OBSERVATION

TD Economics

June 22, 2015

PRICES OFF THEIR BOTTOM, BUT WORLD STILL AWASH IN OIL

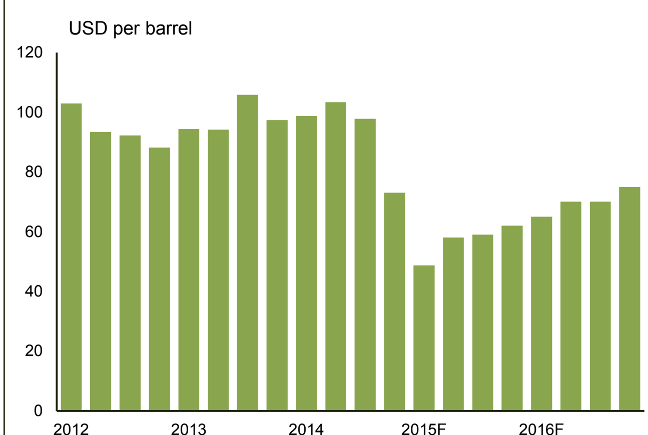
Highlights

- At its mid-year meeting, OPEC decided to leave output quotas unchanged, suggesting that it is committed to its fight for market share. Both OPEC and the U.S. continue to pump out oil at elevated rates, driving the wedge between supply and demand even larger.
- However, output in the U.S. should begin to ease in the second half of this year and continue falling in 2016 as the lack of investment since the price collapse begins to be felt on the production front. While it will help to improve the market balance, it will take time to work down the massive glut currently in the market.
- As such, there is considerable risk for another leg down in prices in the coming months. Overall, we suspect that expectations for an improvement in market dynamics will help to keep the WTI benchmark hovering around its current level of US$60 per barrel in the near term, before heading higher to an average of US$70 per barrel in 2016.

It has been about a year since crude oil prices started to fall, and around six months since OPEC decided that it no longer wanted to be the one to balance the global crude oil market, effectively controlling prices. This change of heart comes as the cartel has been losing market share since the rise of shale oil production in the United States. As such, all eyes have been on the U.S. output numbers to determine whether or not OPEC's strategy is working. While the U.S. continues to pump out oil at near record highs, rig counts have fallen dramatically and there have been some draws on storage in the last few weeks, which has helped to lift prices. The WTI benchmark is now hovering close to the US$60 per barrel mark, up from the trough of US$43 per barrel hit in March.

The uptick in prices, however, has been driven largely by a reversal in market sentiment rather than a change in market dynamics. Indeed, the world remains awash in oil, with production still far outpacing demand. This suggests that OPEC's strategy will need more time to work. Moreover, given the glut that still persists, there is considerable risk for another leg down in prices in the coming months. Overall, we expect WTI to average just under US$60 per barrel through the third quarter, before heading up to an average of US$70 per barrel in 2016.

CHART 1: WTI CRUDE OIL PRICE FORECAST



Source: Haver Analytics, Forecast by TD Securities

OPEC holding the line

At OPEC's meeting on June 5th, the cartel decided to leave output quotas unchanged, noting that the sharp correction in prices due to the oversupplied market has now abated, with prices moving off their lows in recent months. It highlighted the fact that

Dina Ignjatovic, Economist, 416-982-2555

demand is expected to pick up in the second half of the year alongside the global economy, while growth in non-OPEC supply is expected to slow to a third of the pace recorded last year. Pointing to global inventory levels sitting above the 5-year average, the organization assessed the market as ‘comfortably supplied’.

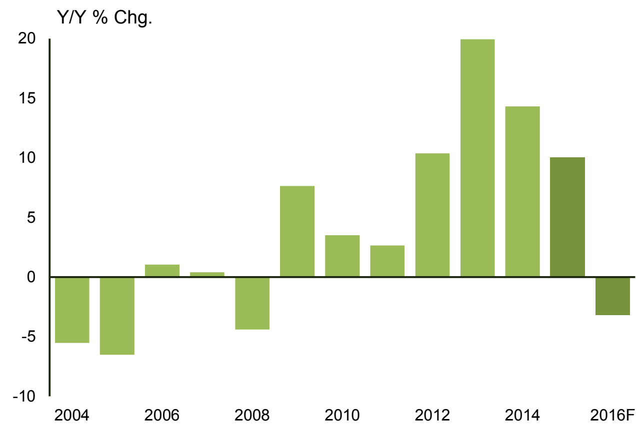
OPEC is sending a clear message that despite the over-supplied market, it is not going to back down. Several members would prefer higher prices (and need higher prices to balance government books); however, the cartel is sticking with its strategy in the hopes of driving out higher cost producers such as the U.S. shale oil producers.

