OBSERVATION

TD Economics

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OPEC AND NON-OPEC GROUP AGREE TO EXTEND PRODUCTION CUTS

Highlights

- As expected, OPEC and the select group of 11 non-OPEC producers announced an agreement to extend existing production cuts through the first quarter of 2018. Markets seem to have been hoping for something more, as prices are down 4% today.
- The overall success of this strategy depends on the response from producers who are not participating in the deal, particularly U.S. shale producers which have been quick to ramp up output over this year. Even assuming further growth in non-OPEC production, signs that global inventories are being drawn down should begin to emerge in the second half of the year, helping to drive prices up to the mid-US$50 per barrel range.

Today, OPEC and the select group of 11 non-OPEC producers announced an agreement to extend existing production cuts through the first quarter of 2018. The current agreement has not been as effective as hoped, and the group of producers remains committed to balancing the market and bringing global inventories back in line with the five-year average. Under the new agreement, output quotas for participating member countries will remain unchanged from that in the first half of the year.

Saudi Arabia and Russia signaled such a deal early last week, after concerns that the initial deal would not be enough to balance the market sent prices down to US$45 per barrel. As such, the outcome of today's meeting was largely built into the market, although it appears as though markets were hoping for a little something more. Prices are down by around 4% today, and currently sit just under US$50 per barrel.

The overall success of this strategy ultimately hinges on the response from producers not participating in the deal – particularly in the U.S. shale industry – which have thus far offset a good chunk of the cuts. While shale output remains the wild card going forward, evidence of falling global inventories should begin to emerge later this year, helping to lift prices toward the mid-US$50 per barrel range.

Compliance to remain high, but offsets to continue

When the initial agreement to curb production was announced, there was some concern surrounding compliance, particularly among OPEC members. But, the compliance rate since January has been quite high at 96%. The non-OPEC group has trailed behind, complying with less than half of the cuts, but have been steadily improving each month. The group has indicated that they intend to reach 100% by June.

While there is some risk that compliance among the group may wane going forward – especially since some maintenance was brought forward into the first half of this year to help meet targets – Saudi Arabia's oil minister continues to reiterate that they are committed to doing whatever it takes to restore balance in the market. Moreover, so long as prices remain around or above the US$50 per barrel mark, the incentive to comply will be there. One thing to keep an eye on is output from the two exempt countries, Libya and Nigeria, as production in both is expected to ramp up. This could offset a considerable chunk of the total OPEC cuts, requiring others – namely Saudi Arabia – to cover the difference.

Dina Ignjatovic, Economist, 416-982-2555

While prolonging the production curtailments will certainly help get the market on the path to rebalancing, the agreement only comprises about 60% of global supply, leaving a significant part of the market free to increase output, and does not take into account any potential weakness in demand.

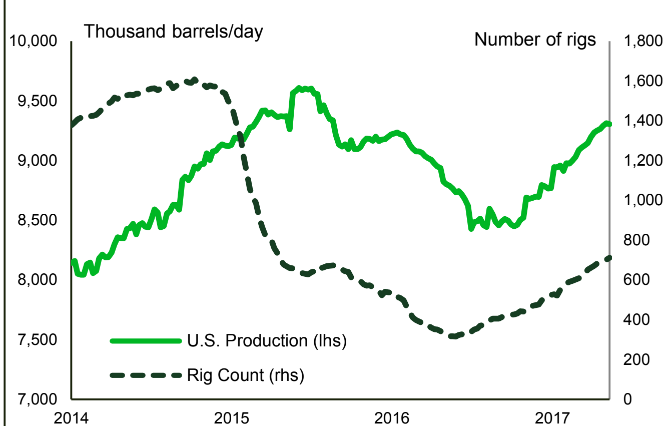
Of the joint 1.8 million barrel per day production cuts agreed upon, nearly half has been offset by higher output elsewhere – particularly in the U.S. where shale production has been quick to ramp up. Indeed, production in the U.S. has reached 9.3 million barrels per day, the highest level seen since August 2015. Canada, Brazil and the North Sea have also recorded increases this year.

This trend is set to continue, with Canada, Brazil and the North Sea on track to increase production further this year as new projects ramp up. But, much of the focus will be on the biggest wild card: U.S. shale output. Production in the U.S. is set to continue its recent uptrend, as oil rig counts in the U.S. have more than doubled from year-ago levels and are back to levels not seen since early-2015. In fact, total U.S. production could surpass the previous high of 9.6 million barrels per day (mid-2015) before the end of this year. Moreover, many producers have hedged through the end of this year and into 2018 which will keep output propped up regardless of where prices move. On net, global oil supply is expected to rise by around 1 million barrels per day this year.

Demand growth to fall short of last year's pace

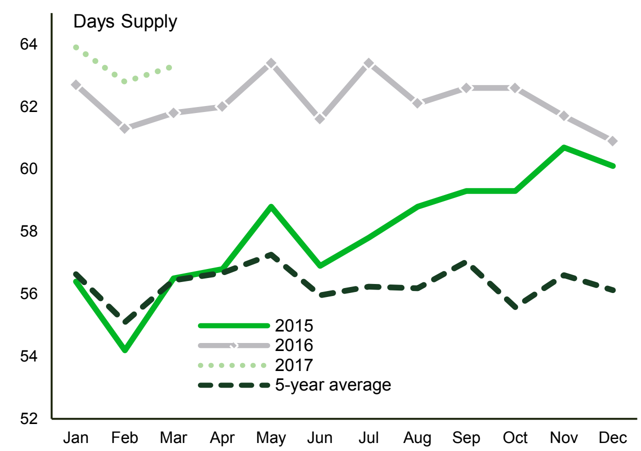
Meanwhile, demand growth during the first quarter was softer than expected, driven in large part by the U.S. – the world's largest consumer – where lower gasoline consumption and unusually warm temperatures slowed overall oil consumption growth. As such, global supply continued to outstrip demand, and recent efforts to curb production have yet to make a meaningful dent in global inventories. In fact, inventories remained at record levels in the first quarter, sitting at 63 days supply.

