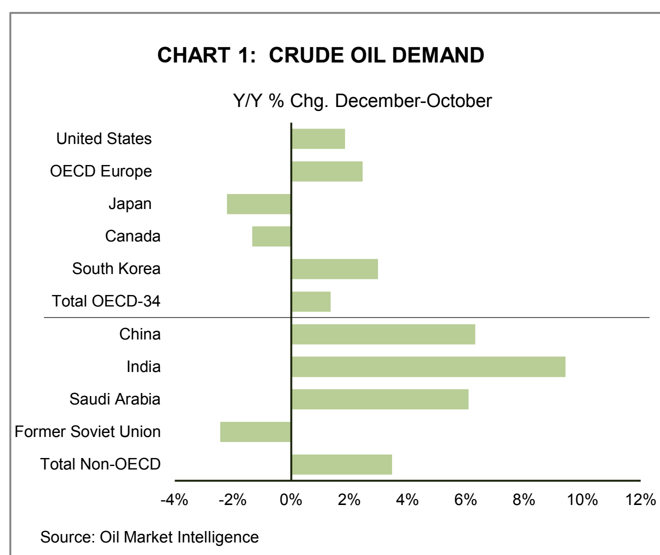
- Crude oil prices have fallen to US$35 per barrel, as the fight for market share has led to a massive global supply glut. With OPEC's latest decision to maintain its stance, production will continue to outpace demand in the near term, keeping prices below US$45 per barrel through mid-2016.
- Thereafter, a weaker U.S. dollar, some improvement in emerging markets and signs of a tightening in market conditions – driven largely by lower non-OPEC production – should help to lift oil prices above US$50 per barrel. However, given the massive amount of inventories that will need to be worked down, the upside for prices will be limited.

Crude oil prices remain in the doldrums, with the WTI benchmark hovering around the US$35 per barrel mark. While demand was soft when prices initially began to slide in mid-2014, the prolonged period of weakness has largely been a supply-side story, with producers fighting for market share. In fact, prices have remained weaker for much longer than most would have anticipated. This highlights the difference between a supply side shock and a demand side shock akin to that in 2008-09, when prices plunged but then bounced back rather strongly.

OPEC's latest decision to maintain elevated output levels suggests that the cartel is unlikely to abandon its strategy and embark on production cuts anytime soon. If this is the case, what will be the catalyst for a recovery in market sentiment and prices – even a modest one? In our view, market participants will be looking for three major pieces to fall into place: a meaningful tightening in market conditions, some signs of improvement in emerging markets, and a pullback in the U.S. dollar. While the latter could emerge as early as the first quarter of next year, the former two are unlikely to happen before the second half of 2016. Until then, prices are likely to remain in the US$35-45 per barrel range, and vulnerable to bouts of further downward pressure.

World remains awash in oil

Low oil prices have been a boon for consumers, with consumption rising in several key regions this year (Chart 1). China, India and the U.S. in particular have given global demand a boost. Still, the 2.4% y/y average growth rate for demand recorded since OPEC's big decision a year ago (not to be the swing producer) pales in comparison to the 4.0% y/y average pace of production growth (Chart 2). Over the last few months, the world has been producing roughly 1.5-2 million barrels per day in excess of demand. What's more, the rise in demand is likely to moderate over the next two years. After a year of low oil prices, the positive impact on demand will diminish. Ultimately, it will largely be up to the supply side to bring the market back into balance.



