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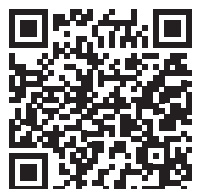
InFocus

Macro comment

The oil market's unstable equilibrium



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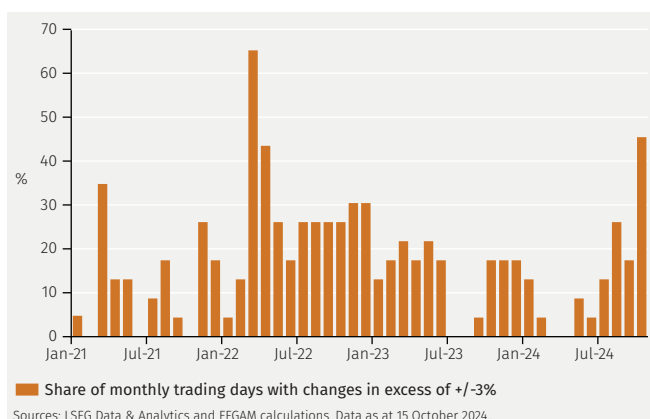


THE OIL MARKET'S UNSTABLE EQUILIBRIUM

Oil price volatility has surged recently, reflecting various uncertainties. In this edition of *InFocus*, Senior Economist GianLuigi Mandruzzato looks at the factors that drive the oil price and concludes that downside risks prevail.

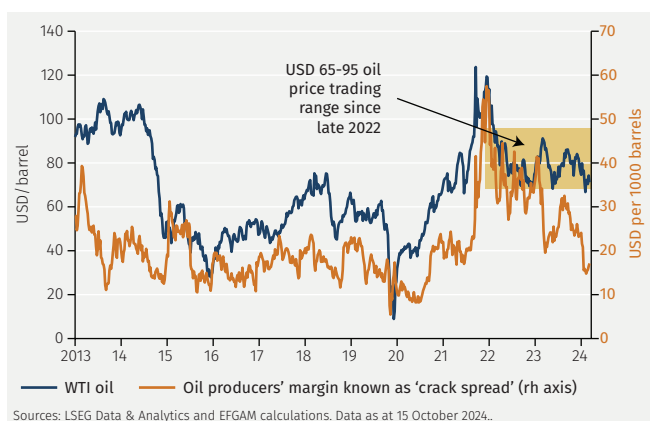
Since the end of the summer, oil price volatility has increased significantly. This is demonstrated by the frequency with which large daily price changes have occurred to an extent that has not been seen since the start of the war in Ukraine. Figure 1 shows the share of trading days in each month since the beginning of 2021 that saw West Texas Intermediate (WTI) oil price changes larger than 3% in absolute terms.

1. Increased WTI oil price volatility



The price of WTI oil has nevertheless remained within the broad trading range of USD 65 to USD 95 per barrel (pb) that has prevailed since the end of 2022 (see Figure 2). Moreover, in the most recent period the price has slipped towards the lower end of the range.

2. WTI oil price and crack spread



This is surprising in light of tensions in the Middle East, the continuation of OPEC+ production cuts, and the fact that the hurricane season in the US is still very intense. Furthermore, it suggests that prospects for the oil market are highly uncertain.

To assess the outlook for oil, it is useful to consider which factors will likely influence oil supply and demand in the future. Some of them, such as the hurricane season, are relevant mainly in the short term; others, such as progress on the energy transition, will have an increasing impact in the medium and long term. Furthermore, these factors often influence each other: for example, the outcome of the US election will also have an impact on geopolitical tensions, but these geopolitical tensions also play a role in determining who will be the next US President.

Below, we present the main factors relevant to the oil market and assess how they could affect prices in different scenarios.

The hurricane season

In recent weeks, two powerful hurricanes have hit the United States, supporting crude oil prices as they passed. Similar events could repeat in the coming weeks, increasing, at least temporarily, the risk premium associated with the oil price.

Beyond the short-term impact, the price of crude oil will be affected by constraints on oil supply, due to possible damage to oil infrastructure, and by the negative effects on economic activity and demand for petroleum products. Which of the two effects prevails will determine the net impact on crude oil prices.

The US elections

With less than two weeks to go, the US presidential election remains too close to call. Polls indicate that the candidates are divided by a handful of votes in the decisive swing states.

A Trump administration is seen favouring an increase in US oil and refined products production, and thus supporting a decline in the price of crude oil.¹ This trend would be strengthened if, as many expect, GDP growth is penalised by other policies proposed by Trump, including the imposition of tariffs on US imports.

¹ See 'Sector playbook ahead of the US Presidential election', EFG *InFocus*, 16 October 2024.

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Conversely, a Harris administration is seen placing greater emphasis on the fight against climate change and energy transition. The effect of such policies on prices is uncertain. While Harris has softened her criticism of the shale industry, her policies will be less conducive to increasing US oil supply. The potentially favourable impact on crude prices will be mitigated, if not more than offset, by policies aimed at curbing CO2 emissions and increasing energy production from renewable sources.