On that front, while investment in the U.S. oil sector has certainly taken a hit – impacting future production – the strategy has yet to have a meaningful impact on output levels. What’s more, with prices staging a bit of a rebound to about US$60 per barrel, many projects are still profitable. And, current futures prices – which have been higher than the spot price – are providing incentive to store oil. The U.S. has continued to ride the momentum of previous investments, which has led the country to account for 90% of the total increase in non-OPEC supply since November when OPEC revealed it would no longer be the swing producer. But, market participants have been encouraged by the fact that rig counts in the U.S. have been cut in half. In theory, lower rig counts should translate into lower production levels. This will likely be the case eventually, but it will take time to show up in production numbers given the increased productivity of rigs as well as the higher initial production rates and steeper decline curves – particularly when drilling for shale oil. As such, while output in the U.S. appears to have levelled off, it will remain quite elevated until the wells that are currently being drilled become depleted – signs of which should begin to surface in the second half of the year. Indeed, TD Securities expects American production to fall modestly from its current pace of 9.6 million barrels per day to 9.3 million barrels per day by year-end, and to continue sliding in 2016, averaging (a still-elevated) 9.1 million barrels per day for the year.

Outside the U.S., production has been mixed among other key non-OPEC producing regions; Canadian, Brazilian and North Sea output has continued to trend up, while production in Russia and China has been relatively flat. Output in Mexico and several smaller non-OPEC producing countries has been drifting down.

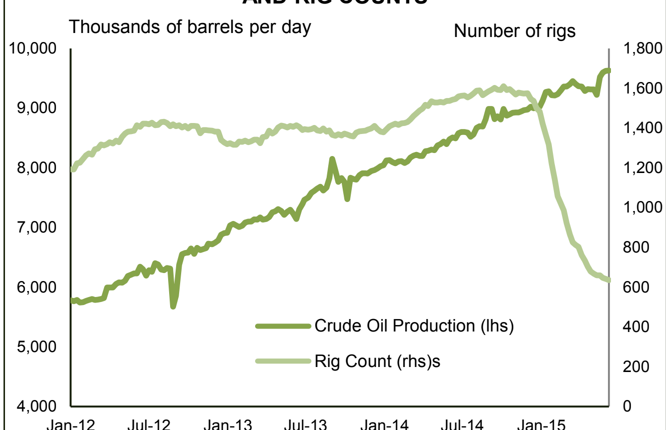
OPEC, however, has turned on the taps in recent months, accounting for about two thirds of the global supply increase

CHART 3: U.S. OIL PRODUCTION GROWTH



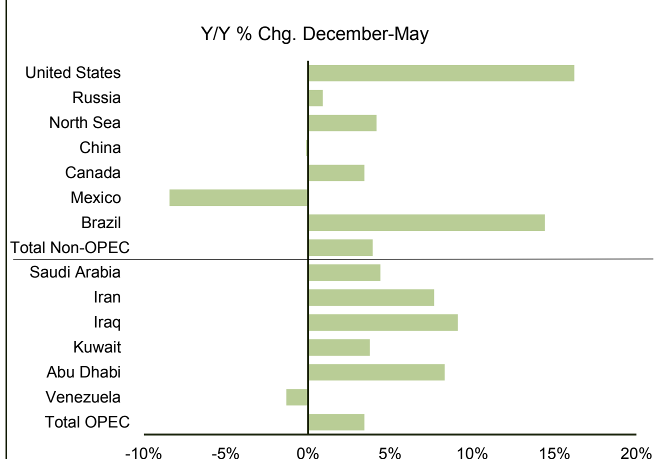
Source: EIA, Forecast by TD Securities

CHART 2: U.S. CRUDE OIL PRODUCTION AND RIG COUNTS



Source: Baker Hughes, EIA

CHART 4: GLOBAL OIL PRODUCTION GROWTH



Source: Oil Market Intelligence

since November. About half of this gain has come from Saudi Arabia, where production has surpassed 10 million barrels per day, marking a record high. Iraq has also been ramping up production, a trend that is expected to continue going forward. As a whole, the cartel has consistently been pumping out more than the target quota, with the excess over the last three months averaging about 1 million barrels per day. Although a nuclear agreement is still uncertain at this point, Iran is preparing to return output to pre-sanction levels once a deal is reached and sanctions are lifted, which will add even more oil to OPEC's supply.