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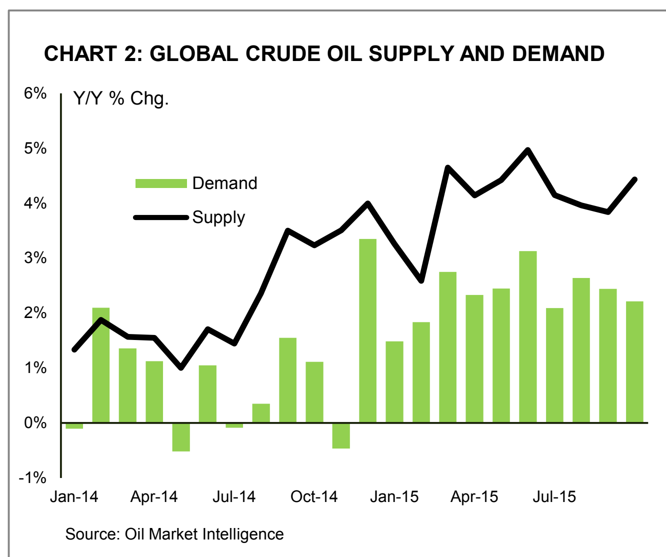
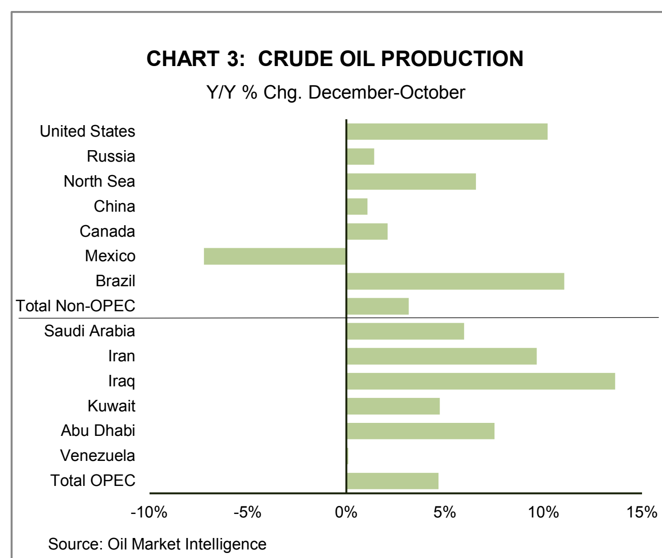


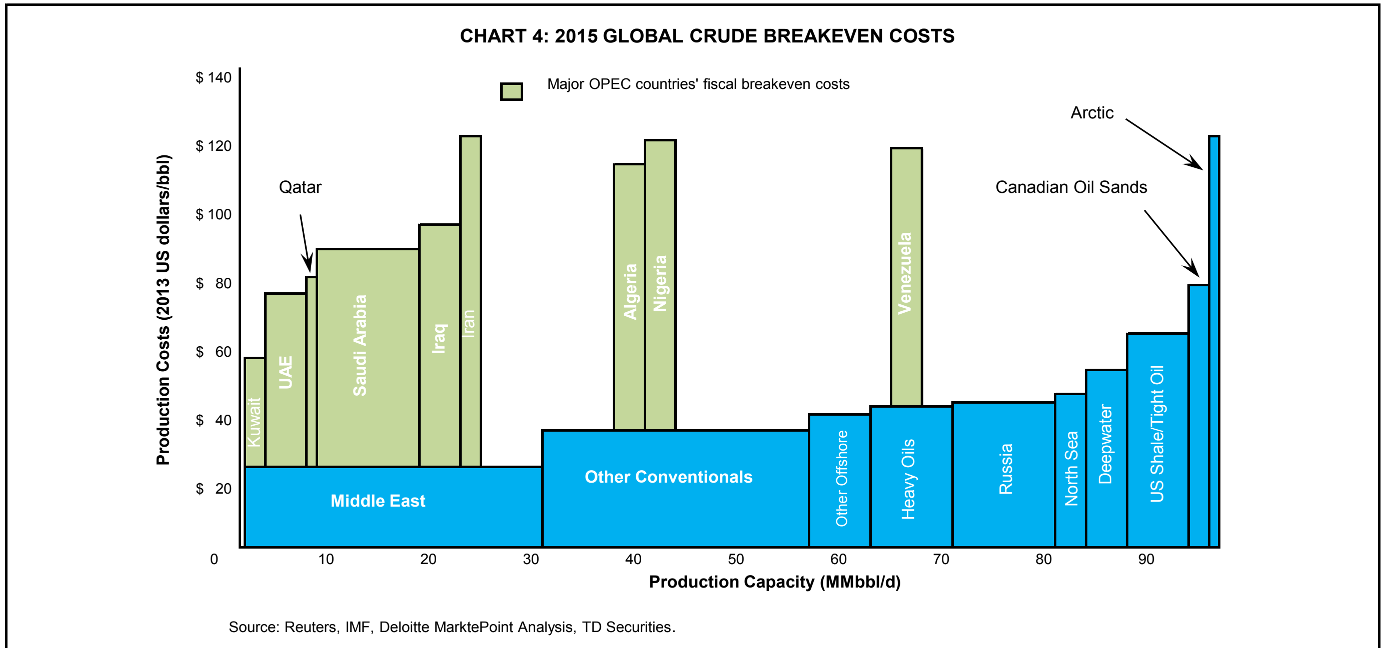
On that front, it will take some time. Despite the low oil price environment, production has remained quite resilient. OPEC has been producing about 2 million barrels per day above its self-imposed quota, with output in Saudi Arabia, Iraq and Iran up significantly. At its December 4th meeting, OPEC did not provide an official production ceiling, which essentially implies that it intends to continue to fight for market share so a quota is meaningless. The cartel has indicated that its strategy is working – as it weeds out some higher cost producers – but it is a slow process. Most OPEC countries need higher prices in order to balance their fiscal books and have been pushing for a cut back in production. But, given Saudi Arabia's dominance within the group – being the largest producer and having the most spare capacity – nothing will change unless that country is onboard. This is unlikely, as Saudi Arabia has enough financial reserves to withstand lower prices for some time to come, and it will only consider production cuts if others – including non-OPEC producers – agree to do the same.

