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OIL MARKET SENTIMENT DEFAULTS TO DEMAND GROWTH FEARS

Presidents Donald Trump and Xi Jinping agreed a trade war truce at their high-profile meeting on the sidelines of the G20 leaders summit in Osaka on June 29. Senior-level negotiations between the US and China, aimed at nailing down that elusive trade deal, were expected to resume soon after.

OPEC and non-OPEC energy ministers, meeting in Vienna over July 1-2, agreed to extend their 1.2 million b/d of combined production cuts beyond June as expected, but went a step further by committing for nine months, instead of the conventional six.

One would have thought that the two developments, especially so close to each other, might give crude prices a sizeable boost. However, not only did they fail to spark a rally, but they couldn't even keep Brent and WTI from being knocked off their month-high perches seen at the end of June.

Crude remained on a slippery slope. Brent and WTI ended the first week of July 2-4% below their levels of June 28, pre-Osaka and pre-OPEC.

What gives? The answer, in one word, is demand.

More specifically, it is a fear enveloping the market that global oil demand growth is undershooting the rise in supply and that gap may widen further.

US-CHINA REPRIEVE NOT A GAME-CHANGER

Let's look at the resumption of US-China trade negotiations. The world's hopes are increasingly tempered, the longer the economic giants remain in conflict. The gulf between them on some core issues, which came to the fore when their talks collapsed in early May, has given optimists a reality check.

Confusion over what exactly Trump promised Xi in Osaka with regard to Huawei and the possibility that the revived talks may get quickly scuppered by the US adopting a hardline stance over the Chinese telecoms giant it recently blacklisted is moderating hopes.

This will be round three of Washington and Beijing's attempt to find common ground on their trade dispute (phase one was over May-August 2018, when the two had launched their tit-for-tat import tariffs, and phase two was over January-May this year, after Trump and Xi declared a ceasefire at their meeting on the sidelines of the G20 summit in Buenos Aires on December 1).

Unlike the 90-day truce that set a brisk pace for the last round of talks, there is no timeframe this time.

With Beijing having rolled out stimulus measures since the start of this year in a bid to keep its growth engine chugging and the US Federal Reserve looking to throw easy money at headwinds from the country's trade and tariff wars, the calculus for a trade deal has changed.

At this point, it is hard to gauge the extent of economic pressure and political urgency on either side to reach an agreement. The process could drag on for several months.

In the meantime, the import tariffs slapped by the US and China against each other since last year remain in place.

The only real relief after the Osaka weekend in terms of the growing risk to global economic growth is that Washington and Beijing have stepped back from ratcheting up their trade war through attacks against each other's commerce and economies, which had spilled way beyond punitive tariffs in recent weeks.

As a whole, the picture is not one that potential oil bulls could hang their hats on.

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MANUFACTURING, INVESTING ON THE WANE

The US-China trade war and its ripple effects showed up in dampened factory activity across a wide swath of the globe in June, which is a worrying sign for the world's growth prospects.

Manufacturing activity as measured by purchasing managers' indexes or PMIs stumbled in the US, China, Japan, the eurozone and India, among others, last month.

The month-on-month growth slowed down to the slowest pace in months or years in some cases, or slipped deeper into negative territory, as in the eurozone.

Making things worse, the US has threatened to impose import tariffs on $11 billion of European Union products in retaliation for European subsidies to airplane manufacturer Airbus, sending fresh jitters through the markets.

Increasing uncertainty in boardrooms, including those in America, is resulting in companies reining in capital expenditure.

Global corporate capex is expected to grow by just 3% in 2019, according to a recent forecast by S&P Global Ratings, compared with 11% last year.

Benchmark US stock indexes, however, are following their own Pied Piper. They hit new all-time highs in the first week of July as expectations for the US Federal Reserve cutting interest rates grew stronger.

However, as we have noted before, the oil market has diverged sharply since the beginning of June, and remains immune to the euphoria in some of the equity markets across the globe due to the dovish tilt of several major central banks.

SUPPLY FEARS MAY BE OVERDONE

Some in the oil market have puzzled over the avalanche of bearish sentiment in crude at a time of severe crimps on Venezuelan and Iranian supply, OPEC+ sticking to output restraints (and likely to continue exceeding the cuts, thanks to Saudi Arabia) even as geopolitical tensions in the Middle East are the highest of any time that most of us can remember.

None of this should come as a surprise to our readers, however. We have been foreshadowing the steady rise in oil demand concerns pushing side supply worries.

Maybe crude is over-sold. But an argument worth considering is that all the supply restraints, constraints and fears may be a bit overdone.

MIDEAST TENSIONS CAST ASIDE

Rising tensions and growing rhetoric between the US and Iran, sabotage of oil tankers in the Gulf of Oman, and a surge in missile, rocket and armed drone attacks on facilities in Saudi Arabia and Iraq are, no doubt, cause for some fear premium in crude.

When Iran shot down an US unmanned surveillance drone that it claimed had entered its airspace on June 20 and Trump came close to ordering a strike against some Iranian targets later the same day, it did seem like the two might be on the brink of a war.

