Daily Oil Fundamentals

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When to start getting concerned

The current run higher has been fierce, convincing, and uncompromising. It started towards the end of August and apart from the odd, occasional, and brief prof-taking the march higher has continued unabated. In fact, such has been intensity of this move that the voices of those advocating $100/bbl oil prices in the not-so-distant future are getting louder. The major oil futures contracts, crude oil as well as products, have all gained more than 30% in value since August 20.

In our attempt to spot when the turning point might arrive it is a useful exercise to identify what are the main factors behind the price strength. In fact, it is almost as helpful to list the factors against which this resilient price rise is taking place. This turbulence or headwind, which oil is smoothly sailing through, is called inflation. It emerges in many forms, the most prevalent of which is high consumer and producer prices. Let us take the two biggest economies in the world, China, and the US. Producer prices in the Far Eastern superpower were up 10.7% in September year-on-year, the fastest increase since at least 1996, whilst consumer prices also rose. In the US consumer price index climbed 0.4% from August and the annual rise was 5.4%. Prices paid to producers jumped 0.5% on the month and 8.6% on the year. Eurozone PPI registered a 3.4% increase on the year.

Rising prices usually lead to growing concerns about the health of the economy and it is no different this time around. Economic growth forecasts have been revised down in both countries and consequently stock markets have not been able to match the performance of oil. The more than 30% advance in oil in the past two months is considered splendid when compared to the gain of 2% in the S&P 500 Index or a jump of 4.5% in the Shanghai Composite Index, which includes a retreat of 3.5% since mid-September.

Inflation worries raise the prospect of interest rate rise (as some central banks have already done so), which leads to an increase in bond yields and a flight into the US dollar, both of which put downward pressure on oil prices under normal circumstances. These are, however, exceptional times and investors have remained faithful to oil despite the dollar index is at the same level as two months ago and the 3-year Treasury yield is up from 0.44% to 0.71%.

If persistently inflated prices have a prolonged effect on aggregate demand, oil will inevitably be impacted – but not just yet. A combination of factors both on the supply and the demand side of the equation imply tight physical market and therefore healthy thirst for the black stuff for the next few months. These include oil output in the Gulf of Mexico, which has not recovered completely after Hurricane Ida. The reluctance of the OPEC+ alliance to raise output ceiling by more than the pre-agreed 400,000 bpd per month is also seen as supportive. Global oil demand, which generally climbs during the winter months received an additional boost from the supply crunch in natural gas, LNG, electricity, and coal. Although gas prices have retreated from the historic highs seen two weeks ago and China contemplates to tame galloping thermal coal prices the switch to oil, which, according to the Saudi energy minister, has increased global oil demand by 600,000 bpd, ensures significant depletion in global oil inventories for the balance of the year. This could take OECD oil stocks close to 2.7 billion bbls towards the year end, an ominously low level for any oil bears to take comfort from.

Any increase in global oil supply or fall in global oil demand would change the current upbeat sentiment. This change, however, might not come until after winter passes north of the Equator and/or OPEC+ caves into the demand of consuming nations to meaningfully up production, which would be difficult and counterproductive to do in the first quarter of next year when growth in global oil consumption traditionally takes a breather.

OTC Prices & Futures Spreads 20/10/2021	Close	±
December 30-Day BFOE ($/bbl)	84.59	0
December Brent/Dubai EFS ($/bbl)	4.00	-0.08
November Urals CFD MED ($/bbl)	-2.10	0.00
ICE December/January Brent ($/bbl)	0.67	-0.05
NYMEX December/January WTI ($/bbl)	1.04	0.10
December WTI/Brent Arb ($/bbl)	-2.40	0.24

Futures Prices 20/10/2021	Open	High	Low	Close	±	% ±
ICE December Brent ($/bbl)	85.19	85.89	83.61	85.82	0.72	0.85%
NYMEX November WTI ($/bbl)	83.34	84.25	81.30	83.87	0.91	1.10%
ICE December Murban ($/bbl)	83.93	84.53	83.41	84.95	0.70	0.83%
NYMEX November Heating Oil (¢/gal)	256.58	259.32	251.70	259.23	3.16	1.23%
NYMEX November RBOB (¢/gal)	248.18	251.12	242.63	250.84	3.29	1.33%
NYMEX November Natural Gas ($/mmBtu)	5.066	5.221	4.912	5.170	0.082	1.61%
ICE November Gasoil ($/mt)	738.75	744.25	724.00	738.25	3.25	0.44%

Revived demand, plunging stocks

On a smaller case the Weekly Petroleum Status report from the EIA is a true reflection of the market thinking about the underlying oil balance – prices are resilient because of declining inventories and healthy consumption. Whilst the 400,000 bbls drawdown in crude oil stocks is miniscule, when you compare it with the 3.3 million bbls build reported by the API it looks bullish, all of the sudden. Add to that the 2.3 million bbls drop in Cushing inventories, and not only the outright price but the structure of the US crude oil marker gets a proper boost.

The real support, however, comes from products. The combination of dwindling refinery utilization due to maintenance (-2% on the week) and a meaningful rise in products supplied inevitably led to a 5.4 million bbls drop in gasoline and a 3.9 million bbls draw in distillate inventories. Products supplied, the proxy for US demand, has risen nearly 2 mbpd in the past week, including a jump of 450,000 bpd in gasoline and 350,000 bpd in distillate demand. In fact, with consumption at 21.8 mbpd total commercial inventories cover a mere 56 days of demand. This weekly figure is admittedly not indicative for the future, nonetheless it provides a sharp snapshot about the state of the US oil market. Commercial oil inventories, that, on average, make up 45% of OECD stocks fell below 1.23 billion bbls last week only for the third time since March 2019 implying a stock level of 2.73 billion in the developed part of the world.

An unexpectedly supportive stock data, combined with a slightly weaker dollar and stronger equities naturally led to what chart watchers would call a technical bounce off the short-term moving average supports. The performance in the second half of the day, however, was a fully justified and impressive recovery from the day's lows based on solid oil fundamentals, which provides forward guidance for the remainder of the year.

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