Weekly Market Flash

Another Whiplash Week (and Month, and Year) for Oil

August 12, 2016

As July came to a close the chatter among oil price watchers in the financial media was about the onset of "bear market territory" as Brent crude prices fell some 20 percent from their recent June highs. That might have been newsworthy were the asset in question Dow Jones or Nasdaq stocks. But crude oil? Another day, another radical price swing. There had already been four corrections of 10 percent or more, followed by snapbacks of an equal or greater magnitude, between the beginning of the year and Valentine's Day. More recently, spot Brent crude prices spiked by nearly 20 percent between early May and early June as US production continued to slow, outages in Canada, Nigeria and Libya hit supply volumes, and Saudi Arabia promised its OPEC peers that it would not flood the markets with new product in efforts to grab new market share.

Reality Bites Back

Just one month later, reality proved to be somewhat different from June's rosy picture. Saudi production in July spiked to a record level of 10.67 million barrels per day, contrary to its earlier promises of restraint. The Middle East is baking in a massive heat wave, with temperatures spiking over 120 degrees and air conditioners cranking up and straining local energy company supplies. Elsewhere, though, demand in key markets including the US, China and India waned. A big contributing factor to waning demand has been record high downstream inventory levels. In recent years, oil refineries in the US and elsewhere turned up gasoline production volumes as low prices pushed consumers back into their beloved gas guzzlers of yore. This has resulted in record inventories for the refiners and thus reduced demand for new crude supplies.

Finally, in addition to higher Saudi supply and lower global demand, the supply cuts from outages in Nigeria and elsewhere abated and volumes kicked back into gear as those situations resolved themselves. Hedge fund managers took stock of these developments in late July and decided they didn't like what they saw. Brent crude plummeted from over $45 to $40 from July 21 to August 2 as speculators reversed their earlier optimistic bets. Market commentators channeled their best inner Yogi Berra to proclaim "déjà vu all over again" as prices failed to sustain an upside breakout. The negative view was subsequently reinforced by a new International Energy Agency report, published earlier this week, forecasting 2017 demand levels to be lower than previously expected.

Hope Springs Eternal

Those factors – continuing record levels of production alongside weaker global demand and in particular a downstream inventory glut – would appear to be fairly stiff headwinds. So what accounts for the 10 percent price spike since August 2 and, in particular, the 5 percent jump in Brent October futures that happened yesterday? Stop us if you've heard this one before…a possible OPEC production freeze! We got a news tidbit from OPEC at the beginning of this week that there would be an "informal" meeting of cartel ministers on the sidelines of an unrelated energy industry conference scheduled to take place in September. That sparked an immediate bump in spot and futures markets.

Then came the IEA report, mentioned above, with its dour outlook on demand, to temper animal spirits. Never fear! On Thursday, comments from Saudi energy minister Khalid al Falih were "mistakenly" released to journalists, in which the minister expressed his belief that coordinated action among OPEC members could help balance oil market conditions. Yes, you have indeed heard this one before. There was a similar amount of hype and speculation leading up to the OPEC meeting in Doha, Qatar, back in April. As with yesterday's remarks, there were plenty of conditionals and weasel-words in the pre-Doha communiqués, and in the end nothing got done at that meeting. No freeze, no productions cuts, no nothing.

We are highly skeptical that anything more lasting will be accomplished on the sidelines of September's sideline confab, either. Even if OPEC's beleaguered small-nation producers managed to convince the Saudis to go ahead and back a production freeze – a very big and unlikely if – we would not see that as having a dominant and lasting effect on the structural supply / demand problems the industry continues to face. Meanwhile, integrated oil producers continue to wrestle with the double-whammy of low price realizations upstream and strained margins downstream. Big Oil continues to face an environment of Big Problems.

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