

# OPEC's supply cuts pre-empt economic weakness

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**Aneeka Gupta**

Director, Macroeconomic Research, WisdomTree Europe

The Organisation of Petroleum Exporting Countries and its partners (OPEC+) producers surprised the market with a decision on Sunday 2 April 2023 to lower production limits by more than 1mn barrels per day (bpd) from May through the end of 2023. This decision was announced ahead of the OPEC+ Joint Ministerial Monitoring Committee (JMMC) meeting scheduled on 3 April and was contrary to market expectations that the committee would keep policy unchanged. Over the prior week, OPEC+ ministers were giving public assurances that they would stick to their production targets for the entire year. This cut tells us that OPEC+ is pre-empting weaker demand into the year and was looking to shore up the market.

*Source: OPEC, WisdomTree as of 2 April 2023.*

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

**OPEC+ announcement may have caught speculators by surprise**

It is evident Sunday's decision caught the market by surprise evident from the commitment of trader's report which showed net speculative positioning in Brent crude oil futures at -44k contracts were 146% below the 5-year average. Sentiment on the crude oil market had been weak prior to the decision.

*Source: Commodity Futures Trading Commission, WisdomTree as of 28 March 2023.*

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**Demand outlook remains soft amidst weaker economic backdrop**

OPEC has been markedly dovish on oil demand for some time relative to other forecasters such as the Energy Information Administration (EIA). This cut helps solve the disparity that existed between OPEC and the EIA. OPEC expects oil demand to grow by around 2mn bpd in 2023. A significant portion of this growth (nearly 710,000bpd) is reliant on Chinese oil demand<sup>1</sup>. Given that such a large amount of demand hinges on a single economy poses a risk to the demand outlook as the pace of China's recovery post re-opening has not been as robust as previously anticipated. At the same time, tightening credit conditions owing to the recent banking crisis is also likely to weigh on growth forecasts in the rest of the developed world. Global Purchasing Managers Indices (PMI) indicators suggest manufacturing activity has contracted since September 2022.

## Supply outlook will be driven by new OPEC+ cuts

Since Russia has been producing less than its notional limit, the reduction on actual production will be less than 1mn bpd. But with Saudi Arabia committing to voluntary reduction of 500,000bpd we would expect the overall decline in OPEC supply to be around 900,000bpd by the beginning of May 2023. Assuming OPEC production holding at the recent 28.9mn bpd for April, our balances would point to an equilibrium in Q2 and a return to a deficit in Q3 and Q4. This deficit is largely a function of OPEC+ cuts as opposed to stronger demand globally.

The front end of the Brent crude oil futures curve remains in backwardation with a roll yield of +0.4%.

*Source: Bloomberg, WisdomTree as of 5 April 2023.*

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OPEC+ producers can also cut without the fear that they will lose significant market share to non-OPEC members. Previously, OPEC+ would be reluctant to let prices rise too high, as it would incentivise a supply response from US producers. However, US producers today appear more focussed on capital discipline and maximizing shareholder returns. The US also has limited capacity to plug the shortfall created by OPEC+ cuts owing to last year's unprecedented release from strategic US oil reserves (now at a 40-year low).

## Conclusion

In the short term, OPEC production cuts are almost always supportive evident from the recent price reaction Brent crude oil prices have risen (+6.54%<sup>2</sup>). However, over the medium term, the price response to cuts have been more mixed as they do tend to signal underlying weakness in the supply/demand balance. Either OPEC countries are expecting demand to be significantly weaker or doubt oil production in Russia will decline as sharply as forecasted.

So, with speculative positioning at currently low levels alongside further inventory draws expected later in the year, the risks are tilted towards the upside for crude oil prices. However, given the uncertainty in the macro environment, we expect the upside in prices to be capped at about US\$90 per barrel.

1 OPEC - The Organisation of Petroleum Exporting Countries

2 Bloomberg from 31 March 2023 to 5 April 2023

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