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MOUNTING GLOBAL SUPPLY RISKS NOT FULLY PRICED INTO CRUDE

The US government took the oil market by surprise with its announcement on April 22 that it will not renew the six-month sanction waivers granted to buyers of Iranian crude, after they expire on May 2.

The move directly affects China, India, Japan, South Korea and Turkey. Three other countries that were granted exemptions from US sanctions against Iran's oil and shipping sectors from November 5 last year — Taiwan, Italy and Greece — did not use them at all.

A tight world oil market potentially losing up to 1.4 million b/d of Iranian crude and 300,000 b/d of condensates creates the tail risk of a supply shock in the coming months. But crude is not reflecting a fear premium.

Brent spiked to a six-month high of $74.57/barrel and WTI to $66.30 in the wake of the Iran waivers news, but prices cooled off soon after, as US President Donald Trump and his officials stressed that they had secured a commitment from OPEC producers Saudi Arabia and the UAE to boost output.

There was some confusion as to who exactly the Trump administration had spoken to, given that OPEC secretary-general Mohammed Barkindo said it wasn't him and news agencies quoted Saudi sources as saying that there had been no such conversations involving their energy minister or the Crown Prince.

Saudi Energy Minister Khalid al-Falih's comments on the matter were cautious and restrained. His key messages were: 1) The Kingdom did not see the need to raise production immediately and 2) Saudi Arabia would fulfil any demands for additional crude from its customers.

The oil market appears sanguine for the time being that OPEC has the ability and the intent to offset any shortfall resulting from the disappearance of Iranian barrels. Crude backed down considerably from its six-month highs by the end of April and continued to weaken through the first few days of May, especially after the US-China trade deal suddenly looked to be in jeopardy.

What doesn't add up, however, is that crude prices did not sustainably appreciate even when a clutch of supply outages and risks stacked up through April, in addition to Iran. The crude market has become dangerously and curiously complacent on supply availability and stability.

The misplaced sanguinity has made crude futures susceptible to panicky sell-offs. That was evident in the week of May 6, after Trump sprung another surprise on the financial markets, threatening to ratchet up import tariffs against China on May 10 if a trade deal was not signed by then.

Crude futures were whipsawed along with global stock markets and slipped to one-month lows.

Nonetheless, senior US and Chinese officials kept to their schedule of meetings in Washington in the week of May 6. The two sides have locked horns in the final stages of their talks and the deal may be delayed, but is unlikely to be derailed.

When the US-China trade agreement comes together, we expect the financial markets to get a fillip and crude to notch modest gains. Most of the "deal premium" has already been priced into crude since the start of this year, when Washington and Beijing resumed talks with a view to ending their trade war.

In the meantime, Beijing's economic stimulus measures appear to have started bearing fruit. The Chinese economy grew at a steady 6.4% in the first quarter of 2019, beating analyst expectations and defying forecasts of a slowdown.

Crude is set for an interesting tug-of-war between bears in the futures market and a bullish looming supply crunch in the physical market; between gloom over China and rising geopolitical tensions in the oil-rich Middle East.

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SUPPLY RISKS HAVE STACKED UP

The crimps and flashpoints that emerged in the second half of April were continuing as we wrote this report in early May.

OPEC member **Libya**'s crude production, averaging around 1.1 million b/d, is at risk of disruption from militant attacks on oil fields and related infrastructure as the country remains embroiled in a month-old civil war that shows no signs of abating.

Venezuela's political crisis has escalated sharply since Juan Guaido mobilised a civilian uprising against embattled President Nicolas Maduro at the end of April. Neither leader is backing down and uncertainty clouds the future of the country and its oil output, which plummeted to a 16-year low of around 730,000 b/d in March.

Nigeria's crude export volumes have plunged in April following a fire on the Nembe Creek Trunk Line, which transports Bonny Light crude, and a forced shutdown of wells in the Amenam field, both in the country's militant-affected Niger Delta region.

Russia was forced to shut down the Druzhba pipeline that transports around 1 million b/d of its crude to refiners in central and eastern Europe on April 25 due to a major oil contamination problem. It resumed pumping clean oil into the pipeline on April 30, but it could take weeks for the flows to return to normal.