The Middle East crisis

Following Iran's missile attack on Israel on 1 October, fears that the Israeli retaliation would hit Iranian oil infrastructure caused crude oil prices to rise. Speculation that Israel's response will probably focus only on military targets led to a rapid fall in prices.

This demonstrates investors' concerns about the security of energy supply linked to an escalation of the Middle East crisis. Although the danger seems to have subsided for now, the persistence of tensions justifies a high risk premium on oil prices.

Markets' main concern is an attempt by Iran to block the Strait of Hormuz along the lines of what its allies, the Houthis, did to the Strait of Bab el-Mandeb that connects the Gulf of Aden to the Red Sea. The Strait of Hormuz is the main chokepoint for seaborne fossil fuels trade, through which a fifth of the world's supply of oil and liquefied natural gas passes (see Figure 3). If tanker transit through the Strait of Hormuz were to be compromised, oil prices could reach new all-time highs. The impact on oil and gas importing economies could be much worse than what happened after the start of the war in Ukraine in 2022 and, in the worst-case scenario, could approach that of the oil crises of the 1970s.

Conversely, a reduction in tensions would favour a decline in the risk premium, moving prices closer to the underlying fundamentals of crude oil supply and demand.

The OPEC+ strategy

According to the most recent estimates by the International Energy Agency (IEA), the physical oil market was, on average, in equilibrium in the first three quarters of 2024.² Starting from the fourth quarter of 2024 and throughout 2025, an excess supply of more than 1 million barrels per day (mbd) is expected. This scenario reflects the expected increase of 1.8 mbd in supply from non-OPEC+ countries which helps explain the decline in oil prices. However, it only considers a moderate increase in OPEC+ supply, which could instead increase by 2.2 mbd between December 2024 and the end of 2025 if the cartel increased production in line with its announcement in June.³

Given the risks of such a scenario for the stability of the oil market, one might expect OPEC+ to decide to further postpone the increase in supply scheduled to start in December. In a more extreme scenario, some commentators believe that OPEC+ could freeze the supply increase. However, reaching such an agreement is not a given due to the different objectives of OPEC+ members.

The announcement that OPEC+ would increase oil supply was surprising. At the time, the IEA projections pointed to a supply surplus in the following quarters and the oil price, just above USD 80 pb, was far from the unofficial target range of between USD 90 and 100 pb.

The decision probably reflected awareness that the strategy of reducing supply to support prices favours non-OPEC+ producers who have gained market share over the years. This has created tensions within OPEC+, resulting in Senegal's exit from the cartel at the end of 2023 and growing criticism of production limits by the UAE, Iraq and Kazakhstan.

Respecting the compromise for a progressive increase in production is probably essential for the very existence of OPEC+, within which tensions remain high. This is demonstrated by repeated official calls to respect production quotas, which have been exceeded by several countries in recent months for a total of 0.8 mbd of excess oil output.

3. Oil and Liquefied Natural Gas flows through the Strait of Hormuz

	2018	2019	2020	2021	2022	1H23
Total oil flows through Strait of Hormuz	21.3	19.9	18.3	18.8	20.8	20.5
<i>Crude oil and condensate</i>	16.4	15	13.5	13.7	15.2	14.7
<i>Petroleum products</i>	4.9	4.9	4.8	5.1	5.6	5.8
World maritime oil trade	77.4	77.1	71.9	73.2	75.2	76.3
World total petroleum and other liquids consumption	100.1	100.9	91.6	97.1	99.6	100.3
LNG flows through Strait of Hormuz (billion cubic feet per day)	10.3	10.6	10.4	10.6	10.9	10.8

Source: US Energy Information Administration, The Strait of Hormuz is the world's most important oil transit chokepoint, November 2023.

² See IEA October *Oil Market Report*.

³ See 'OPEC+ stops price targeting strategy', EFG Macro Flash Note, 7 June 2024.

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According to the Wall Street Journal, the Saudi Minister of Oil has alluded to the possibility that if production quotas are not respected, prices could fall significantly. Many observers have interpreted this warning as a sign that Saudi Arabia, which bears the brunt of the production cuts, may unilaterally increase production as it did in 2014 and 2020 following disagreements within the cartel. On both occasions, prices collapsed; if this were to happen again, prices could fall to a range of USD 30 to 40 pb (see Figure 2).

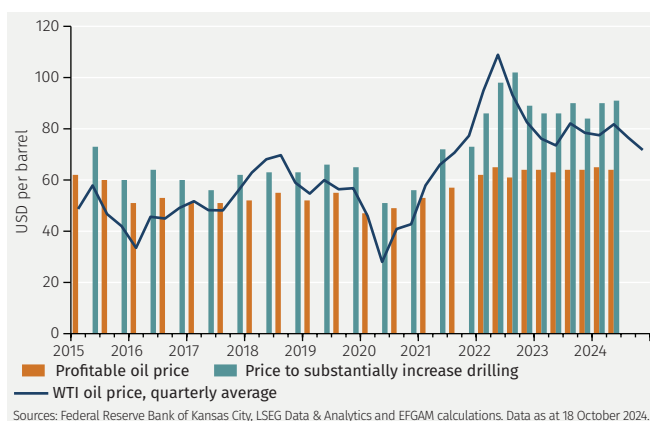
In conclusion, the likely increase in OPEC+ supply in the coming quarters will put downward pressure on oil and refined product prices, the intensity of which will depend on the cohesion within the cartel.

