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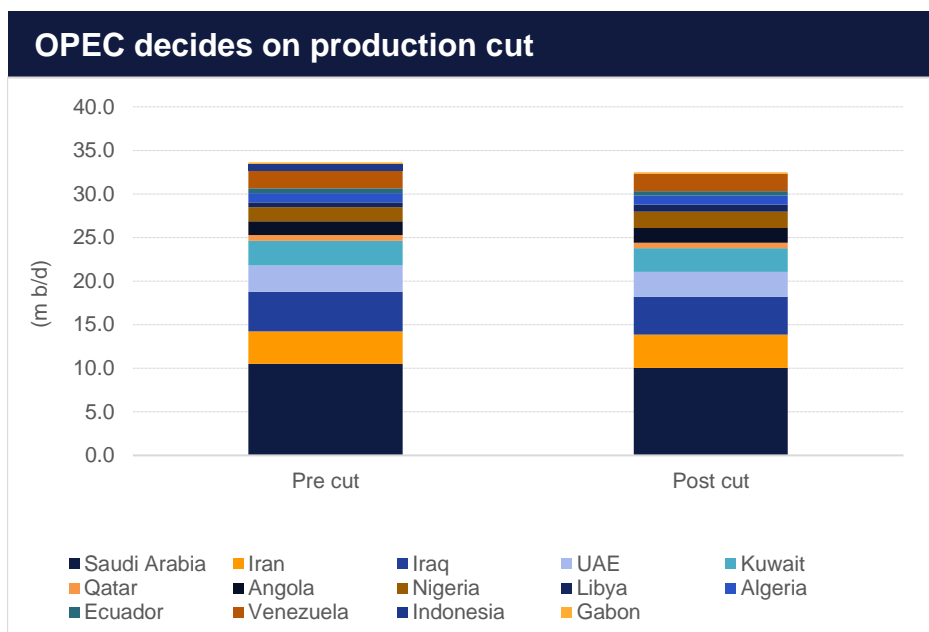
4 December 2016

Crude oil update

OPEC cuts, what next?

OPEC endorsed its Algiers agreement and has agreed to collectively cut production to 32.5m b/d with effect from January 2017. The stakes had been high for OPEC to come to an agreement considering how heavily the market was discounting a failure but the producers' bloc has now effectively abandoned its market share strategy, adopted at the end of 2014, in favour of targeting prices.

OPEC countries will now have set production limits roughly 4.5% lower than their baseline levels. Saudi Arabia has accepted a cut of 486k b/d while the UAE will cut by 139k b/d, Kuwait by 131k b/d and Qatar by 30k b/d. Among the other major producers within OPEC, Iraq has agreed to cut production by 210k b/d while Iran is allowed to raise output 90k b/d to just under 3.8m b/d. OPEC has also managed to secure at least verbal commitment from non-OPEC producers, mainly Russia, to cut production by 600k b/d next year. Both Nigeria and Libya have been excused from the production cut agreement as their oil industries are in repair mode following militant attacks and the impact of civil war.



Source: OPEC, Emirates NBD Research.

Several questions emerge immediately out of the production cut:

- Will it be enough to balance markets?
- Can non-OPEC producers reasonably be expected to participate?
- How long does the cut last?
- Will adherence to the agreement be any better than past production coordination?
- And finally, what will be the long-term impact on prices?

Is it enough?