What's more, there is potential for OPEC's output to rise even further over the near term, as the P5+1 nuclear agreement that was reached earlier this year should lead sanctions against Iran to be lifted by the spring. Iran has already been ramping up production and will continue to do so. Iran will likely add 500K barrels per day over the next year, potentially more depending on market conditions and prices. Other OPEC members are not expected to make room for this oncoming oil, so total OPEC supply is likely to remain at or above current levels.

Non-OPEC production has continued to grow in spite of low oil prices, with Mexico the only major producing country to reduce output this year (Chart 3). The shale industry in the U.S. – which has been the game changer in the oil market over the last couple of years – has managed to keep pumping out oil despite higher production costs than most other types of extraction, thanks to increased efficiencies. While rig counts have dropped significantly, production has remained elevated at over 9 million barrels per day. Part of the reason for this is that some producers were hedged, as they locked in future sales at higher prices. Given that the futures prices have also come down significantly, production levels should ease once these contracts mature. Evidence of this should emerge by the second half of 2016.

What *has* been severely impacted, however, is investment in the oil sector throughout non-OPEC nations, as current price levels are below the break-even costs for many new projects (Chart 4). As evidenced by production numbers this year, lack of investment does not have an immediate impact on output, but will certainly have bearing down the road. In the U.S., because the decline curves for shale oil are quite steep as wells become depleted relatively quickly, this drop in investment is likely to show up in the production numbers by the latter part of 2016. But, the impact may not be dramatic at first, as there are plenty of wells that have been drilled and are just waiting to be hooked up. With time, U.S. production should become more responsive to the low price environment that has detriorated the financial health of oil producers and limited access to capital. If prices remain low, some producers may not be able to maintain existing operations either. For 2016 as a whole, U.S. production is likely to fall to the 8.5-9 million barrels per day range, which is more in line with 2014 levels.

