

### OIL TO REMAIN UNDER PRESSURE AS LONG AS US-CHINA TRADE WAR FESTERS

**C**rude entered June in a financial markets vortex set in motion by the collapse of the US-China trade negotiations at the beginning of May and intensified by a rash of retaliatory measures by the two countries that have gone far beyond simply levying import tariffs against each other.

A persistent risk-off sentiment saw Brent and WTI hit five-month lows on June 5. They rebounded somewhat over June 6-7 amid a stock markets rally, as investors cheered a fresh dovish tilt on the part of the US Federal Reserve.

US Fed officials, acknowledging the headwinds from the US-China trade war, began hinting at the possibility of monetary policy easing towards the end of May. On June 3, Fed Chairman Jerome Powell signalled that the central bank was open to cutting interest rates, fuelling a rally in the stock markets.

The market is now pricing in a US rate cut as early as July, though some analysts argue that it is not as certain as consensus assumptions.

The stock market cheer was intact as we wrote this report, but crude's gains lagged far behind those notched by benchmark US indexes.

At the close of the week to June 7, Brent and WTI futures languished 11-12% below their year-to-date highs of \$74.57/barrel and \$66.30/barrel that were notched over April 23-24, when optimism over Beijing and Washington sealing a trade agreement was at its peak.

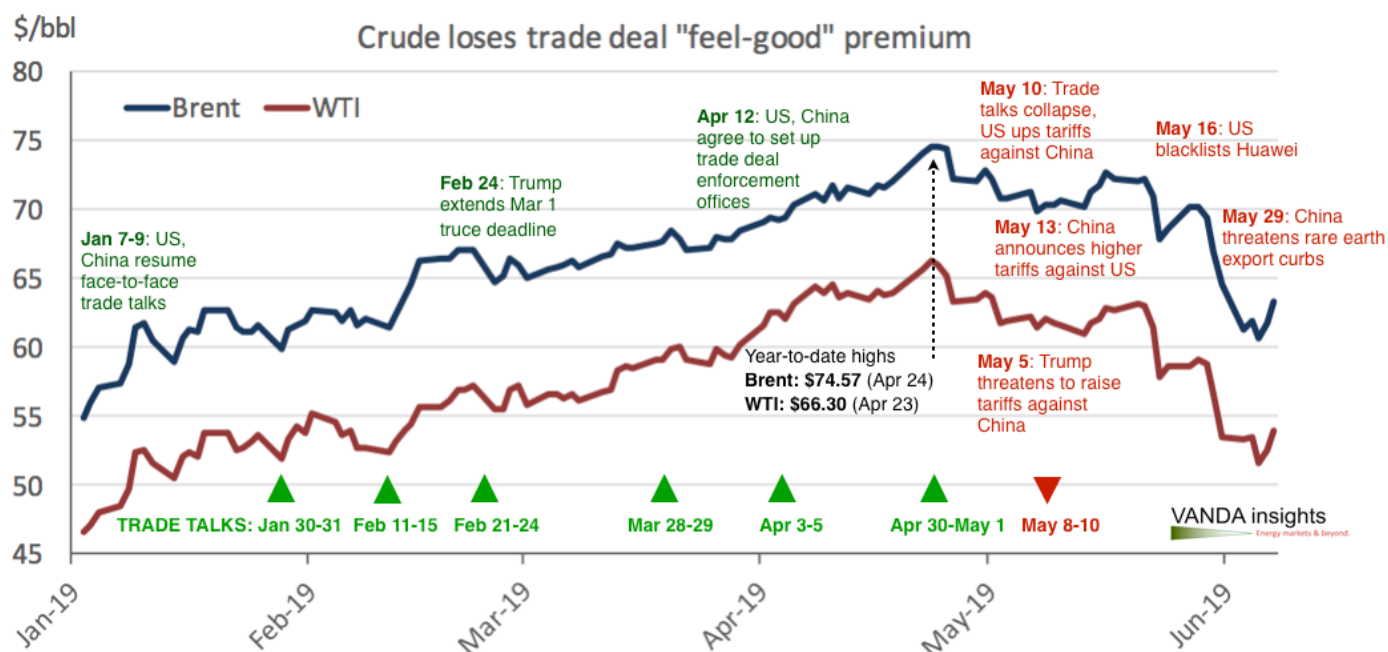
Crude has mostly dovetailed the global financial markets jitters since the breakdown of the US-China trade talks in the first week of May.

