DaMina Advisors

www.daminaadvisors.com

May 16, 2019

Crude Oil Prices: 30-Day Risk Outlook - Up, up and away

Greg Priddy, DaMina Senior Fellow, Oil Geopolitics

Brent crude oil has been remarkably stable in recent weeks, holding in the low $70s even as traders grapple with a panoply of different risks – including a renewed US- China trade war, chaos in Venezuela and Libya, and rising US-Iran tensions in the wake of President Trump's unexpected decision to allow all of the sanctions waivers for Iranian oil exports to lapse on 2 May. However the most likely price path into the early summer months is a gradual structural climb in prices, as the market lets go of the idea that there will be substantial workarounds to sanctions on Iranian oil, and also accepts that Saudi Arabia is not likely to completely offset lost volumes from Iran, preferring to let supplies tighten. Meanwhile, a significant risk exists of major military escalation in the Persian Gulf, which should give pause to anyone considering short-selling other than oil producers which are hedging, even as it is not the most probable scenario.

Core focus is on volume losses from Iran and offsets, in context of demand growth

Most analysts, including us, did not anticipate that President Trump would cease to issue waivers entirely before the 2 May expiration date. Now, a number of them have clung to the assumption that the oil will still flow somehow, since China, India, and Turkey have not officially committed to complying with the US diktat. However, the evidence thus far suggests that Iranian exports will be very low, with a loss of close to 1 million bpd. Turkey had not signaled compliance, but state-owned refiner Tupras has been placing orders with alternate sources. Indian refiners also are doing so, even as the government formally states that it only follows UN-mandated sanctions as a matter of policy. Finally, the major Chinese refiners have not placed any orders for May. Thus far, not a single tanker has picked up a cargo at the main Iranian loading facilities in May. It is possible that China especially could change course at some point, but for now the policy seems set.

The fact that the accumulating evidence of steep losses of Iranian barrels has come at the same time as the selloff in equities and general "risk off" sentiment that swept the market beginning last week on renewed US-China trade tensions has blunted the impact. But negotiations will continue with China, and even if the new higher tariffs stay in place, the economic damage will accumulate gradually. While the International Energy Agency revised demand growth downward today, it remains reasonably robust. The US economy, in particular, is in a strong initial position to withstand this for the short-term.

On the other side of the balance, President Trump failed to extract a concrete commitment from the Saudis to increase production before he nixed the sanctions waivers. The Saudis have since made statements about making extra volumes available if their customers request it, but have also made clear that their export volumes will not increase substantially through June – the end of the current OPEC+ deal – as well as at one point calling for an extension of the deal at current levels through the end of the year. That is going to produce some tensions with the US, but the Saudis are not likely to cave in this time. They feel like they were misled by Trump last year when he got them to produce over 11 million bpd in the fall, and then issued the waivers, so they are going to err on the side of caution this time. They would clearly like to see higher prices, probably around $80 per barrel, but not much above that.

June OPEC+ meeting will be less important, whatever the outcome

Meanwhile, Russia is still in our view much more reticent about seeing prices much higher than current levels, even with the volume loss from Iran pushing back the timeframe for any renewed glut driven by growth in US shale oil production well into 2020. It is too early to make a firm call on the outcome of the 25-26 June OPEC+ meeting, but the primary observation is that it matters a lot less. Russia will come into compliance only due to the problems that they have had with contaminated oil on the Druzhba pipeline to Central Europe, and it is quite plausible that they will not sign on to an extension, preferring to grow their production. But within OPEC, there are relatively few members which have major spare capacity – mostly Saudi Arabia, the UAE, and Kuwait (not counting Iran of course). Iraq already seems to be cheating again, with the threat of a price collapse to the levels they feared last fall having subsided.

Whatever the outcome of the OPEC+ meeting, the Saudis are not likely to open the spigot all at once, preferring to gradually tighten inventories further knowing that they can tap the brakes on the price increase if they want to. However, that will leave relatively thin spare capacity to the extent they increase output. Unless demand gets hit hard, that implies a modest upside to prices – mid to upper $70s by summer.

Gulf 'fat tail risks' are highly relevant

With the episodes reported Sunday of attacks on ships near the Strait of Hormuz and Tuesday on by drones on two oil pipeline pumping stations on central Saudi Arabia (both of which are open to question given the lack of evidence made public to support them), the market has begun to be attuned again to headline risks related to US-Iran tensions. There are hawks in the US administration like National Security Advisor John Bolton who probably do see a military-driven regime change effort by the US as desirable, but President Trump does not seem to be among them. But a dangerous dynamic is in place where the demands Iran has made to stay in the 2015 nuclear deal almost certainly will not be met, and when the 60-day clock runs out on that, they will face a choice about whether to withdraw from the deal. There is a path toward escalation which is clear, but either Iran or the US, or both, could find ways to exit this path. In the current dynamic, though, it would be very easy for military miscalculations to escalate quickly. Iran's asymmetric warfare capabilities – especially ballistic and anti-ship missiles – are vulnerable to US aircraft, and that presents them with a "use it or lose it" choice that could drive escalation quickly if there is even a minor military clash. It is difficult to assign a number to this, but for oil traders and investors, this is something which should be considered an improbable-but-plausible high-impact risk.

Libya and Venezuela will probably remain secondary variables

Lastly, while developments in Libya and Venezuela should be monitored, at this point is seems unlikely that either will have a big impact on markets in the next few months. Venezuelan crude output actually rose a bit in April after the big hit it took in March from the lack of US diluent imports and massive power outages, but new reporting from Platt's suggests it was down again in May. We are likely to see further fluctuations in volumes from Venezuela going forward, but not an abrupt cutoff, as we argued in a note earlier this year.

Libyan volumes have actually moved higher since Gen. Khalifa Haftar of the self-styled Libyan National Army (LNA) began his offensive to take Tripoli. While that has bogged down, none of the fighting is near oil infrastructure, and the Libyan NOC continues to operate in a politically neutral manner. Haftar has the upper hand due to strong UAE and Egyptian support, as well as a policy shift by President Trump to acquiesce in their offensive. It is not likely that the forces of the Tripoli Government of National Accord (GNA) will be able to mount offensives to retake oil infrastructure, even if they hold on to the strip of coastal cities around Tripoli which they still control. Despite talk of raising output, Libya is at its near-term maximum capacity, and it will take new investment to raise that – not coming in the near future.

Contact: Research@DaMinaAdvisors.Com

Phone +1 647 808 9671/+44 7779 656 878

DaMina Advisors is a preeminent Africa-Asia focused independent frontier markets political risk research, due diligence, M&A transactions consulting and strategic geopolitical risks advisory firm. DaMina Advisors is legally registered and has offices in the US, Canada, The UK and Ghana. DaMina is headquartered in Toronto.

www.daminaadvisors.com

On Twitter @DaMina_Advisors