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Crude oil update

OPEC rolls over...

OPEC has extended its existing production cut agreement with its non-OPEC partners for an additional nine months, taking the deal into the first quarter of 2018. The meeting on Thursday seems to have gone off relatively smoothly with no major disputes between producing nations and OPEC welcomed a new member in Equatorial Guinea. Importantly, OPEC's non-member partners, of which Russia is the most critical producer, also agreed to keep in place the production cuts for nine months.

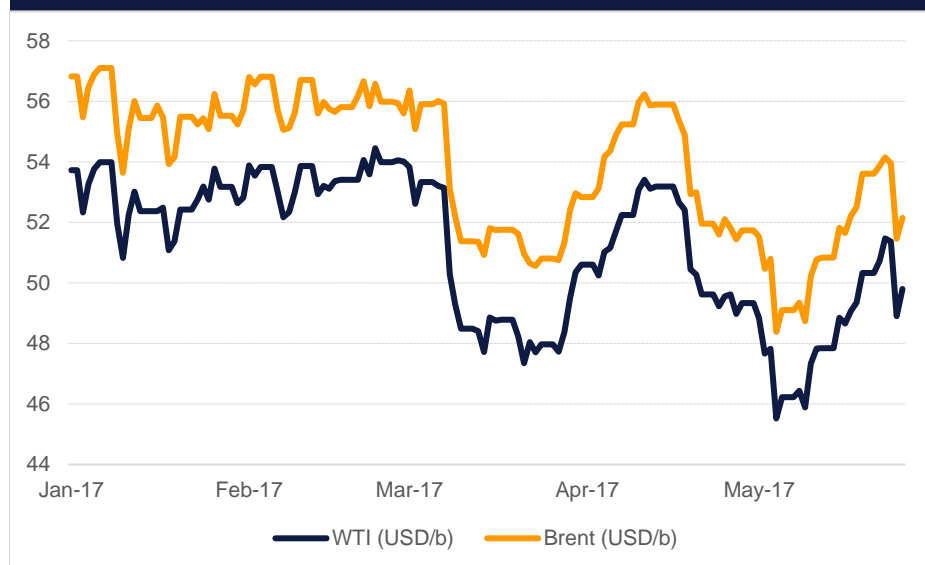
Perhaps the biggest takeaway from the meeting is the extraordinary level of constructive oil market diplomacy that currently exists between OPEC members and their partners in the deal. Despite the political tensions that exist between some members, the issues affecting the oil market seem to outweigh those differences and is allowing OPEC to communicate with a coherent and consistent message.

Market gives a thumbs down

However, the message was effectively rejected by the market as not doing enough to balance crude supplies with demand. After a week in which OPEC ministers said they would do 'whatever it takes' to balance the market investors built expectations that a deal that went further than the current level of cuts would emerge on Thursday. The market likely was expecting that either Nigeria or Libya, both of whom have been exempted from the production limits, would be part of the deal or that the existing cutters would agree to a new, lower target. In the end with OPEC taking the simplest route investors gave the producers' bloc a failing grade in terms of managing the market and oil prices tanked as a result, taking WTI futures back below USD 50/b and Brent down from over USD 54/b to just above USD 52/b at the close on Friday.

A single day move in prices won't be enough to disrupt OPEC's overall strategy. Indeed, the drop on Thursday represents a decline of USD 431,000 in the value of a fully loaded VLCC on a cargo priced against a monthly Brent settlement compared with if prices had been unchanged. So the heavy selling that occurred as a response strikes us more as investor repositioning about a lack of positive surprise rather than a wholesale revaluation of the market's fundamentals.

Market gives a thumbs down to OPEC's extension



Source: EIKON, Emirates NBD Research.

But what will be the impact of extending cuts? We believe that if compliance with production targets stays at the same level it has been at the start of the year for the remainder of 2017 then the crude market will move into a small deficit in the second half of the year. That will generally be supportive for prices but the level of the cuts at most will prevent the market from going into freefall, rather than sparking a major rally in prices.

Inventory draw unlikely to be as significant as OPEC hopes

The emergence of a deficit will by its nature mean there will be some drawdown in crude and product inventories but the scale of the cuts means we don't think stocks will end the year anywhere close to their five-year average and question whether this is a useful metric anymore. By the end of 2017 a five-year average of inventories will take into account the impact of shale oil and OPEC hitting peak production in 2014-16, meaning that the comparison level itself will be exceptionally high. A five year average of 2.99bn bbl at the end of 2017 represents more than 63 days of OECD demand compared with less than 60 days in 2014 and earlier. The cuts will lead to a decline in the 'excess' inventory level but overall levels will hardly be 'tight'.

