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OPEC+ gets to a deal

OPEC+ agreed at the end of last week to cut production in an attempt to stabilize crude prices which had fallen 30% from October peaks. A deal appeared in jeopardy after Thursday's OPEC-only meeting in which Iran refused to participate in any cut given it is under US sanctions and the scale of the cut proposed by ministers underwhelmed markets. However, thanks to participation in the cuts from Russia a deal was salvaged on Friday and OPEC+ will now take 1.2m b/d off the markets from January 2019.

OPEC members will provide 0.8m b/d of the cuts while non-OPEC countries (Russia, Kazakhstan, Sudan and Mexico among others) will cut by 0.4m b/d. However, unlike the 2016 Declaration of Cooperation cuts of 1.8m b/d, there were no specific country allocations and the OPEC statement was limited on details. Despite the vague commitments in OPEC's official statement, the market response in the near term was positive, helping Brent end the week up 5% at USD 61.67/b and WTI up 3.3% at USD 52.61/b.

Only a few countries in OPEC appear capable of taking on production cuts as part of the deal. Since the start of the year production has increased in Saudi Arabia, Iraq, the UAE, Kuwait, Algeria and Libya. However, Libya has reportedly managed to gain exemption from the cuts leaving the 0.8m b/d to be parceled out between the five remaining countries. The cuts will be in place for the first six months of the year and will largely bring output in line with our own projections for the UAE and Saudi Arabia. We did not expect the increase in output from May to be permanent or sustained at the recent elevated levels and hence our production forecasts for both countries are largely unchanged in response to the deal. Our projection for Kuwait will be revised lower if it complies with the cuts as closely as it did in 2017. For Iraq we estimate it will need to cut output by around 160k b/d but its compliance with previous production cut deals has been low. (For a more detailed assessment of why we believe OPEC countries were unlikely to keep production high for the long run see our note "OPEC: holding back", published in October 2018).

By agreeing to relatively vague terms OPEC+ looks to be counting on further supply disruptions to hit markets over the next few months. Iran's crude exports remain under sanctions even if importers have received temporary US waivers while there still appears to be no sign of a turnaround in Venezuela's declining production. Most recently, the Canadian province of Alberta directly intervened in its oil market, mandating a production cut. The oil market is reliably unpredictable as far as guaranteeing supply at a given level but expecting unplanned outages to do some of the work of cutting supply is a risky strategy for OPEC+ countries heavily exposed to near term prices.

Production from OPEC members will display a much more flexible profile going forward, responding to near term market conditions. Hence we wouldn't rule out OPEC unwinding or deepening these cuts at their next meeting in April if market conditions warrant it.

The scale of the cuts will help limit the increase in inventories expected for 2019 but isn't enough to push the market back into deficit. We project a market surplus of around 1.2m b/d in Q1 with the new production levels (compared with an original projection of 1.5m b/d). Compliance with the terms of the deal will be difficult to assess, and harder for OPEC to police with no official targets. Indeed Russia's participation appeared to be contingent on its own cuts coming in a phased manner rather than an immediate drop in production. On this measure then the OPEC+ cuts are unlikely to spark a major turnaround in prices or allow them to push back up to above USD 80/b in Brent in the near term.

Despite the assertions from Khalid al Falih, the Saudi energy minister, that US producers will be breathing a sigh of relief in response to the production cuts we still expect the US oil market to follow an independent, or more properly insulated, course for 2019. Infrastructure challenges will be the biggest factor for US (and Canadian) producers to overcome next year even if OPEC and its allies create more inviting oil market conditions. Indeed, OPEC ministers themselves may be breathing sighs of relief that tighter financing conditions, volatile equity markets and too few pipelines will put the brakes on rapid growth in North American oil.

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