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Commodities

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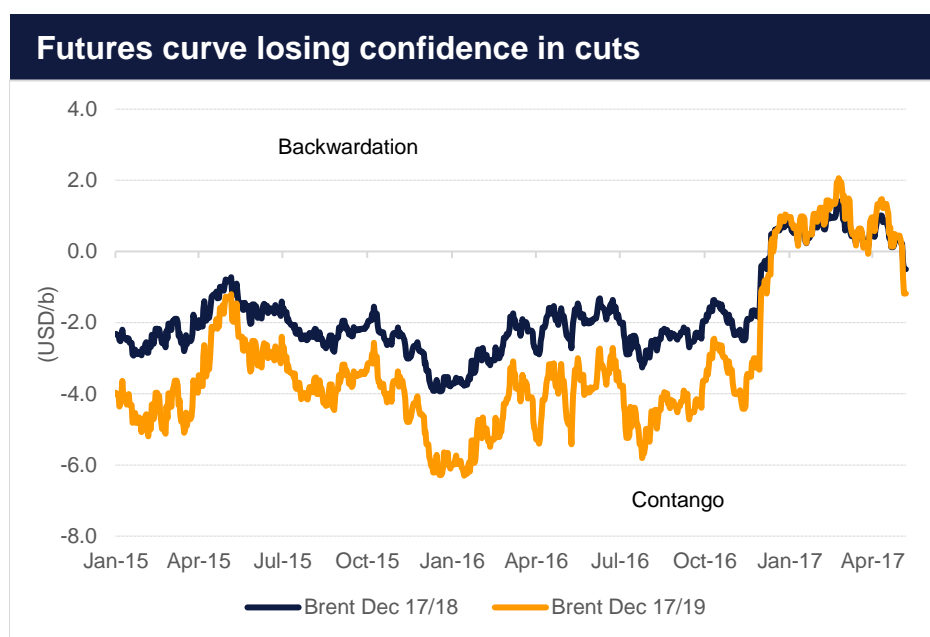
Crude oil update

Oil futures curve weakens ahead of OPEC meeting

With only a few weeks to go ahead of OPEC's next regular meeting the oil futures market is shuddering. Brent and WTI futures gave up more than 5% and 6% in the past week and have lost ground for three weeks running, their longest stretch of declines since November 2016. Both contracts have now moved below the USD 50/b handle and are trading lower than long-term moving averages.

We doubt that a rally in spot prices was ever a priority outcome for OPEC members in deciding to support a production cut, considering how many factors outside their control can impact the oil price in the near term. Rather, an adjustment to the shape of the forward curve would have been a more significant objective as it directly impacts revenues received both by OPEC exporters and non-OPEC producers, including shale oil producers in the US.

Traditional term exporters like OPEC members normally price against the front-end of a forward curve for physical oil and thus benefit from near term tightness, or a backwardated market, when near-term prices are higher than longer-dated ones. In contrast, producers in the US would likely have entered into hedging agreements for a considerable share of their output as a condition of accessing bank finance. This hedging would be in place further along the curve, allowing for producers to keep output steady regardless of changes to spot prices.

