What’s Hot: Is it all bears from here for oil prices?

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How have oil markets evaded the bearish sentiment in equities in the last six months? Have the fundamentals between the two risk markets really diverged or, as the OPEC1 claim, oil markets have simply been panicking? Is the discrepancy now getting corrected?

Source: Bloomberg, data as of 21 July 2022. Brent Oil prices reflect the generic first Brent Oil futures contract price.

Historical performance is not an indication of future performance, and any investments may go down in value.

Might the cure for high prices be high prices?

Commodity prices are ultimately a function of demand and supply. Energy consumption isn’t inelastic, i.e., when prices rise due to supply constraints, consumption isn’t unaffected. Discretionary spending on energy can be reduced by limiting non-essential car and plane journeys. Painful? Yes. But doable? Also, yes.

Even where things stand now, global demand and supply figures do not necessarily support the bull run in oil markets in recent months. According to the International Energy Agency, global oil demand was 99.2 million barrels per day (mb/d) in June while supply stood at 99.5 mb/d. Moreover, global oil supply is expected to average 100.1 mb/d in 2022 before hitting an annual record of 101.1 mb/d in 20232.

So, Brent oil prices exceeding $123/barrel in June, up from under $78/barrel at the start of the year3, doesn’t seem like a function of on the ground demand and supply dynamics.

Further demand destruction on the cards?

China is still pursuing a zero-Covid policy, and forty-one Chinese cities are under full or partial lockdowns or district-based controls, covering 264mn people in regions that account for about 18.7 per cent of the country’s economic activity4. China is the second largest oil consuming country in the world and further lockdowns could dent demand again, as they have in recent months (see figure 02).

Source: Bloomberg, data as of 21 July 2022.

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What does OPEC say?

Saudi Arabia and the United Arab Emirates (UAE), the two countries where most of OPEC's spare capacity sits, have both resisted pressure until now from the West to increase supply in the wake of rising prices. While some have seen this as the group's inability to increase output, the US Energy Information Administration (EIA) state that OPEC's spare capacity in the second quarter of this year was 2.85 mb/d and will remain above 2.5 mb/d through 2023. This is much higher than the 2003-2008 period when price rallied sharply, and spare capacity was below 2.5 mb/d5.

The OPEC have repeatedly asserted that the case for increasing supply at a faster rate is not strong enough as prices have rallied due to markets panicking over the Russia-Ukraine conflict.

Oil bulls can easily argue that OPEC could cut production if demand slows down meaningfully and this could cause prices to rise. Admittedly, this is possible. But it seems like the group is taking a more measured approach in view of the medium term demand outlook rather than making hasty decisions, in raising supply now and cutting later.

Is tackling oil prices the solution to inflation?

Probably yes. Consumer spending in the US has exceeded pre-pandemic trend levels. This is certainly not the case in Europe. But inflation is equally rampant in both regions. Energy prices are arguably playing a larger role in driving inflation than other components of aggregate demand. Perhaps governments can help their central banks avoid pushing their economies into a recession by rethinking energy policy and sanctions. While Russian oil exports fell slightly by 250 thousand barrels/day (kb/d) in June to 7.4 mb/d, export revenues increased by $700 million month on month to $20.4 billion due to higher prices, 40% above last year's average6. So, the West's plan to punish Russia via the oil market doesn't seem to be working.

What's the bottom line?

Oil prices were on the rise at the start of the year on expectations that demand might outpace supply as people start travelling again. But while chaos at airports around the world does confirm that travel activity has picked up, supply has been ample to meet the additional demand.

And then there has been the Russia-Ukraine conflict. Some might call it panic, other might call it a geopolitical risk premium. Either way, the perceived risk of supply shortages has helped sustain oil prices higher while equities, and other risk assets, have pulled back on recessionary fears. Markets may now be moving to address this discrepancy.

1 The Organization of the Petroleum Exporting Countries.

2 According to the International Energy Agency's Oil Market Report July 2022.

3 Source: Bloomberg.

4 Source: Financial Times article from July 18 quoting a report from Nomura.

5 Source: US Energy Information Administration, data as of 12 July 2022.

6 According to the International Energy Agency’s Oil Market Report July 2022.

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