A combination of scheduled field maintenance and natural declines in the **North Sea** is set to slash crude loadings from the region to around 1.27 million b/d in June, nearly 500,000 b/d down from May.

Sudan has been racked by massive protests aimed at pushing the military junta out of power following the ouster of Omar al-Bashir as president on April 11. The country pumps about 80,000 b/d of crude and provides vital conduit to South Sudan's 150,000 b/d oil production to reach the export markets.

US AMPS UP PRESSURE ON IRAN

Speculation that the US may ease its no-waivers stance at some point or perhaps not strictly enforce the secondary sanctions against buyers of Iranian oil has been laid to rest.

Washington's latest strategy is to force Tehran into a corner by cutting off all its major sources of dollar revenue. Iran on May 9 suspended some of its commitments under the 2015 nuclear deal and within hours, the US government said it was imposing sanctions on the Islamic Republic's minerals and metals exports.

The US Treasury is also weighing targeted sanctions against financial networks operating in Singapore, Malaysia, the UAE and Armenia, which transfer dollars to Iranian firms for petrochemical exports, The Wall Street Journal reported.

Iranian companies exported $14.1 billion worth of petrochemicals in the fiscal year ended March 2019, according to the country's Mehr news agency. Petrochemical sales are banned under the US' current sanctions against Iran. Mineral and metals exports including iron ore, steel, copper, lead and zinc fetched around $9.2 billion.

The US is also said to be looking at cracking down on Iran's sale of goods to Afghanistan and on shell companies and foreign currency transactions operating out of Turkey, the UAE and Iraq.

Iran is examining new ways to sell its oil, the Islamic Republic News Agency quoted oil minister Bijan Zanganeh as saying at an oil and gas conference in Tehran on May 1, though he did not offer details.

Iran is unlikely to be able to sell its oil overseas other than through small, ad-hoc and under-the-radar deals. Any moves by the European Union to help Iran sell its oil are also unlikely to work.

US secondary sanctions, which threaten to lock any entity dealing with Iranian oil out of the US financial system, are a major deterrent for potential buyes.

Washington's resolve and ability to punish entities violating its secondary sanctions against Iran has not been tested, and it is not clear if there is a monitoring mechanism in place. However, the US need not go after every errant party — it could simply pursue a couple or so and make an example out of them.

TEHRAN TALKS TOUGH BUT LACKS LEVERAGE

US sanctions against the oil sectors of Iran and Venezuela are "creating the death and collapse of OPEC," Zanganeh said at the Tehran conference in late April.

Nonetheless, Iran would not leave OPEC, according to the National Iranian Oil Company's CEO Masoud Karbasian.

We don't think Iran is in danger of quitting OPEC. Tehran does not have the necessary sway to tell the group to not raise output or take its market share. But by staying within the organization, Iran has a voice in it and a first-hand knowledge of what its peers are thinking and planning. It has a seat at the table with Iraq, a neighbour with which it has close trade ties, and Venezuela, which now shares its sanctions pain.

Iran would neither gain anything nor prove a point by quitting OPEC. With US sanctions continuing to limit its output, and being exempted from the last round of OPEC/non-OPEC production cuts, Iran also has no leverage over the rest of the group by threatening to leave. OPEC all but shrugged off the departure of long-time member Qatar from the bloc last year.

Iran's Islamic Revolutionary Guards Corp. has threatened retaliation against US sanctions by blocking the Strait of Hormuz, a vital waterway for oil and gas shipments. An estimated 18.5 million b/d of crude and refined products moved through the chokepoint connecting the Persian Gulf and the Gulf of Oman in 2016.

That threat has been issued several times through history, but never carried out. The oil market, justifiably, is not taking it seriously.

However, tensions in the Middle East could rise if Iran quits the landmark 2015 nuclear deal that it signed with the P5+1 powers — US, UK, Germany, France, Russia and China.

Iranian President Hassan Rouhani has given signatories to the deal 60 days from May 8 to alleviate the pressure on Iran due to the unilateral US sanctions, failing which, Tehran would end restrictions on uranium enrichment.

Iran's economy is expected to contract by 6% in 2019, after having shrunk by 3.9% last year, according to the International Monetary Fund. Inflation could reach as high as 40% this year.

