GLOBAL CRUDE OIL OUTLOOK 2019

Demand to slow in 2019, still underpinned by China and India

Lower prices and downstream expansion will be supportive

US production still a wildcard with large volumes of US oil to hit the market

Tightening monetary conditions and a stronger US dollar may hurt supply and demand

Early effects of IMO 2020 to potentially strain the refining complex

Middle East risk steady with Saudi Arabia likely to support further cuts
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WILL CRUDE OIL DEMAND SUBSIDENCE IN 2019? A BRIEF RISK OVERVIEW

Global crude oil demand may slow in 2019 on tighter liquidity and a slightly higher risk of economic downturn. However, lower prices and downstream expansion, in particular in the petrochemical sector, will be supportive. The US remains a wildcard, with no intent to be tied in a production agreement. Price and supply wise, its Middle East ally Saudi Arabia still stands at loggerheads. The level of geopolitical risk will remain steady, including the US hard stance against China and Iran, and volatile politics in the wider Arab Gulf region.

BY JULIEN MATHONNIERE - JANUARY 2019

Global oil demand is projected to have grown by about 1.50m bbl/day in 2018, a slower level than in 2017 but still a healthy one. Beyond the core air, marine and road transportation fuels, the call on oil as a petrochemical feedstock has been a powerful growth engine.

In the US, the expansion of chemical capacity has supported demand for liquid hydrocarbons (crude oil and natural gas liquids), as in Japan, where the petrochemical industry is expected to remain one of the main sources of demand in 2019. Likewise, South Korea’s petrochemical and industrial sectors have captured the bulk of oil demand growth in 2018 and are forecast to keep the same trajectory in 2019.

On the non-OECD side, China has propped up global crude demand through a thriving petrochemical industry and a developing middle class that supports steady car sales and higher gasoline consumption. Several large downstream expansion projects are set to provide some demand upside too.

The country also retains a crucial role as a major foreign investor, notably in the Middle East region, where the future path of energy commodity prices will be key. The 400,000 bbl/day YASREF joint venture between Saudi Aramco and Sinopec is an example of that funnelling of Chinese funds into global downstream projects.

Likewise, in India, domestic consumption and the rise of a large middle class fuel crude oil demand. The country notably owns the world’s largest refinery in Jamnagar, Gujarat, a 1.24m bbl/day plant partly quenching the fuel thirst of its east coast metropolis Mumbai and nearby Pakistan.

CHINA’S RESPONSE TO US STANCE

China has been caught in a trade spat with the US and both countries were still trying to iron out their different on trade tariffs in early 2019. China remains highly dependent on resource imports priced in US dollars. Therefore, the country has a strong incentive to “de-dollarise” commodity prices and promote a greater use of the renminbi, its national currency.

The purpose of the recently launched crude oil future contract on the Shanghai Futures Exchange (INE) was a first step in that direction, allowing Chinese buyers to lock in oil prices and pay in their domestic currency.

In theory, it might be a threat to the US dollar’s well-established role as the world’s main petro-currency, even if the Chinese yuan is still a long way from dethroning the US dollar. Beyond a renminbi-denominated oil (or precious metal) future contract, the renminbi will also need to be a credible alternative, with a track record as a strong currency (strong cash returns).

Regardless, the INE crude oil futures have picked up market share from Brent and WTI throughout 2018. For investors willing to assume foreign exchange risk, China is a thriving, very liquid market. However, there is a risk of losing control of the exchange rate when swapping Chinese yuan for US dollars. One possible short-term improvement could be to link China’s oil futures to gold as an alternative for international payments.
However, China exhibits a weakening credit growth despite six months of cautious policy support.

Unless the country decides to implement stronger fiscal stimulus, its GDP is expected to weaken until the second quarter of 2019, with growth forecast at around 6.1%, down from 6.5% in 2018. And China’s demand remain critical to the global markets, including for crude oil.

A HIGHER RISK OF DOWNTURN

The Fed’s five-year break-even rate, which represents investors’ view on the annual inflation rate until 2023, is now standing at around 1.50%, indicating that markets are not overtly concerned about the inflation risk.

Yet, there is a higher risk of economic downturn in 2019, and a stronger probability that the US economy may converge with other developed nations economies.

Global economic growth is forecast to weaken from about 3.7% in 2018 to 3.5% in 2019. The wider analysts’ consensus clearly points to downside risk, but without any indicators suggesting a real risk of recession in 2019.

India will remain the fastest-growing economy at about 7.2%, followed by China at an expected 6.1%. In comparison, the US will hover around 2.6% and the Eurozone at 1.7%.

As a result, a number of money managers have encouraged their clients to stock up on lower-risk, more liquid assets to defend against rising volatility and widening credit spreads. As they save cash for opportunities ahead, some investors may be less willing to invest in replacement oil reserves and new, long-drawn oil exploration and production projects. Although this is unlikely to affect oil prices in the short-term, it increases the possibility of a supply crunch in the mid to long-term.

On the other hand, it may also stave off the appetite for risky ventures beyond the well-surveyed area of the US oil patch. Again, this may help cap the potential upside of US crude output.