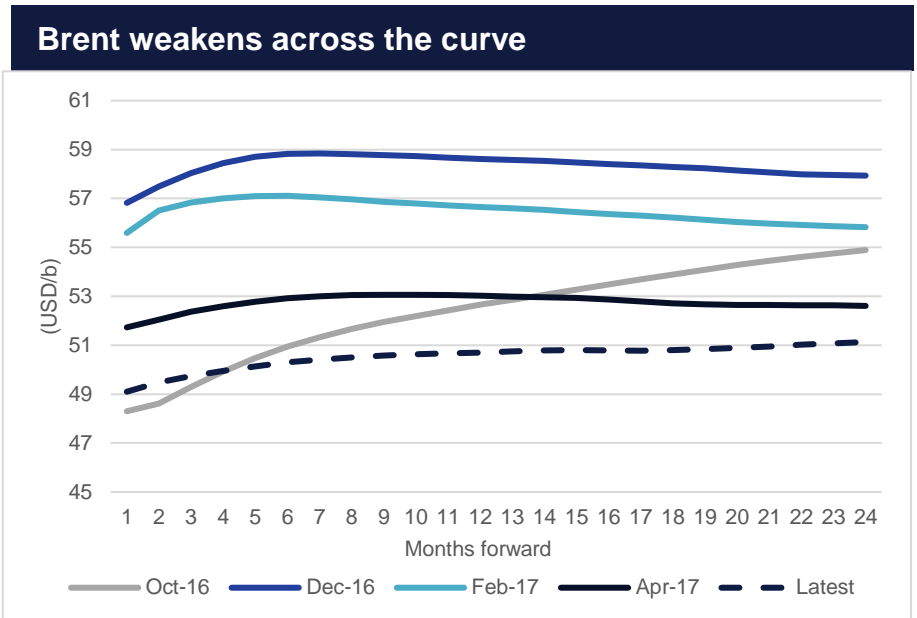


Source: Bloomberg, Emirates NBD Research.

When OPEC announced its production cut agreement at the end of November, it sparked a rally in flat prices which then held remarkably steady for much of Q1 but have now broken lower. The oil futures curve also shifted away from the deep contango into which it had fallen from mid-2014 and moved closer to trading flat and flirted occasionally with a full shift into backwardation. However, that premium for near-term prices always appeared on thin ice considering weak evidence that OPEC's cuts were actually resulting in a tighter oil market.

A flip of the curve back into contango sends a less confident signal for the trajectory for oil prices in the near term. The market will parse with growing scrutiny any statement from OPEC officials in support of extending its production cut during its May 25th meeting. But an extension may already be priced into the market considering how widely telegraphed support for an extension appears to be. But conviction in the deal may be waning. Both the Iraqi and Iranian oil ministers have said they will "go along" with whatever OPEC decides at the end of the month rather than arguing for a definitive change to the deal that will hasten the market's rebalancing.

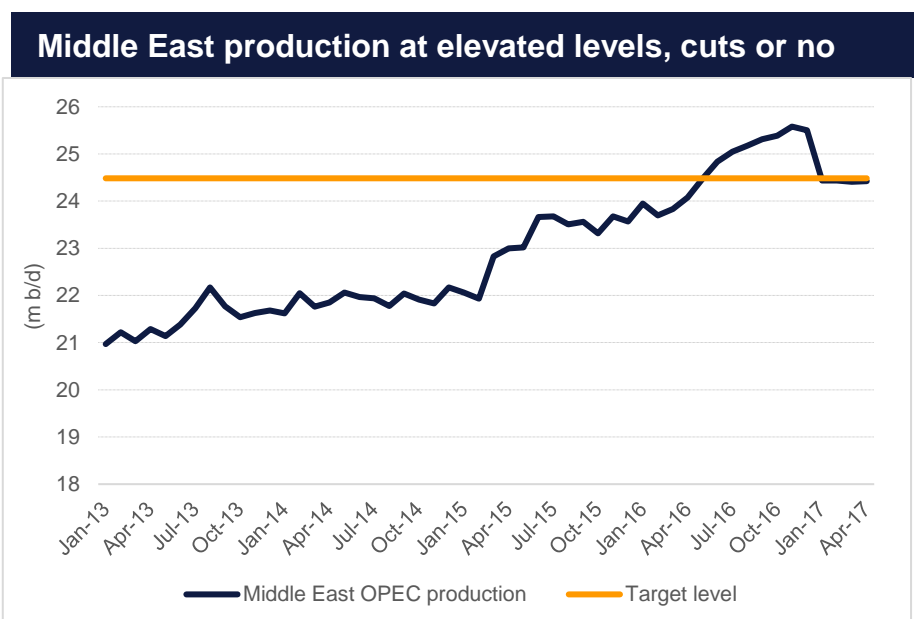
The re-flip into contango is still in its early stages and is not at levels that would make storage trades economic. However, it is worth noting that the contango that has emerged in the market is now pricing longer-dated futures below the level they were ahead of OPEC's decision.



Source: Bloomberg, Emirates NBD Research.

We had been skeptical that a backwardated market would appear with much conviction considering the current market's fundamentals, not the least of which are:

- Burdensome inventories. Even if stocks draw consistently for several months it will take considerable levels of demand to move them anywhere closer to historic norms.
- The short response cycle of US producers. The US oil industry has responded relatively quickly to oil prices, adding nearly 400 rigs from a trough in Q2 2016. At the same time the US has emerged as a new supplier of crude to traditional OPEC markets like China.
- The high base from which OPEC made its cuts was far above historic levels.



Source: OPEC Monthly Oil Market Report, Emirates NBD Research.

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