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Commodities Strategy

Is Brent Crude Oil Price Sustainable Above USD 70/bbl?

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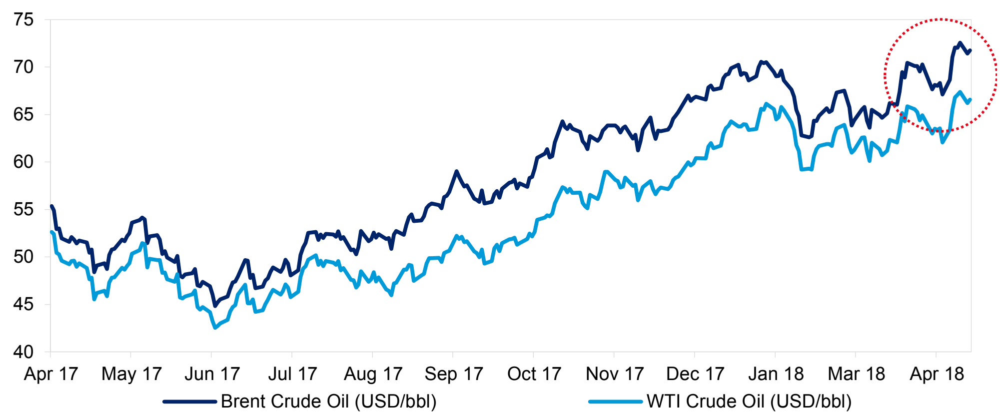
- In recent weeks, two key positive factors managed to lift Brent crude oil above USD 70/bbl. First is the escalating geopolitical risk in the Middle East. Second is the on-going drawdown in excess global crude oil inventories due to the OPEC led production cut.
- However, the strong rise in US crude oil production risks generating new imbalances. US crude oil inventory has started to grow again as rig counts jump above 800, while US crude oil exports is growing strongly. In addition, net long position in crude oil on NYMEX has now jumped to a decade long high.
- Overall, we believe that once the geopolitical risk subsides, Brent crude oil may pull back and settle down in the USD 60 to 70/bbl range. Given the strong rise in US crude oil production, it is likely that WTI crude oil will continue to trade at a clear discount to Brent crude oil
- Our technical analysis of Brent crude oil price suggests that despite the break of a strong resistance level, a sustained upmove appears unlikely at this stage. Brent crude oil is likely to drift back down towards the rising trend line support currently residing at USD 68.5/bbl.

The Return Of Geopolitical Risk Premium For Crude Oil

Over the past two weeks, both WTI and Brent crude oil have rallied about USD 5/bbl. Brent crude oil traded higher from USD 67 to USD 72/bbl, while WTI crude oil also jumped from USD 62 to USD 67/bbl. This USD 5/bbl rally in crude oil was off the back of the escalation of the Syrian crisis that cumulated in the joint missile strike on Syrian chemical weapons facilities by US, France and Britain. Furthermore, one could also argue that this USD 5/bbl rally in crude oil is the geopolitical risk premium on crude oil. So far, the geopolitical risk remains elevated with the US government now preparing possible sanctions on firms that provided support for the alleged chemical weapons.

Chart 1: Brent Crude Oil Trades Above USD 70 / bbl On Rising Geopolitical Tensions

Source: Bloomberg, UOB Global Economics & Markets Research



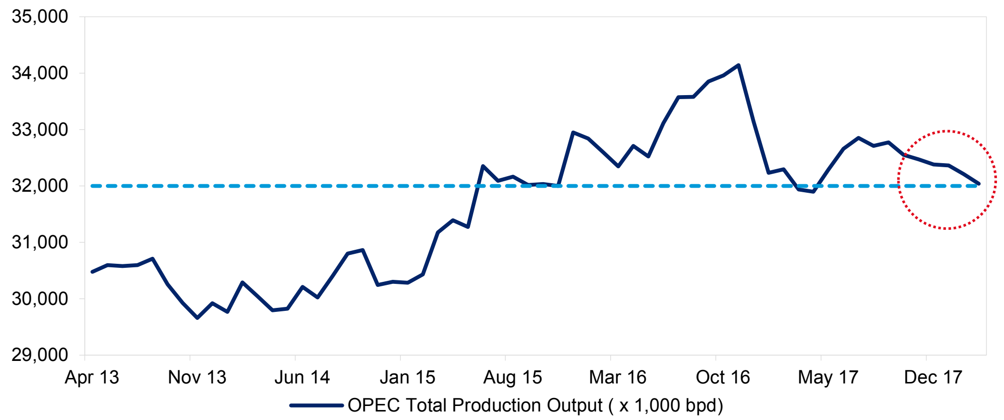
The OPEC Led Production Cut Also Appears To Have Worked Its Magic

On top of the above mentioned return of geopolitical risk premium, the OPEC led production cut on crude oil also appeared to be working. In Jan 2017, OPEC, together with Russia and 9 other oil producing nations (OPEC, Russia + 9) joined hands to implement production cuts. OPEC agreed to cut 1.2 million (mio) bpd from their Oct 2016 production levels, while Russia + 9 committed to cut 0.6 mio bpd from their Oct 2016 production levels, leading to a joint production cut of 1.8 mio bpd. That agreement was extended in Dec 2017 for another year till end of 2018.