Global demand still trailing supply

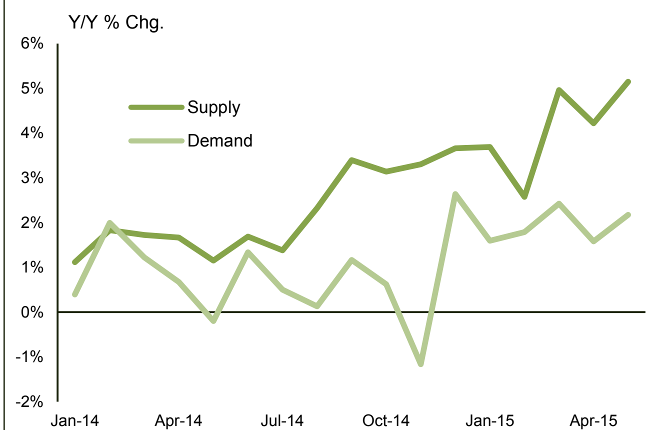
Meanwhile, low prices have yet to trigger a meaningful pick-up in global consumption. Non-OECD demand growth – which accounts for the bulk of demand growth – has been slower than historical norms as several emerging markets are struggling on the economic front. Oil demand growth in China – which is the world's second largest oil consumer – has held at a steady 2% over the last 6 months, much slower than the 6% average growth rate seen in recent years. Meanwhile, demand in Latin America has been flat over the last few months. On the flipside, one bright spot has been India, where demand has grown 8.1% since November, and the country has now displaced Japan as the world's third largest consumer of the fuel. The rise in demand is due in part to refinery expansions in the country. Consumption in Saudi Arabia has also been strong, averaging 3.4% growth over the last six months.

In the developed world, the U.S. has been a key source of demand growth, rising by an average of 2.8% (y/y) per month since November. May was a particularly strong month for the world's top oil consuming country, as consumption was up 4.8% (y/y). In Europe, demand growth was robust over the December-February period, but has since flattened out. South Korean oil consumption has also been growing rapidly, up 4.5% since November. Elsewhere within the OECD countries, demand has been fairly weak.

Global oil glut persists

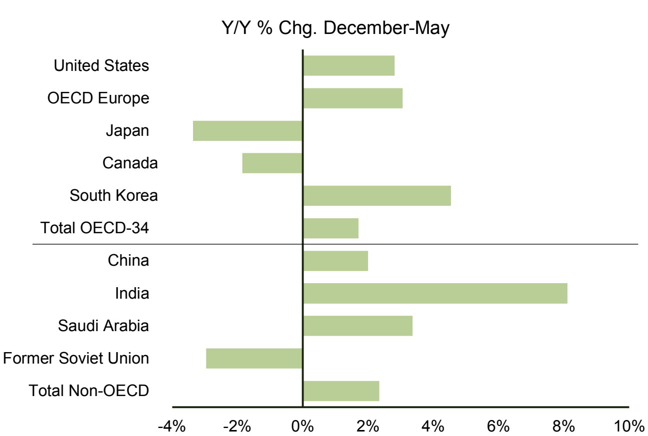
So while global supply has remained resilient in light of low oil prices – up by an average of 4% y/y since November, the increase in world demand has been half that rate. Hence, the oil market is still far from balanced. The surplus in the market grew to over 4 million barrels per day in May – the highest level since 2005. This gap should begin to narrow in the second half of the year, as demand picks up along-