TIGHTENING LIQUIDITY

Lower oil prices are likely to boost demand, but OPEC’s efforts will have little bearing on the global economy. Global oil prices may be influenced by less visible developments, among which a drain on US dollar liquidity.

The current monetary tightening, which materialised in a fourth policy rate increase by the US Federal Reserve and hence a stronger US dollar, has put emerging economies under strain.
Emerging market equities were down 25% between late January 2018 and late November 2018, with a low probability of rebounding in 2019 without more government spending from China (government spending). Global oil demand is forecast to grow by about 1.29m bbl/day in 2019, 1.04m bbl/day of which will come from non-OECD countries, according to OPEC.

There is strong refined product growth from countries like India, Indonesia, Singapore and Thailand. For the past few years, those emerging economies have benefited from high liquidity and tight fiscal policies, but the trend is inverting towards looser policies and tighter monetary supply.

The run-up in US Treasury yields and appreciation of the dollar hence poses a significant stress test to the global financial system. It also means that the cost of borrowing money will increase and that pending higher oil prices, some oil fields may not be profitable at $50/bbl, especially in the US.

Given the ample crude supply early into 2019, the oil market may balance at a lower marginal cost of production, which means that higher-cost barrels will be priced out of the market.

**THE US WILDCARD**

So far, US shale drillers have benefited from cheap money and little oilfield service cost inflation. But a tighter monetary market may put some of them under duress in 2019.

Markets run on sentiments more than numbers, and a rise in recession fears is a stronger risk in 2019. Although trade frictions have now partially been baked into commodity prices, investors’ reactions remain unpredictable.

Beyond the risk of an unbalanced oil market, US oil remains the wild card in 2019, being no party to any supply agreement.

US shale drillers have proved more responsive to price swings than big oil, but their aggregate response is extremely difficult to gauge since they do not coordinate their supply decisions.

Likewise, consumption responds to changes in price with a 6 to 18 month lag. By the time demand destruction becomes visible, it is too late and prices will have risen too much.

With prices low enough, the US Administration still has a good hand in the game. President Donald Trump has backed off on his threats on Iran, but he still has the ability to punish and can decide to go harder on the Islamic Republic within the next six months.

US Federal Reserve Chairman Jerome Powell recently reasserted its independence after being criticised by the US President. In other words, even if a pause is US Fed policy rate hikes is probable in the first half of 2019, monetary tightening will persist as the Fed continues to re-purchase bonds and stocks to reduce its balance sheet holdings, effectively removing cash from the US economy.

**THE PREMISES OF IMO 2020**

The first effects of International Maritime Organisation (IMO) 2020 new sulphur regulation may also start to be visible in 2019, or at least to begin to translate into a number of downstream production patterns.

The new IMO 2020 regulation will come into force on 1 January 2020, setting the new global sulphur cap for marine fuels at 0.5%.
Although compliance over the first year is estimated to be around 75%, higher refinery runs of at least 400,000 bbl/day will be needed to meet the required move to the new global bunker fuel standard.

This is expected to strain the refining system, as the production of cleaner and lower-sulphur products will have to replace that of higher-sulphur residual fuel.

This may widen differentials between light clean and heavy dirty products, even if the penetration of scrubbing technology is expected to progress at scale and partly offset demand for cleaner fuels - at least in the immediate aftermath of the new regulation.

A strained refining market will in turn affect the crude oil market, as well as product differentials. There are expectations, in the longer-run, that low-sulphur crude may command a stronger premium, while discounts for heavy sour grades could potentially widen significantly.

The resulting margin effects will be more or less visible depending on refineries' complexity and flexibility. Complex refineries could benefit from higher margins if the price of their crude intake drops.

MIDDLE EAST RISKS
In the Middle East, Washington has turned its back on Iran again, leaving more leeway to Russian influence. Meanwhile, its Saudi ally is unlikely to lift the embargo against Qatar in 2019, also pushing Doha further into the destabilising arms of Turkey and Iran.

Turkey's lira was among the worst currency performers in 2018, and the country still relies heavily on foreign influence. As a result, increased pressure on the country's central bank may unwind some of the tightening delivered in the second half of 2018, especially as the March 2019 elections loom.

Saudi Arabia still produces some of the cheapest barrels in the world, at less than $10/bbl, but according to the IMF, the country's fiscal break-even price, based on its current
government expenditure, stands in excess of $70/bbl. This may pledge in favour of additional production cuts in 2019, as the country already hinted to.

More worryingly, maybe, the postponed Saudi Aramco’s IPO has epitomised the kingdom’s unpredictable foreign policy and highly volatile domestic politics, dealing investors’ confidence a serious blow.

A new generation of rulers in the Middle East has challenged the time-long model of tenured, predictable leadership, which is now becoming an exception rather than the rule.

Higher prices tend to spur additional production volumes from OPEC but also from non-OPEC countries, especially from the US. But too high a clearing price could also dent global demand growth.

With a higher chance of economic slowdown in 2019, a jolt in prices seems unlikely but on the other hand, cheaper oil prices will help sustain demand into the first half of the year.

The plan for oil producers is now to gradually return to a backwardated Brent market, whereby prompt prices are higher than longer-dated future prices, usually in response to tighter supply.