End of a Bullish Cycle? Crude Runup Hits Supply Wall

Price recovery depends on OPEC restraint.

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Data Sources for This Publication
U.S. Energy Information Administration
CME Group
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Market Rout

Last week a market rout put paid to a long positive run that saw prompt prices for U.S. benchmark West Texas Intermediate crude increase 80% from $42.53/barrel on June 21, 2017, to $76.41/barrel on Oct. 3, 2018. Since then, WTI prices shed 27% to close at $55.69/barrel on Nov. 13, recovering to $56.56/barrel on Nov. 16. Prices for international benchmark Brent dropped 24% from their high of $86.29/barrel on Oct. 3 to $65.47/barrel on Nov. 13, recovering to $66.76/barrel by Nov. 16. The sudden price collapse reflects a change in market expectations about world crude supply/demand fundamentals. This note reviews the price slump and whether the damage can be reversed.

Third Quarter Optimism

Last month we published an optimistic view of the crude oil market (see "Third-Quarter U.S. Crude Review and Outlook"). The timing of that report coincided with the high point for Brent and WTI prices in 2018 on Oct. 3. Our analysis described how record domestic production and exports followed higher crude prices, which had been on an upswing since June 2017. The threat of U.S. sanctions on Iran removing most of that nation's supply from the market in November pushed crude prices to their high point for the year as analysts predicted a tight supply balance by year-end.

As we pointed out two weeks ago (see "Is the Permian Still King of the Hill?"), crude production continues to increase, up 2.8 million barrels a day to 11.3 mmb/d since its low point of 8.5 mmb/d in September 2016 (according to Energy Information Administration monthly data). The latest EIA Drilling Productivity Report (November 2018) confirms continued production growth in the shale basins is expected through year-end, despite pipeline takeaway constraints in the Permian and more recently the Bakken. Crude exports have retreated somewhat since July, with China going cold turkey in August due to trade tariff concerns but are still averaging over 2 mmb/d in the weekly EIA reports and remain at record levels this year.

Awash With Surplus Crude

The only concern we raised at the start of October was that demand for crude could falter by year-end, causing a price collapse in the face of growing production. That concern about an oversupplied market was then just a twinkle in a few bearish analysts' eyes. By last week it had become a reality and was the leading culprit behind tumbling crude prices.

A lot happened in the month since our upbeat third-quarter analysis. In the face of impending Iran sanctions, both Saudi Arabia and Russia turned on the taps and increased production to help balance the market and to poach a share of Iran's embargoed barrels. U.S. weekly EIA supply data showed production jumping to 11.6 mmb/d during the last week of October. Crude inventories also continued to edge up for the eighth week in a row, up 18 million barrels in the Gulf Coast region and 12 million barrels at the Cushing, Oklahoma, Midwest trading hub since mid-September. Immediately before sanctions were due to be applied, the U.S. government granted waivers to eight of Iran's largest customers, including China, India, and South Korea, allowing them to continue purchases for six months to the extent of at least 800 thousand barrels/day. All these announcements and events increased concerns that far from being tight in the face of Iranian sanctions, the market might instead be awash with surplus crude. Concerns about oversupply were then compounded by EIA and OPEC production forecasts for 2019 indicating lower demand growth than previously assumed.