Since then, there has been good OPEC compliance to the production cuts in excess of 100%. In the latest update for February, OPEC disclosed that it is cutting in excess of 1.5 mio bpd compared to its target cut of 1.2 mio bpd. In other words, OPEC compliance is now as high as 125% of the production cut target. In addition, OPEC also reported that its collective output fell below 32 mio bpd as its estimate for global crude oil demand rose to 32.6 mio bpd for 2018.

Chart 2: OPEC's Total Production Output Has Dropped Below 32 mio bpd

Source: Bloomberg, UOB Global Economics & Markets Research



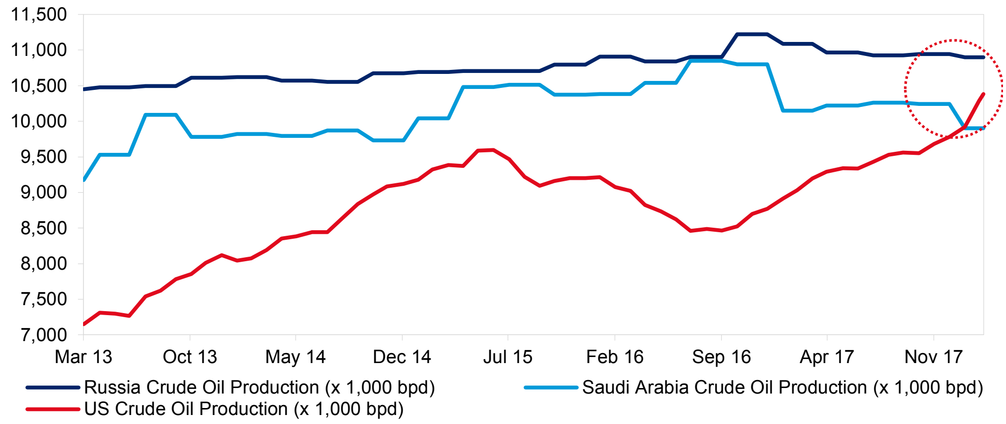
Consequently, after one and a half years of production cut, coupled with strong global demand growth for crude oil, the International Energy Agency (IEA) also reported that the OECD global crude oil stock has now fallen from its peak of about 400 mio barrels above the 5 year average to just barely 40 mio barrels above the 5 year average. The IEA claims that it is now “mission accomplished” for OPEC as excess global crude oil inventory will be fully eliminated in the coming quarter.

But US Oil Production Continues To Grow Strongly

The success of the OPEC led production cut is good news for crude oil bulls. However, on the other hand, crude oil production from the US continues to grow at a very strong pace. As a result of the shale oil production boom, US crude oil production has now jumped above the 10 mio bpd level to about 10.3 mio bpd. At 10.3 mio bpd, US crude oil production has now surpassed that of Saudi Arabia, which is capped by the production cut to under the 10 mio bpd level at 9.9 mio bpd. In fact, industry estimates suggest that at the rate the US crude oil production increases, the US will surpass Russia before the end of the year, to become the world's largest producer of crude oil. Currently, Russia produces about 10.9 mio bpd.

Chart 3: US Crude Oil Production Has Now Over Taken Saudi Arabia

Source: Bloomberg, UOB Global Economics & Markets Research



The strong growth in US production risks generating renewed imbalances in crude oil markets. After correcting for two years, crude oil inventory at the Cushing hub has started to build again. US crude oil export has grown exponentially to around 1.5 mio bpd. In addition, US active rig count has more than doubled from its low back in 2014 and in recent update, jumped decisively above 800 to 815. All the above mentioned developments are negative for crude oil.