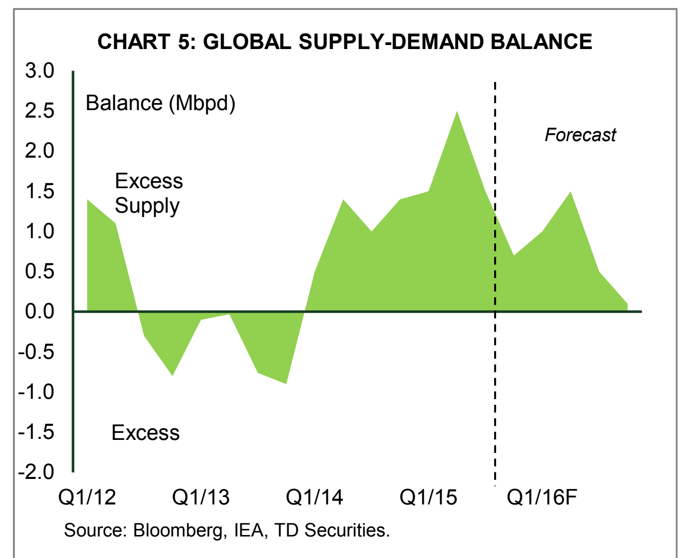


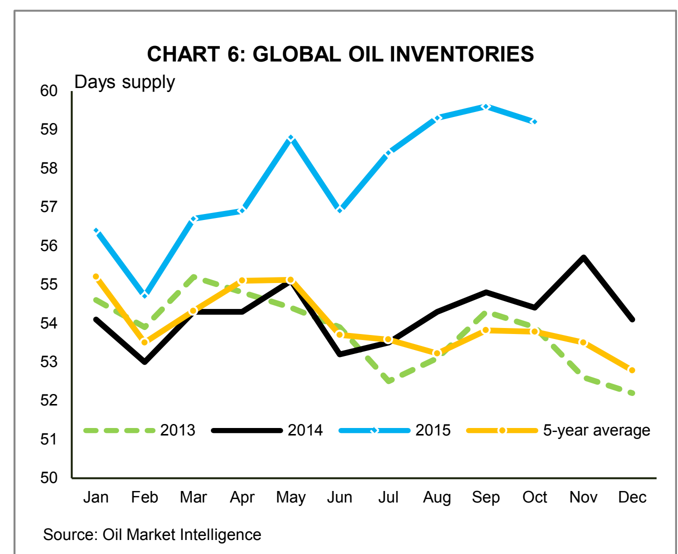


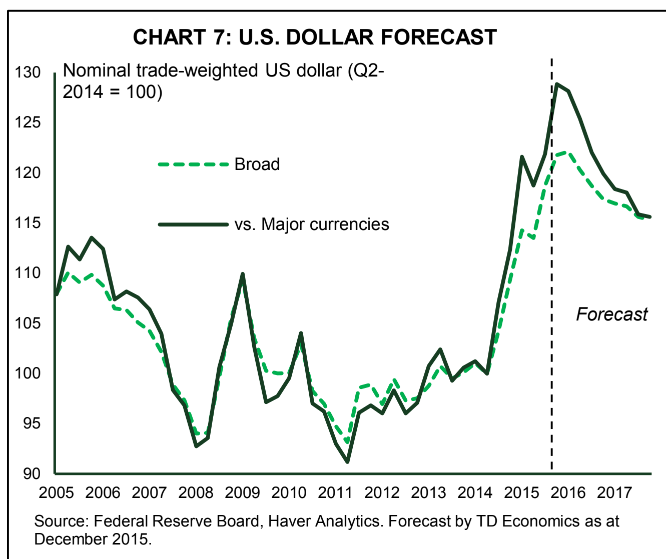
In Canada, the weak Canadian dollar is providing some cushion to the plunge in oil prices, but the drop is still hurting producers and weighing on investment. The decline curves in Canada are generally not as steep as those in the U.S. shale industry, and much of the project costs are upfront – especially in the oilsands. So while conventional production is likely to decline next year, output from the oilsands is expected to grow. In fact, the projects that were supposed to come online through 2017 are likely to go ahead, as much of the investment took place before oil prices began to plunge last year. It has largely been the projects that were in the earlier stages of development that have been impacted. So after rising modestly though 2018, Canadian production in 2019 and beyond is expected to be quite flat.