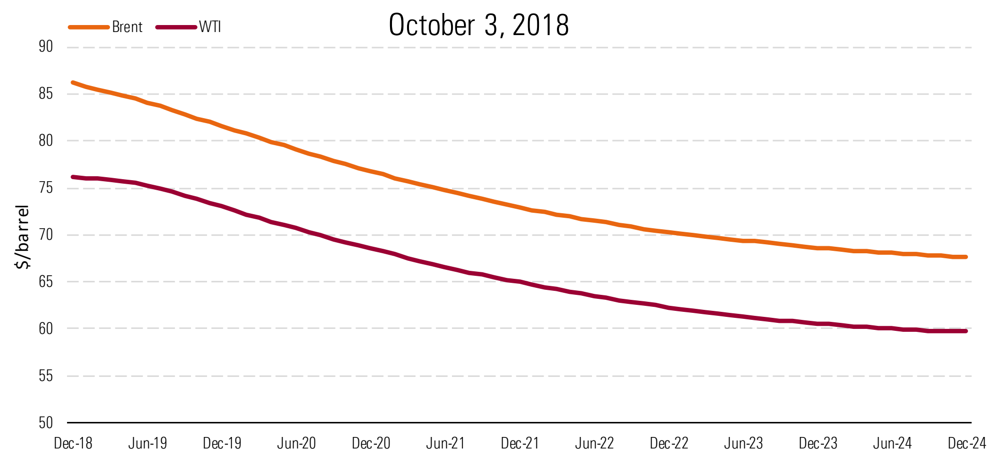
OPEC vs. Trump

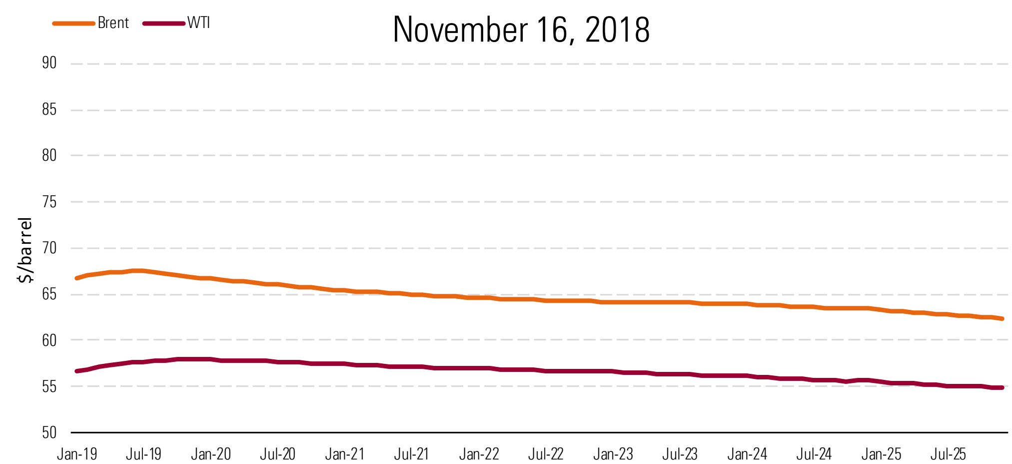
These fundamental factors—a mixture of actual analysis and conjecture about the impact of Iranian sanctions—started the crude price rout that accelerated last week. Financial investors predictably increased the magnitude of the downward spiral with long futures positions heading for the exits en masse. By the time OPEC and its allies met in Abu Dhabi on Nov. 11, their agenda to monitor a balanced market had turned to calls for production cuts in 2019 and a Saudi promise to reduce output in December. These normally bullish pronouncements designed to put a line under falling prices were rudely counteracted by a presidential tweet calling for OPEC to leave the market (and prices) alone. The net result was a further 7.5% fall in WTI and 7% fall in Brent on Nov. 12 and 13 from their respective closes on Nov. 9.

Forward Contango

As prices have fallen from their positive trajectory at the start of October into bear territory early last week, so futures market forward curves have changed their structure. Exhibit 1 shows Brent and WTI forward curves for Oct. 3 (top) and Nov. 16 (bottom). Apart from the wholesale $20/barrel downshift in prices at the front of the curve, the shape has changed from relatively steep backwardation (prices in the future are lower) to a mild contango (prices in the future are higher) for at least the first year out on the curve. The Brent crude premium over WTI on Nov. 16 remained wide at an average $9.69/barrel in the prompt year and $7.87/barrel on average at the back of the curve in 2024, reflecting higher U.S. crude production being discounted to find a home in export markets.