CHART 6: GLOBAL OIL SUPPLY AND DEMAND GROWTH



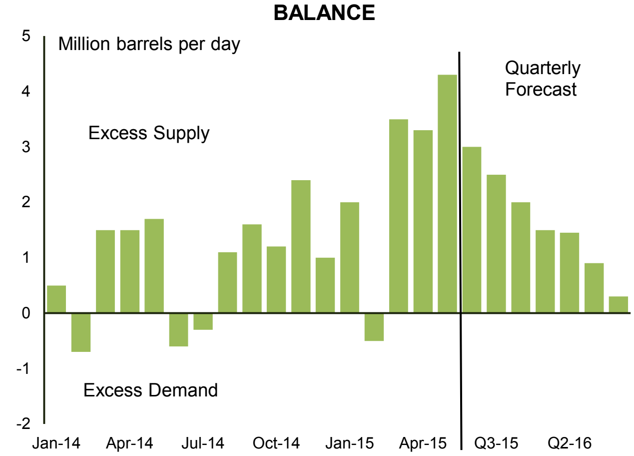
Source: Oil Market Intelligence

CHART 5: GLOBAL OIL DEMAND GROWTH



Source: Oil Market Intelligence

CHART 7: GLOBAL OIL SUPPLY-DEMAND BALANCE



Source: Oil Market Intelligence, TD Economics side improvements in global growth and supply loses some steam. Still, it will take time to work down the massive glut, with the market unlikely to move back into a more balanced position until the end of 2016.

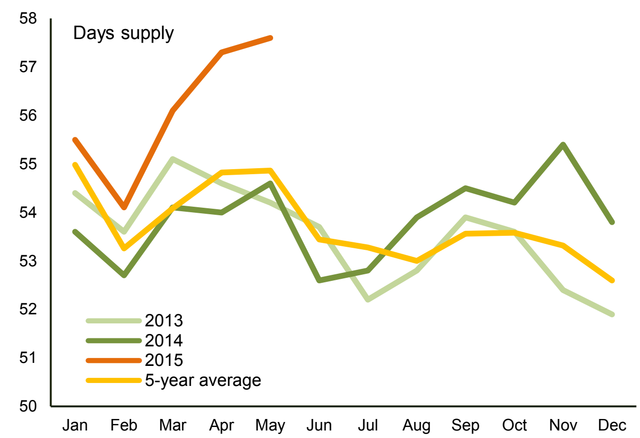
Expectations for an improvement in the supply-demand balance has likely been a driving force behind the change in market sentiment, and resulting uptick in prices. However, there are still some key risks in the oil market that could lead to another leg down in prices. Storage utilization in the U.S. is sitting at 88%, and space could become an issue following the peak summer demand season when refineries are idled for maintenance. What's more, at over 57 days supply, global inventories are at a record high. And, it appears as though more oil is being stored at sea, as demand for supertankers surged in May. If production continues to outpace consumption by a wide margin, storage around the globe may become an issue as well.

In the meantime, the slight tightening in the U.S. oil market – falling inventories – and loosening in the global market has nearly wiped out the spread between the WTI and Brent benchmark prices. This is unlikely to last, as the decline in U.S. oil imports – largely responsible for the drop in storage levels – is expected to reverse course in the near term, thereby loosening the market somewhat. This should lead to a widening in the differential over the second half of the year and into 2016.

Bottom Line

There are two wild cards in the oil market: OPEC and U.S. production. If both regions continue to pump out oil at these rates, prices are likely to take a hit. It is clear that OPEC has no intention of cutting production. Moreover, if the potential increases from Iraq and Iran materialize – although the prospects of the latter happening in the very near future is questionable – OPEC's supply could move even higher above quotas, delaying any improvement in the supply-demand balance and weighing on prices. So it will likely be up to the U.S.to show some decline in production –

CHART 8: GLOBAL OIL INVENTORIES



Source: Oil Market Intelligence

which we do expect to happen in the coming months as wells start to become depleted. We suspect that expectations for a diminishing in the oil glut will help to keep prices around current levels before heading higher to average US$70 per barrel next year as actual signs of an improvement in the market balance emerge.

We do caution that there are several factors that, if realized, could lead to another correction in prices and increased volatility. These include higher production, storage capacity constraints, geopolitical tensions, and slower-than-expected economic activity in key consuming regions such as China, the U.S. and Europe. Furthermore, if prices climb high enough (on a sustained basis) to entice some higher-cost producers to start ramping up output again – likely around US$75-80 per barrel – prices will be subject to further bouts of downward pressure as more production will be expected to come on stream. All told, for OPEC's strategy to work, prices will have to remain below these production-enticing levels for quite a while.

Dina Ignjatovic, Economist
416-982-2555