Shale oil supply

A change in OPEC+ strategy will affect supply from other producing countries, including the US. Non-OPEC+ producers have benefited from high prices and less competition to increase production, which in the US rose to a record 13.4 mbd.

However, a sharp drop in oil prices would put producers with high operating costs in difficulty. According to the Federal Reserve Bank of Kansas City's Energy Survey, US shale producers need a WTI oil price around USD 65 pb to be profitable and above USD 90 pb to significantly increase drilling (see Figure 4).

4. US shale oil producers' threshold prices and WTI



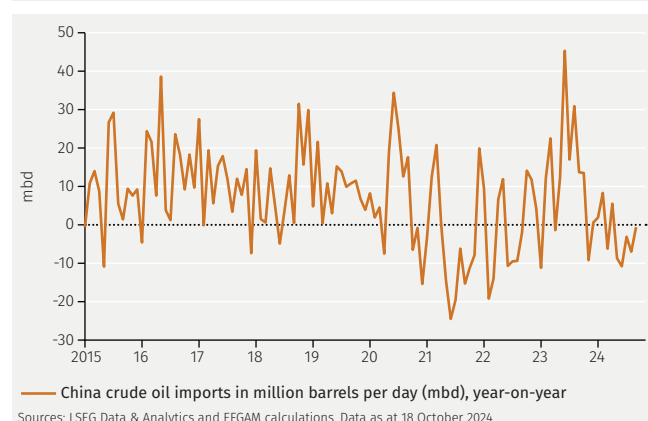
One can therefore expect that if oil prices fall below USD 60 pb for a prolonged period, supply from non-OPEC+ countries will decline significantly. This would rebalance the market, at least partially supporting prices in the medium term.

China's uncertain recovery

Weak Chinese demand is among the causes of the recent decline in oil prices. In the March-September 2024 period, Chinese imports of crude oil and refined products fell by an

average of 4.6% year-on-year, equivalent to a decrease in demand of 0.65 mbd (see Figure 5).

5. China oil imports faltering



Unsurprisingly, oil prices rose after the recent announcement of various policies to support the Chinese economy. However, the lack of detail on the fiscal measures subsequently depressed prices again, reflecting fears that the economy will not recover much. Many observers expect the announcement of decisive measures to boost growth at the end of October, but there is a clear risk that disappointment will further depress oil product prices.

The energy transition

The oil market balance in the medium to long term will also be influenced by demand trends. A recurring feature of recent reports from the IEA and the US Energy Information Administration has been downward revisions to global demand projections for petroleum products. The acceleration of the energy transition in recent years has probably had an impact.

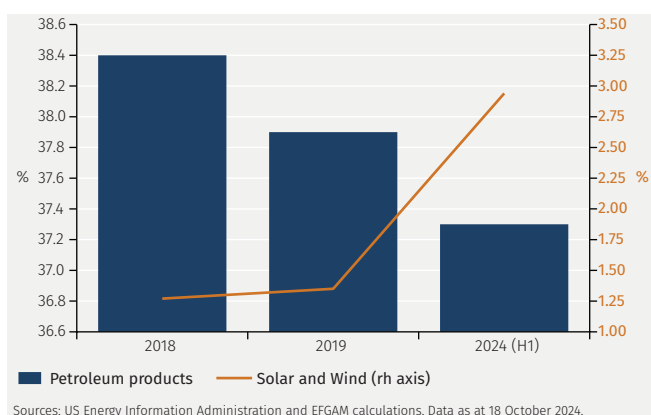
An example of this is what happened in the US. Despite vigorous growth in GDP in recent years, in the first six months of 2024 the demand for petroleum products was about 4.5% lower than the average for the two-year period from 2018-19 (see Figure 6), which explains why US refiners' margins, or crack spreads, remain depressed (see Figure 2). In the same period, the share of solar and wind energy in total consumption more than doubled, reaching almost 3% of the total. If this trend continues, demand for petroleum products will be reduced structurally.

Conclusions

The recent spike in oil price volatility has taken place in an environment of prices falling towards the lower end of the range that has prevailed since late 2022. The outlook is unusually uncertain and reflects the potentially counteracting impacts of the main drivers of the balance between supply and demand.

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6. US energy consumption (% of total)



Looking at the next few quarters, in our view the most likely scenario seems that the WTI oil price will fall towards the USD 55 to 70 pb range. This would be consistent with a soft landing of the US economy and a moderate recovery in China accompanied by OPEC+ supply increases as announced. The balance of risks for this scenario appears tilted to the downside, reflecting the possibility global oil demand turns out to be weaker than expected, perhaps driven by acceleration of the energy transition, and cohesion within OPEC+ does not improve.