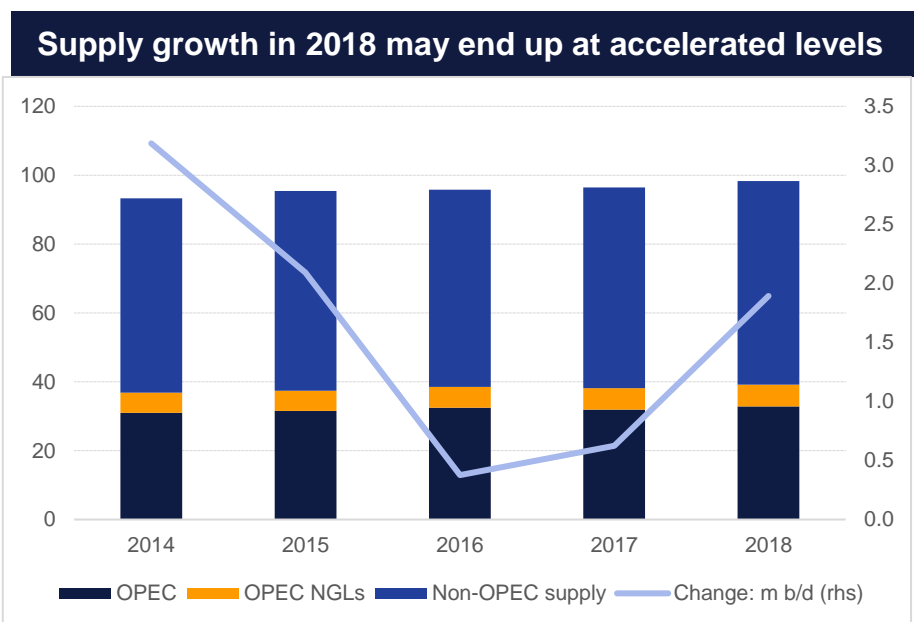
Taking the cuts into 2018 does send a message that OPEC, or at least its influential members, is serious about trying to manage the market but OPEC's ability to impact the market has been tempered. The absence of OPEC oil to important consuming nations like China or India opens up market share to alternative producers, most notably producers in the US shale patch who can respond quickly to changes in market conditions and price structures. The quick response cycle from US shale producers, now free to export at will, helps to offset the impact of OPEC's supply restrictions.

There may also be longer-term issues as a result of OPEC's supply management strategy. This uncertainty over OPEC supply levels could create anxiety in key Asian markets over security of supply and lead to greater volumes of crude from the Americas making its way into regional refineries.

2018: back to the future?

While the outlook for the remainder of 2017 looks fairly secure in terms of OPEC and its partners catalyzing a deficit, the producers have yet to outline an exit strategy. At the end of Q1 2018 will they unload as much as 1.8m b/d of production back onto the market, even if inventories have not yet drawn to historic levels?

OPEC itself is expecting nearly 1m b/d of production growth from the US this year and if we assume a much slower pace of expansion in 2018, the impact of higher output from the US, Canada and Brazil especially will be enough to push the market back into surplus and will lead to a build in inventories once again.



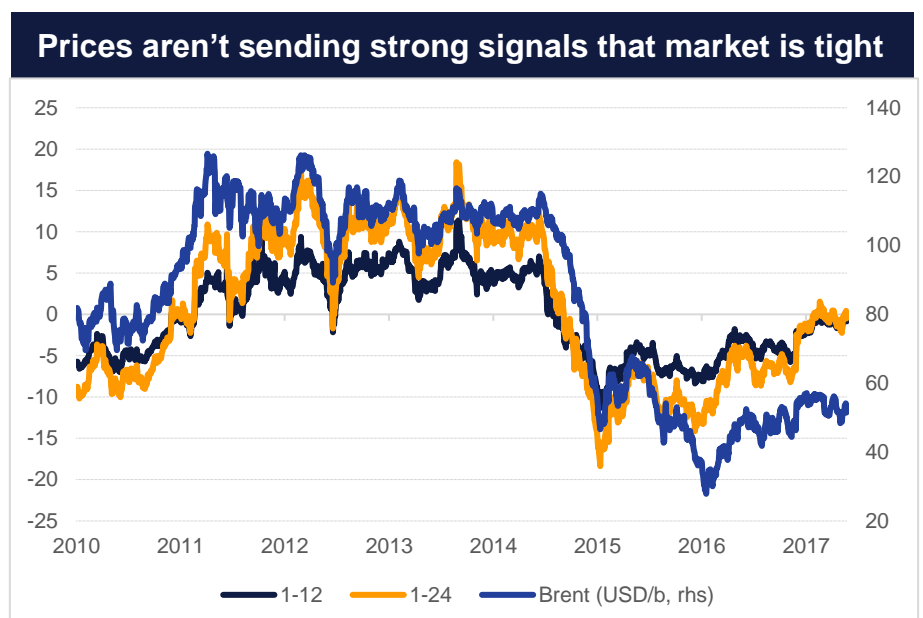
Source: OPEC Monthly Oil Market Report, Emirates NBD Research.