CHART 1: U.S. PRODUCTION AND RIG COUNTS



Source: Baker Hughes, EIA. TD Economics

CHART 2: GLOBAL OIL INVENTORIES



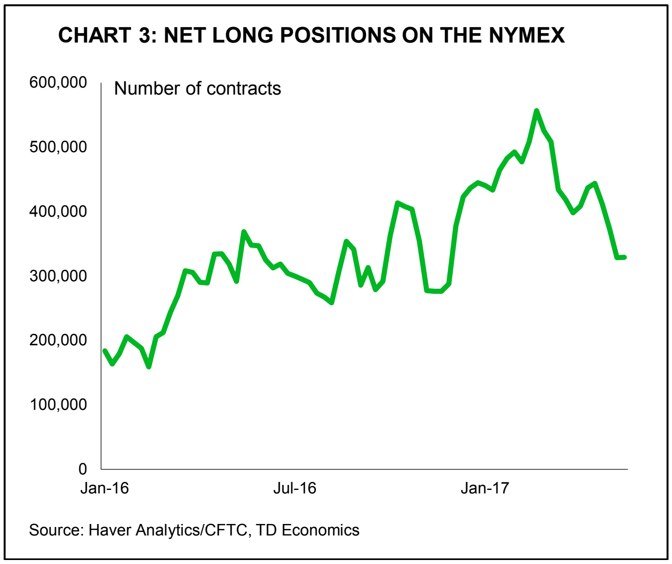
Source: Energy Intelligence, TD Economics

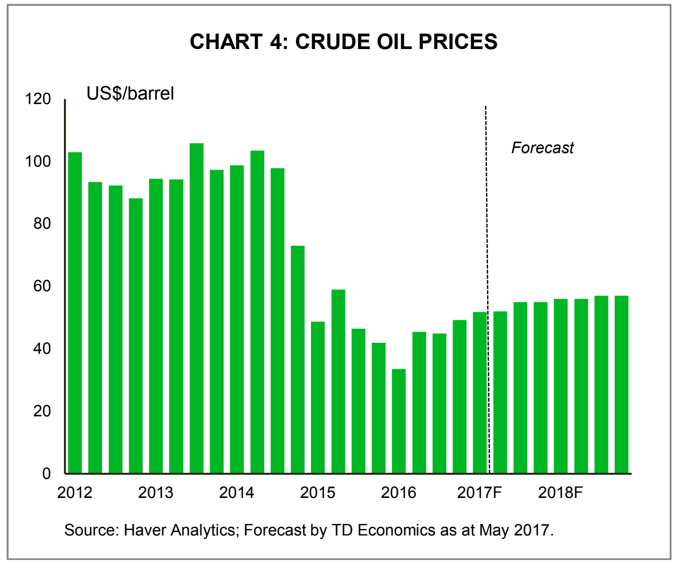
While demand is expected to pick up over the remainder of the year, the annual growth in consumption will likely fall well short of last year's 1.7 million barrel per day increase. After a soft start to the year, momentum in the U.S. and China is expected to build, in line with growth in their overall economies. China has already started to show signs of improvement with record crude oil imports in March, while a seasonal uptick in the U.S. as the summer driving season kicks off should lead to higher overall oil consumption stateside. Elsewhere, demand is unlikely to pick up meaningfully, leaving overall demand growth at around 1.3 million barrels per day.

All told, demand should slightly outpace supply growth this year and signs that the rebalancing in the global oil market is underway should emerge toward the latter part of this year.

Prices gains to be limited

But, don't expect a huge rally in prices. As evidenced by the drop in prices today, the impact of the extension in production cuts is already largely priced in, and there is still a massive glut of inventories that need to be worked down before prices can move sustainably higher. As well, the supply response to higher prices has been fairly swift





– mainly in the U.S. shale industry – and will likely keep a lid on prices until stockpiles return to more manageable levels. Markets have put a lot of focus on U.S. stockpiles, which have begun to come down, but remain well above the 5-year average.

What's more, prices are influenced by more than simply supply-demand fundamentals. Crude oil is now as much a financial instrument as it is a commodity and risk appetite can have a considerable impact on prices. Non-commercial net long positions on the NYMEX – a benchmark for speculative activity – were quite elevated in late-April, leaving the market vulnerable to any deterioration in risk sentiment surrounding crude oil – one that materialized and sent prices down sharply in early-May as short covering took hold. Net long positions are currently sitting at the lowest level since just before the current production cut agreement was announced.

Today's agreement should provide investors with some solace that several key producers are committed to eliminating the supply glut and that the path to rebalancing remains underway. Hence, the fundamental picture should gradually improve sentiment toward oil. However, risks remain tilted to the downside, as production both within the OPEC/non-OPEC group and outside could be higher than anticipated and demand growth could remain soft. Moreover, risk appetite is also influenced by factors outside the oil market, and with a number of uncertainties around the globe – particularly surrounding the political environment stateside – volatility is likely to persist.

Bottom Line

All told, an extension of the current production quotas is certainly warranted, given that the restraints to date have yet to have a meaningful impact on global inventories. But, ultimately, the success of OPEC's strategy will depend largely on how much of these cuts are offset by production elsewhere, as well as demand. If the compliance rate remains high, signs that the global oil market is moving toward a more balanced position should surface in the second half of this year, helping to lift prices to the mid-US$50 per barrel level.