All told, it appears as though global supply will continue to grow for at least the next 6-9 months, before losing momentum towards the end of 2016. As a result, production will far outpace demand until then, leaving the global market in a position of excess supply for most of next year (Chart 5). And, even once production is growing more in line with demand, there is a massive amount of inventories that will need to be worked down (Chart 6). As such, prices will be unable to make a meaningful comeback in the near term.

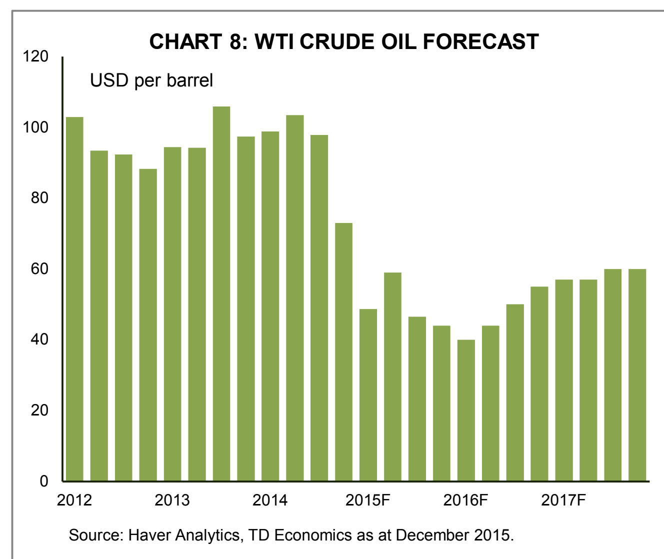
Despite the glut, any improvement in the supply-demand balance should help to boost sentiment, which has been quite weak over the past year. Indeed, bad news has generally had a bigger impact on the downside than good news on the upside, which has helped keep prices low. Other developments could also help to lift sentiment. Some easing in fears surrounding emerging markets – particularly in China







Source: Federal Reserve Board, Haver Analytics. Forecast by TD Economics as at December 2015.



Source: Haver Analytics, TD Economics as at December 2015.

given that it is a key oil consumer – should also lead to more optimism in the latter part of 2016. Once there is evidence that the recently implemented stimulus measures are having a positive impact on the Chinese economy, market sentiment toward the country, and more broadly across other emerging markets, should improve.

As well, a pullback in the U.S. dollar could also lend support, as the two are strongly (inversely) correlated. A higher greenback makes oil – which is priced in U.S. dollars – more expensive for consumers outside the U.S., thereby weighing on demand. The recent appreciation of the currency has certainly not helped non-US demand, although the supply glut has undoubtedly been the key factor behind lower prices. Going forward, differing monetary policies between the U.S. and many other countries around the world will lift the greenback through early 2016; however, it should lose some ground thereafter as the peak divergence in monetary policy passes and improvements in economic activity elsewhere buoy sentiment for other currencies (Chart 7). This depreciation should bode well for oil prices as well as market sentiment.

Bottom Line

Overall, prices are expected to remain quite low through the first half of 2016, before a weaker U.S. dollar, more optimism surrounding emerging markets, and a tapering off in production – particularly in the U.S. – triggers expectations for a more balanced market, helping to lift prices to US$55 per barrel by the end of the year. In 2017, prices are forecast to only reach US$60 per barrel as the market will remain well supplied (Chart 8). This is far below the average level of US$92 per barrel seen during the 2010-14 period, and unlikely to be profitable for several new projects in North America. Of course technological developments and efficiencies will continue to bring the cost of production down in the coming years, but prices will likely need to be higher in order to trigger a significant uptick in investment in the sector.

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