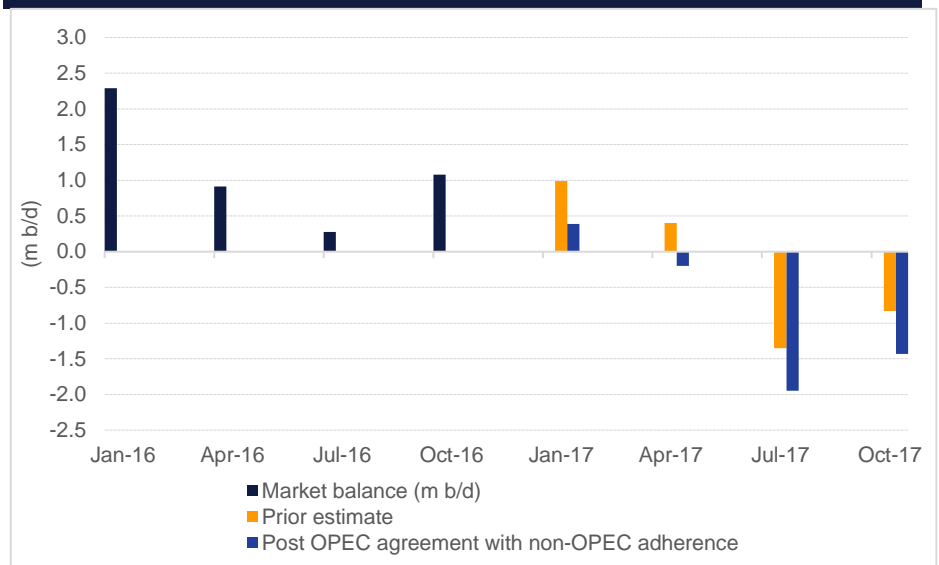
Prior to the cut, OPEC was expecting non-OPEC supplies to expand by around 200k b/d, largely thanks to higher output from Kazakhstan and Brazil amongst smaller additions elsewhere. On that basis and with a 32.5m b/d target, a market deficit would have emerged by the start of H2. With OPEC limiting to 32.5m b/d and some compliance from non-OPEC producers then the market deficit emerges a little earlier, Q2 in our estimates, before widening in H2. On paper then, the deal would help to stop the relentless build in inventories over the past few years.

But the deal is highly contingent on non-OPEC producers who were not party to the agreement, namely the US, holding still. OPEC had penciled in a decline of around 160k b/d for the US next year which may now come under revision. The degree of response from the US is likely not going to be enough to push the market back into surplus. Oil price at USD 55/b – USD 60/b probably won't be high enough to mean the US recovers the nearly 1m b/d decline in output from mid 2015. Even if the US surprises positively with flat to mild output growth (0-200k b/d) then a market deficit is still on the cards, if just a little later next year.

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Market rebalancing should emerge earlier



Source: Bloomberg, Emirates NBD Research.

Will non-OPEC participate?

The biggest if here is whether Russia will indeed cut production. Russia's energy minister endorsed the deal, saying the country would gradually lower production in 2017 after consultations with OPEC. But any lower volumes from Russia are probably going to be contingent on OPEC itself managing to limit production as the two are locked in a fierce battle for market share in major Asian consumers. Among other non-OPEC producers, Oman has said it would track a decline in OPEC output while Azerbaijan won't increase. Kazakhstan wasn't prepared to cut just as the Kashagan field gets up to full speed.

Among the other major 'government-controlled' oil exporters—Mexico, Brazil and Norway—we doubt there would be much compliance with OPEC although some natural depletion may occur.

How long can OPEC keep it up?

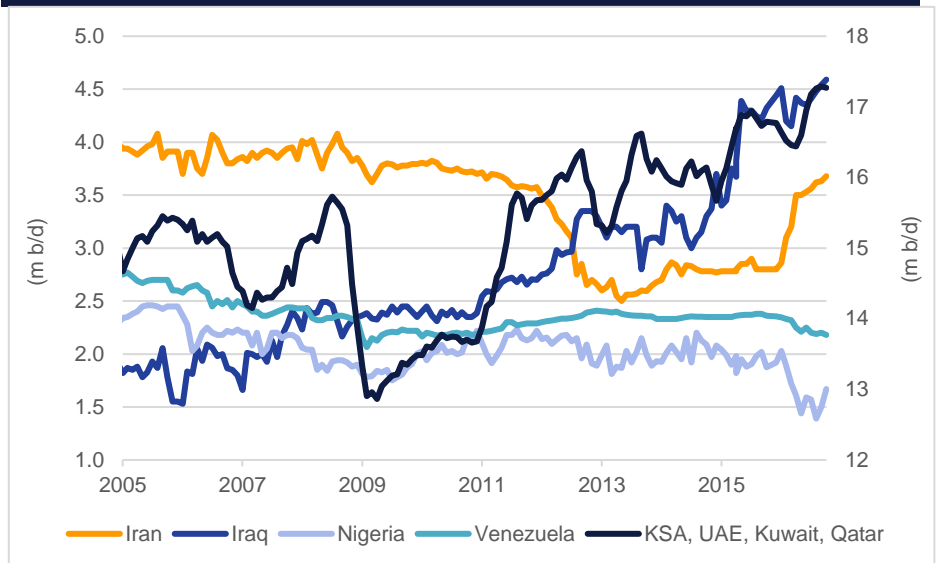
This agreement is set to last for six months after which OPEC will monitor market conditions and decide whether to extend it. A deficit would only emerge, on our estimates, if OPEC kept the cut for all of 2017. OPEC ramping up output to current levels in H2 2017 would mean any deficit would be fleeting.