Chart 4: US Crude Oil Exports Jump On Strong Production Growth

Source: Bloomberg, UOB Global Economics & Markets Research

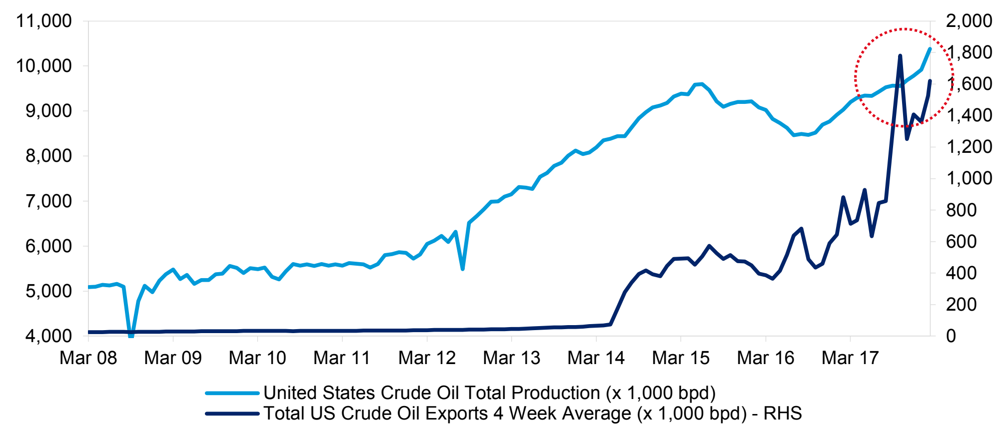
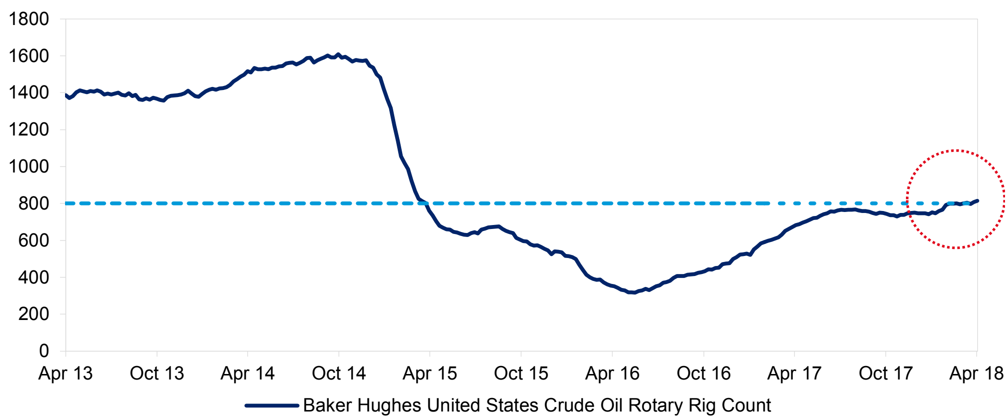


Chart 5: US Rig Count Has Now Risen Back Above 800

Source: Bloomberg, UOB Global Economics & Markets Research

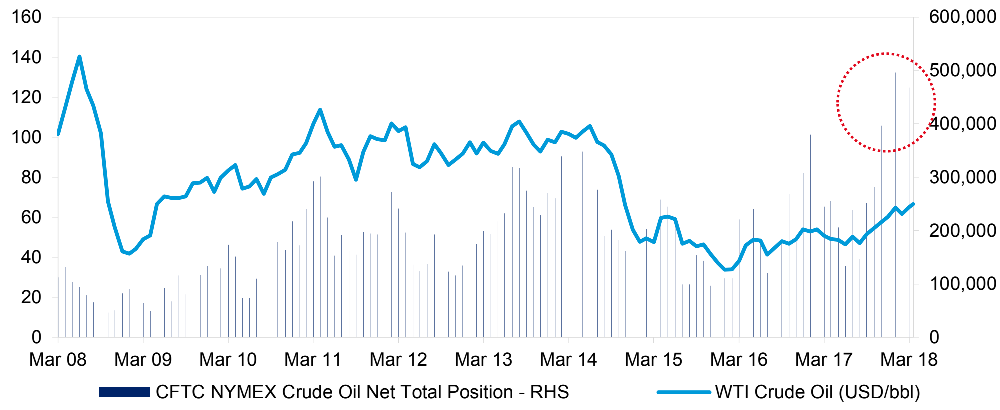


Net Long Positioning On NYMEX Is Now At A Decade Long Record High

Finally, as a result of growing optimism over the goldilocks growth recovery as well as the need to hedge geopolitical risk, net long WTI crude oil positioning on NYMEX has recently spiked to a decade long record high. In other words, the elevated net long positioning puts crude oil at risk of profit taking should the underlying conditions change.

Chart 6: Net Long Positioning On NYMEX Is At Decade Long High

Source: Bloomberg, UOB Global Economics & Markets Research



On Balance, We Maintain Our USD 60 to 70/bbl Outlook For Brent Crude Oil

On a positive note, the near term geopolitical tension in the Middle East will likely keep Brent Crude Oil elevated above USD 70/bbl over the near term. The drawing down of global crude oil inventory is indeed another positive. But, going forward, with US production growing strongly, there may be little appetite from OPEC to continue to maintain its production cut. While OPEC has been disciplined in the production cuts, it is also worth noting that a large part of it is due to a sharp collapse in Venezuela's production. In addition, Russia and the non-OPEC members have been less compliant and are still struggling to keep up with the proposed production cuts.