SAUDIS WILL RAMP UP, BUT CAUTIOUSLY

Saudi Arabia, Russia and OPEC have steered clear of saying categorically that they will raise output in response to the US ending

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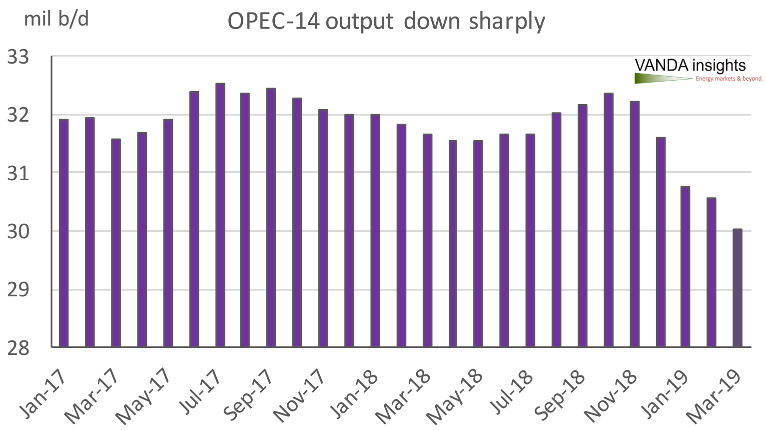
its Iran sanction waivers. **But Saudi Arabia has already begun stepping in to fill the gap. It has been offering its term customers, especially in Asia, additional cargoes for June and July.**

The Kingdom suppressed output to around 9.8 million b/d, half a million barrels per day below its quota, through March and April. As a result, it has a considerable buffer to raise production without violating its pledge under the OPEC/non-OPEC restraint deal.

What the OPEC/non-OPEC ministers decide for the second half of the year at their meeting in Vienna over June 25-26 will depend on how much of Iranian oil disappears from the market, how the other flashpoints of Venezuela, Libya and Nigeria impact world oil supply, and how OECD inventory levels change between now and then.

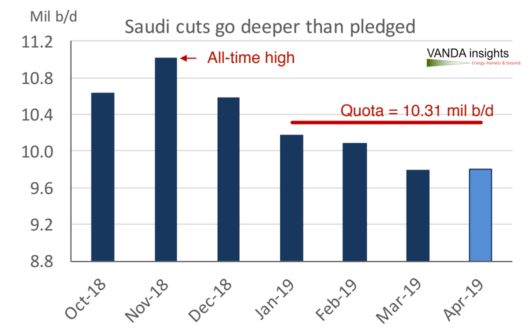
Unless there is a severe supply shock and a sustained price spike in the coming weeks, we expect Saudi Arabia to lean on fellow OPEC producers and Russia to maintain output cuts in the second half. Depending on the severity of supply tightness, OPEC may pledge to not exceed 100% compliance with the cuts or the 1.2 million b/d of collective curbs may be eased somewhat.



Production from OPEC's 14 members slumped to a four-year low of 30.02 million b/d in March, the organisation's April oil market report showed.

Output from the 11 members bound by quotas (Libya, Venezuela and Iran are exempted) was 440,000 b/d below their combined ceiling. In other words, output was slashed by 1.2 million b/d versus last October instead of the 812,000 b/d pledged under last December's deal.

April output likely rose by a marginal 200-300,000 b/d, according to news agencies.



Source: OPEC monthly oil market report. Saudi April production figure is based on statements made by the Energy Minister Khalid al-Falih.

The biggest worry for the oil market in the coming weeks and months is not whether OPEC/non-OPEC will be able to mitigate the loss of more than a million barrels of daily supply from Iran. They just might be able to pull that off.

The real danger is of the producers exhausting their readily available spare capacity while doing so, leaving no room to offset major declines and unforeseen production outages from different parts of the world.

OPEC has a spare capacity of 3.3 million b/d, according to the International Energy Agency, of which 2.2 million b/d is in Saudi Arabia alone. However, the Kingdom remains untested beyond 11 million b/d, the record set last November, which is 1.2 million b/d above current output.

The world needs to brace for plenty of nervous price spikes and heightened volatility in crude in the coming weeks and months.