Will the deal hold or can we expect cheating?

Past efforts at coordinated production levels by OPEC members were never particularly successful with the GCC members the most likely to abide by targets while other countries sought out higher volume to capture more of decent price conditions.

During OPEC's last production cut in the 2008-09 financial crisis, Saudi Arabia, the UAE, Kuwait and Qatar did indeed cut volumes while other major producers kept volumes steady or sought higher output. Considering there is no enforcement or punishment mechanism we anticipate a similar pattern emerging in 2017. But raising output to capture what may be only a limited rally in prices could end up damaging reservoirs and create issues for long-term oil suppliers.

Adherence to OPEC deals doesn't have strong record



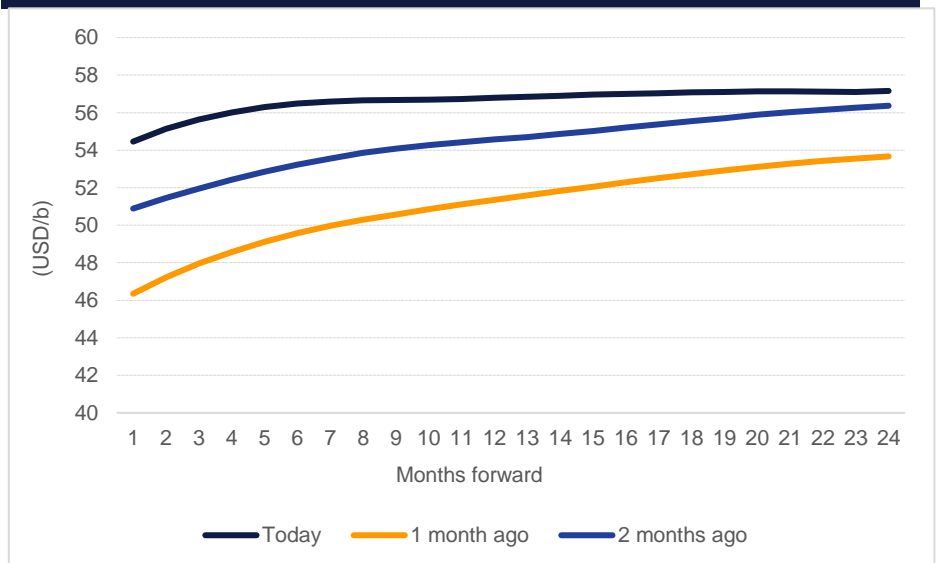
Source: Bloomberg, Emirates NBD Research.

What will happen with oil prices?

Finally, what impact will the OPEC agreement have on oil prices? In the immediate aftermath of the announcement oil prices soared to new 2016 highs. Nearby Brent futures hit as much as USD 54.53/b after the announcement and have jumped more than 17% since the day the OPEC meeting began.

But this is a far changed oil market from when OPEC utterances could dictate prices. The contango in both the forward curves for Brent and WTI have narrowed considerably but have hit a hard plateau around USD 55/b, at least going out two years. The flatness of the curve in the 12-24 month represents the market's expectation of the return of shale amid elevated global supplies, OPEC cuts notwithstanding.

Nearby Brent has rallied while back of the curve still flat



Source: Bloomberg, Emirates NBD Research.

With the OPEC production cut in mind, we are holding our oil price forecasts intact for the time being, expecting Brent to average around USD 55/b (current strip of futures at USD 56.39/b) and WTI at USD 53/b (current strip of forwards at USD 54.63/b).

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