But it has also been prone to additional bearishness from relentless weekly builds in US commercial crude inventories, which have risen to a two-year high.

Meanwhile, a rollover of the 1.2 million b/d of OPEC/non-OPEC cuts into the second half of the year looks like a done deal. Comments by Saudi Energy Minister Khalid al-Falih and his Russian counterpart Alexander Novak at the St. Petersburg International Economic Forum over June 6-8 indicated an agreement between the de facto OPEC and non-OPEC leaders that given the uncertain demand outlook, their supply restraints need to remain in place.

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Source: CME (NYMEX WTI), ICE (Brent), Vanda Insights

## **TRADE WAR: A LONG WAY BACK TO SQUARE ONE**

The next likely pivot point in the trade war is a potential meeting between US President Donald Trump and his Chinese counterpart Xi Jinping during the G20 summit in Osaka, Japan, over June 28-29.

The two sides have ratcheted up their trade war and stepped up their rhetoric to such a degree over the past month that the most optimistic of scenarios from such a meeting can only be another ceasefire and an agreement to resume negotiations.

If Trump holds back on green-lighting the imposition of 25% tariffs on the remaining \$325 billion worth of Chinese goods that it imports annually — he has said that he would make a decision after the G20 summit — that might be a starting point.

Such an outcome would provide a quick psychological boost to the financial markets and oil prices, but that would not have much runway because a trade agreement would still be a long way off.

In all likelihood, it would be another long, arduous journey for the negotiating teams around the sticking points that became a deal-breaker the last time around.

Beijing and Washington would need to backpedal on a series of non-tariff retaliatory measures that they have unleashed over the past few weeks, which means a longer time to get to square one.

The measures have included the US blacklisting the Chinese telecom giant Huawei on May 16, blocking its access to American technology and equipment parts.

China, the holder of world's largest rare earth reserves and the biggest supplier to the US, has threatened to curb their exports.

Rare earths, a group of 17 chemical elements, are used in a range of consumer as well as critical military applications spanning the defence, energy, electronics, and automobile industries.

China has also suspended imports of US soybeans, aimed at dealing a major blow to US farmers and Trump's support base.

The US has been planning weapons sales worth \$2 billion to Taiwan, a move bound to infuriate China.

Beijing, for its part, has vowed to crack down on "unreliable entities" — foreign companies that have adopted discriminatory measures against their Chinese counterparts — and is drawing up a list that is expected to focus on US technology companies.

## **ECONOMIC WOES CAST A SHADOW OVER OIL DEMAND**

The year-old progressively intensifying tariff war between the world's two largest economies is starting to stymie their growth.

Manufacturing activity, as measured by the purchasing managers' index, weakened in both the US and China in May.

China's retail sales have been weakening, while US consumer sentiment fell at the end of May.

Automobile sales in the two countries remain on a downtrend, foreshadowing softer gasoline demand in the world's top two oil consumers.

Refined product sales in the US, a proxy for consumption, averaged 20.29 million b/d in the first quarter of this year, according to the country's Energy Information Administration, only a shade higher than the 22.22 million b/d recorded in the same period of 2018.

Gasoline sales in the US, the world's largest market for the product, averaged 8.96 million b/d in Q1, down from 9.01 million b/d in the same period of last year.

Chinese oil demand climbed by a mere 170,000 b/d year-on-year in Q1, according to the International Energy Agency. To put that in context, the Asian giant, whose appetite accounts for the lion's share of growth in global oil consumption, saw a 450,000 b/d annual rise in demand in 2018.

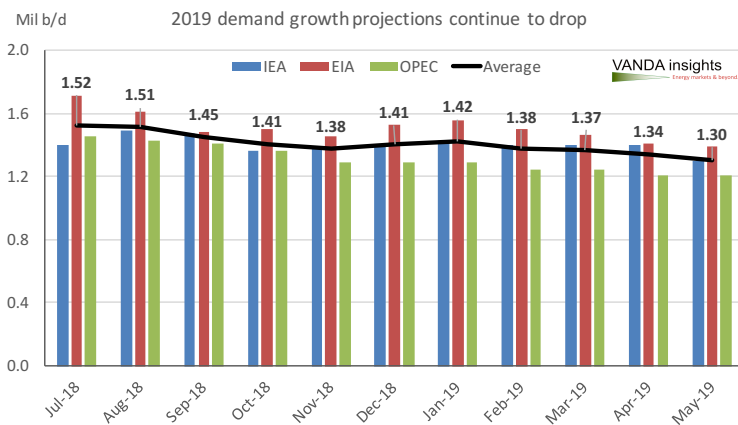
Chinese consumption of gasoil or diesel is expected to drop again in 2019, after having slipped in 2018. Demand for the middle distillate, which accounts for nearly a fourth of the country's total refined products consumption, closely tracks industrial activity.