Overall, we believe that once the geopolitical risk subsides, it is likely that Brent crude oil will pull back below the USD 70/bbl handle and revert to the USD 60 to 70/bbl trading range. The elevated record high net long positioning also suggest that profit taking is an underlying risk for crude oil prices. Given the strong rise in US crude oil production, it is likely that WTI crude oil will continue to trade at a clear discount to Brent crude oil.

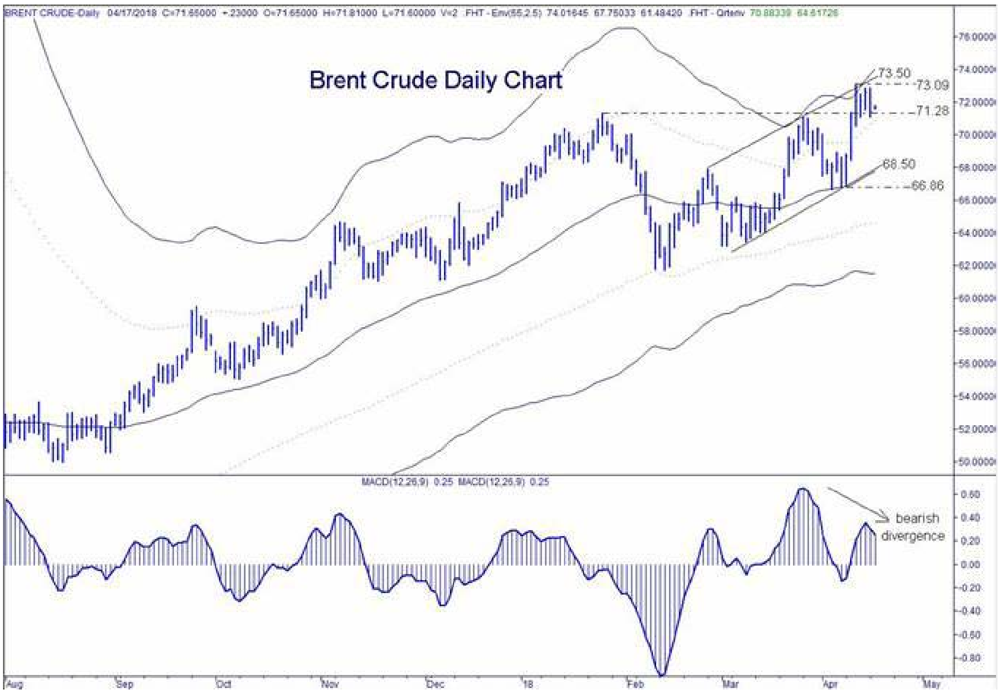
There are two key risks to our cautious view on Brent crude oil, both of which have the potential to lift Brent crude oil higher into the mid-$70s/bbl. First is further escalation in geopolitical risk in the Middle East. In mid-May, the US is due to assess its relief on sanctions against Iran. There is increasing risk that US may impose sanctions on Iran following the escalating tensions with Syria.

Second is OPEC's upcoming June meeting where it is due for a review of the current crude oil production cut agreement. So far, Saudi Arabia has been sending the right messages with Saudi Energy Minister Khalid al-Falih saying recently that they will not "sit by to let another supply glut reappear" and that they will propose to extend the production cut into 2019 at the meeting. Should OPEC decide to extend the production cut into 2019, this will lead to further drawdown of global crude oil inventory and this is supportive of further crude oil strength.

Brent Crude: 71.65/bbl

Despite Break Of Strong Resistance Level, A Sustained Up-Move Appears Unlikely

Source: Reuters, UOB Global Economics & Markets Research



The strong surge in Brent Crude earlier this month took out the January's 71.28 peak and hit a high of 73.09. Despite the break of the strong resistance level, momentum indicators are not showing the characteristics of an impulsive rally and a sustained up-move from here appears unlikely. Furthermore, MACD on the daily chart is showing clear bearish divergence and this reinforces the view the current up-move in Brent Crude is unlikely to accelerate further. However, another 'up-leg' towards the next resistance at 73.50 is not ruled out even though the odds for such a move are not high. That said, we are not anticipating a bearish reversal and for the next several weeks, Brent Crude is more likely to drift lower from current level towards the rising trend-line support (currently residing at 68.50). The next support below this level is at 66.86.

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