Exhibit 1 Brent and WTI Forward Curves, Oct. 3 and Nov. 16, 2018





Source: CME Group, ICE, Morningstar

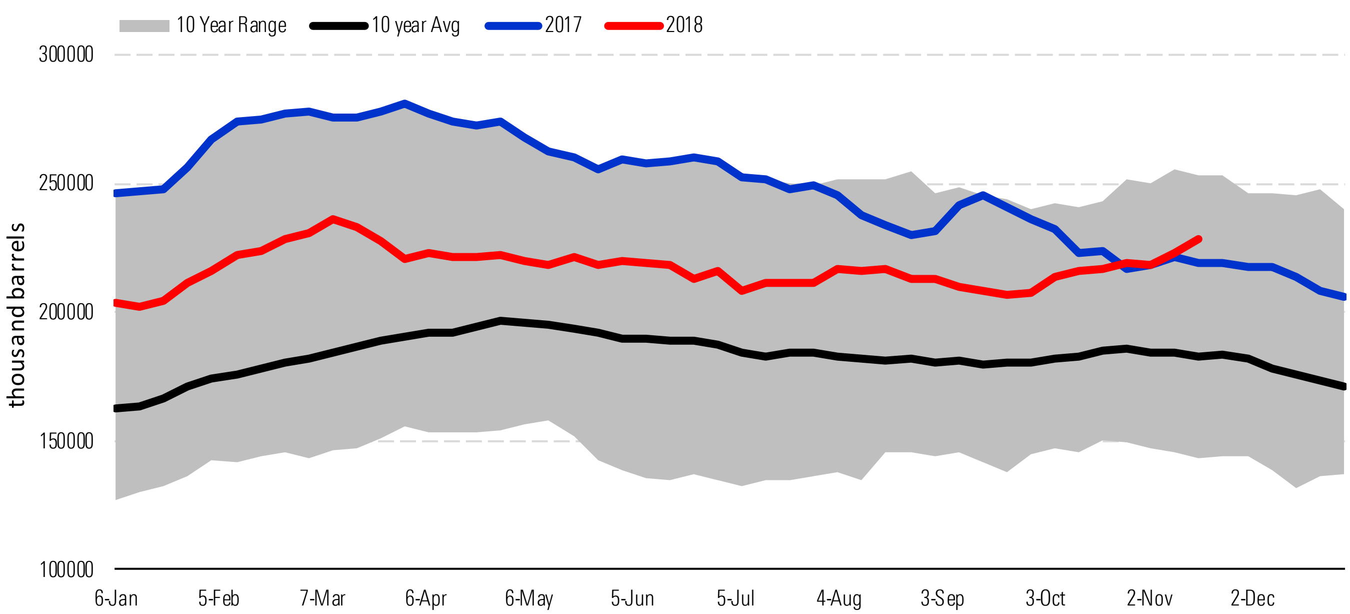
Storage Buildup

Concerns about crude oversupply, reflected in the move into a contango futures structure, are underlined by growing U.S. crude inventories since mid-September, as noted above. For us, the most significant inventory numbers to watch are Cushing and the PADD3 Gulf Coast region. If prices don't recover from their downward slump, then these inventories will continue to increase as a contango market covers the cost of carry and storage becomes more profitable for crude producers than selling to refiners or the export market.

Cushing inventories have been building since mid-September, but there have been good fundamental reasons for this, including lower refinery runs in maintenance season and higher production from the Permian, Rockies, Bakken, and Anadarko running up against outbound pipeline constraints. This crude is still trying to get to the Gulf Coast export market rather than sit in storage. Cushing inventory levels remain 11% below their 10-year average for this time of year as of Nov. 9, according to EIA weekly data.

Gulf Coast region inventories (Exhibit 2) present a more bearish picture than Cushing, with this year's level consistently above the 10-year average and crossing above last year's number during the last week of October (red line crosses the blue in Exhibit 2). This week EIA reported PADD 3 inventories at 229 million barrels as of Nov. 9, up 2% or 5 million barrels from the prior week and heading toward record year-end levels last seen in 2016 (top of grey shaded area). Higher crude inventories at the Gulf Coast are somewhat expected because of takeaway constraints causing a buildup in the Permian at Midland, but recent growth suggests weakness in the export market. In other words, assuming, as we have argued (see our May note "U.S. Crude Exports Take Off"), that growing production is not needed by U.S. refiners and therefore has to find a home overseas, then growing volumes of new production are sitting in storage instead of being exported. With WTI prices at Cushing nearly $10/barrel under Brent and CME Argus Houston WTI $3.15/barrel below Brent, these barrels are priced to go. A continued Gulf Coast inventory buildup signals that world buyers aren't responding.

Exhibit 2 Gulf Coast Seasonal Crude Inventories



Source: EIA, Morningstar

Medicine of Choice

Given the oversupply signals that triggered the recent price collapse, the only cure is a tighter supply/demand balance by the end of this year and into next. Weaker demand can be countered by lower prices triggering higher consumption, but that tends to take months to work through the system. A prompt resolution to the U.S. administration's trade wars would go a long way to mitigate concerns about overseas economic growth (the demand side of the equation) but seems unlikely in the short term. That leaves production discipline as the medicine of choice to resuscitate falling prices. To that end, the OPEC meeting in Abu Dhabi on Nov. 11 produced talk about reducing output, and the further price collapse at the beginning of last week spurred rumors of the Saudis' intent to cut their sales by more than 1 million barrels/day. Although these announcements always have an impact on market sentiment, they are unlikely to push prices back up substantially until a formal commitment is outlined at the OPEC meeting in Vienna on Dec. 6.

Up to OPEC

Weekly supply data released Nov. 15 showed further large crude builds at Cushing and the Gulf Coast as well as a 100 mb/d increase in domestic production to 11.7 mmb/d during the week ended Nov. 9. These are bearish signals suggesting further increases in crude supply while export volumes were down by 350 mb/d, indicating lower demand. So, with U.S. supply still on an upward trend, it falls to OPEC and its Russian allies to deliver production restraint to protect prices when they meet in early December. A credible commitment then would be a welcome early Christmas gift for U.S. producers. M

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