The softening in oil demand occurred at a time both countries actually recorded better-than-expected Q1 GDP growth.

The Chinese economy grew at a stable 6.4% in the first quarter, defying analyst expectations for a slowdown. The US economy expanded by 3.2%, its best start to a year since 2015.

Given the latest deterioration in the US-China trade war and weaker macro-economic indicators, the outlook for their oil demand growth is negative at least through Q2 and Q3, and potentially all of 2019.

### GROWTH FORECASTS TURN BEARISH



Top forecasting agencies lowered their expectations for 2019 global oil demand growth for the fourth month in a row in May.

The year-on-year rise in world oil consumption was projected at 1.30 million b/d for 2019, down from the 1.34 million b/d predicted in April, according to an average of projections by the International Energy Agency, OPEC, and the US Energy Information Administration.

The rate compares with a 2018 annual increase of 1.37 million b/d, as per an average of the latest estimates by the three organisations.

Prominent Wall Street banks Morgan Stanley and Bank of America Merrill Lynch are even more bearish, forecasting demand growth at 1 million b/d or less this year.

### OPEC TO STAY THE COURSE ON CUTS

Given the twin imperatives of global oil demand growth slowdown and continued robust growth in US production, the safest course of action for OPEC and non-OPEC ministers is to roll over their 1.2 million b/d of output cuts into the second half of the year.

Even if the US and China are able to forge a trade agreement in the coming months, they may not be able to arrest the economic deceleration that has already acquired momentum for this year.

The next ministerial meeting of the 14 OPEC member countries and their 10 non-OPEC collaborators is likely to take place over July 3-4, moved from the earlier schedule of June 25-26.

OPEC has consistently produced way below the ceiling it adopted for the first half of 2019, thanks mainly to Saudi Arabia deliberately pumping way below its quota of 10.31 million b/d, and output from

Venezuela and Iran, both hit by US sanctions against the oil sectors, plummeting.

Iranian production slumped to a new 30-year low of 2.2-2.3 million b/d in May, according to Reuters and Bloomberg surveys. May was the first month of US sanctions against Iran's oil sector with no waivers whatsoever that would allow it to continue exporting crude.

The production compares with 2.55 million b/d in April, based on OPEC data.

Iran's oil exports are said to have tanked even more sharply, from around 1.6 million b/d in April to around 400-500,000 b/d in May.

Iran stopped providing official export data late last year, while the best of independent analyst estimates have become tentative since the end of US sanction waivers.

There are reports of unwanted Iranian oil being stored in tankers at sea as well as some volumes being re-labeled and routed to Asian markets clandestinely through intermediary countries.

Experts believe Iran could continue to export up to half a million barrels a day, far from the "zero" flows the US says it is aiming for.

The production decline in Venezuela has steepened since the state-run oil company came under US sanctions on January 28 — it hit a 16-year low of 740,000 b/d in March before inching up in April.

It could plateau from here on, as Caracas has had a few months to find workarounds for the loss of crucial diluent supply from the US and the withdrawal of its crude customers in the US and Europe, the most debilitating effects of US sanctions.

For Saudi Arabia's Al-Falih, who effectively holds the reins of the OPEC/non-OPEC production policy and who has so far succeeded in keeping a relatively dovish Russia by his side when pushing for cuts, caution is the new mantra.

With crude prices having visited five-month lows and OECD oil inventories hovering around their five-year averages (OPEC wants them below that mark), the safest bet is to stick to the curbs.

## THE BIG QUESTION FOR MARKETS

For now, growing conviction of a US interest rate cut has propped up investor sentiment — mostly in the stock markets, and to some extent in oil.

Across the pond, the European Central Bank surprised the market on June 6 by saying that it would keep the current low interest rates steady till at least mid-2020. At the same time, it is studying a possible rate cut and bond purchases to stimulate inflation.

Central banks elsewhere, from Japan to Australia, India and Canada, are also in the dovish camp.

China continues with its stimulus measures to boost consumption. The big question for the financial markets — and by extension oil — is whether all these steps combined can mitigate the economic harm from trade wars and tensions. That, to us, looks difficult.