We doubt that OPEC producers would be prepared to keep cutting production to accommodate alternative producers and consequently keep giving up market share, meaning a renewed existential decision of prices vs market share will come back to the fore in 2018.

How do prices respond?

While the impact of OPEC's cuts plays out we maintain our view that prices will be generally higher y/y than in 2016 but that the gains may be muted going into H2 2017. But the price response to OPEC's extension, either in flat price or spreads, does not signify to us we are in a tight market that could easily allow for a major spike upward out of its current trading range.

The draw in inventories we expect in H2 2017 will probably help shift the market more consistently out of contango but the degree of backwardation will not send a strong signal that the market is short on crude. Indeed, compared with previous levels of backwardation in 2011-14 when supply disruptions from Iran and Libya were affecting the market we are at far more tenuous levels, making us skeptical that serious upside headroom is imminent. A new phase of listless, low volatility markets may set in once last week's shock gets out of the system. Cash allocated to long positions has basically halved from its 2017 high, according to recent COT data and long/short ratios have moved near enough to par which indicates the market doesn't have a strong conviction about direction at the moment.



Source: EIKON, Emirates NBD Research. Note: spreads between first and 12 and 24 month futures.

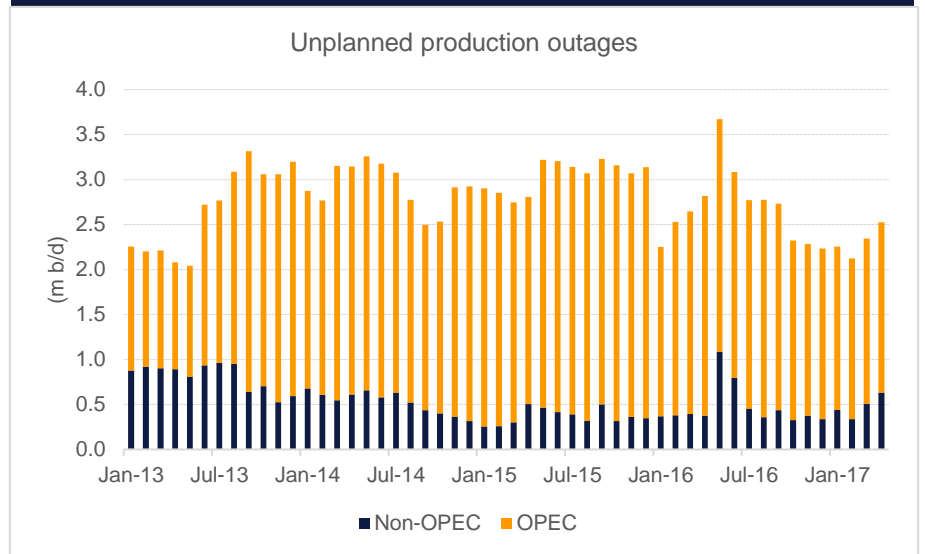
Any further drift lower in spot prices may prompt technical selling and we would expect to see a widening of put premiums over the coming weeks, particularly if the summer driving season fails to deliver the expected inventory draws. Were prices to start accelerating downward we would expect more verbal intervention from OPEC and non-OPEC officials to try and talk the market up.

Is there a positive story for prices?

Sketching out a strong bull case is far more challenging in the current market as the oil market is unusually short on unplanned supply disruptions (see chart next page). Production from Libya and Nigeria, both of which remain exempt from OPEC's deal, has been showing signs of stabilization and improvement while the risk of OPEC members not complying with target levels remains strong.

A major demand spike would be the most welcome development to spur a rally in prices but there too major forecasting agencies have been growing more tentative. The IEA has cut its demand estimate for 2017 to growth of 1.28m b/d in its latest Oil Market Report, down from as much as 1.4m b/d as recently as February. We have tentatively penciled in a stronger recovery in demand for 2018 (at 1.4m b/d) but even that isn't enough to keep the market from staying in a deficit if OPEC and its partners resume production growth.

Output remains trouble free and that's the trouble



Source: EIA STEO, Emirates NBD Research.

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