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But the US did not proceed with the strikes and in spite of the few Iran hawks in the Trump administration, few believe Washington wants military conflict. Or Tehran, for that matter. The oil market has fully discounted the worst-case scenario.

The rash of infrastructure attacks in Saudi Arabia and Iraq, while unfortunate, will not become a cause for worry in the oil market unless an oil facility is targeted and affected.

Attacks on tankers are a different story. Major importing countries in Asia, including those Iran counts on for support such as China and India, rely heavily on oil flowing through the Persian Gulf and the Strait of Hormuz.

Refiners in these countries are already bearing the burden of a dramatic jump in insurance rates for oil tankers plying the Gulf. Any further escalation of threats in the vital shipping zone would have the Asian countries up in arms.

India has beefed up its naval presence in the Gulf region to ensure the safety of Indian-flagged VLCCs bringing crude home.

Regardless of Iran's firm denial of any role in the tanker incidents, suspicion of its involvement alone could strain Tehran's ties with its vital markets in Asia.

In other words, the strategy of targeting oil tankers — irrespective of who is behind the attacks — has limited runway. That is all the more so if Iran continues to distance itself and no one in the region takes responsibility for the sabotage.

On balance, the Middle East risk premium has fully retreated from the crude market.

That is not to say it cannot come back. But any crude price spikes are likely to be a knee-jerk reaction and prone to collapsing under the persistent theme of sluggish demand unless there is a sustained disruption in oil production or shipping from the region.

IRAN EXPORTS FAR FROM ZERO

While both Iran and Venezuela have suffered a precipitous decline in output in recent months due to US sanctions against their oil sectors, neither has seen production fall off a cliff.

The fact that China is continuing to import Iranian crude even after the US ended its sanction waivers on May 2 is no longer a secret, thanks to some industrious, independent ship-tracking companies and investigative journalism.

Details of the clandestine shipments, from the time laden oil tankers leave Iranian shores, to when they switch off transponders to avoid detection by satellites, to cargo transfers conducted on high seas to mask the origin of the barrels, to the oil being discharged at a Chinese port have all been laid bare for the world to see.

Some Iranian oil is also said to be reaching overseas buyers through relabelling via Iraq, though no one is sure of the volumes.

The reports of Chinese imports caught the eye of officials in the Trump administration and are said to have especially raised eyebrows among the Iran hawks.

The latest on that front, according to a report in the Politico, is that Washington is considering allowing Chinese companies with upstream investments in Iran to continue receiving oil from the Islamic Republic.

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That might enable the US to save face while avoiding further exacerbating Beijing with its demands that China fully halt crude imports from Iran. This has to be viewed in the context of the two countries trying to get back on the path of reconciliation from their fierce trade war.

China was the largest buyer of Iranian crude before as well as after the imposition of US sanctions against Iran's oil and shipping sectors last November.

Meanwhile, imports of Iranian crude by India, a close second to China, plummeted in May but did not go down to zero.

June might have been the first month India imported no Iranian crude, according to our analysis of data from ship-brokers.

However, the Indian government has been opposed in principle to Washington's demands for the country's refiners to curtail and halt crude imports from Iran.

India's Minister of State for External Affairs V. Muralidharan reportedly said on July 3 that the country had no plans to halt trade with Iran under the influence of a "third country".

If China and India, Iran's two largest buyers, and Asia's biggest crude importers, choose to ignore US sanctions, it would be a major pivot point for the market.

Could Washington make an exception for China but continue to insist that India stay away from Iranian crude? That could be difficult to pull off.

VENEZUELA OVERCOMES HURDLES

China and India, it seems, have also come to the rescue of the other OPEC producer struggling under US sanctions — Venezuela.

Venezuela's state-owned PDVSA and its joint ventures exported 1.1 million b/d of crude and refined products in June, a 26% jump over May, Reuters reported.

Shipments to China, India as well as Singapore surged last month, it said.

India imported an average 318,000 b/d of Venezuelan crude in the first half of this year, up 14% from the same period of last year, according to our data.

Official Chinese monthly customs data, which is only available till May, shows Venezuelan crude imports slipping 6% year-on-year to an average of around 364,000 b/d over the first five months of 2019.

PDVSA delivers some crude to China and Russia as repayment for loans from those countries. Its main source of cash from crude sales was the US market, the door on which was shut following sanctions imposed by Washington at the end of January.

The Venezuelan company is also said to be planning to rejig its blending and upgrading processes to produce more of the Merey crude preferred by Asian refiners, instead of upgrading the tar-like oil pumped from the Orinoco Belt into light synthetic crude, which it used to ship to the US.

THE REAL NEWS FROM OPEC+ MEETING

An extension of 1.2 million b/d of combined production cuts was a foregone conclusion for the OPEC/non-OPEC ministers' meeting in

Vienna, and baked into crude prices well ahead of time.

The oil market effectively shrugged off the longer, nine-month rollover.

For us, the main highlights of the news out of Vienna were:

- Iran protesting growing “unilateralism” within the wider group.
- A likely switch to using OECD oil stocks over 2010-2014 as a benchmark in place of the current rolling five-year average.
- Adoption of a “charter of cooperation” as a framework for long-term collaboration between OPEC and its non-OPEC allies.
- Saudi Energy Minister Khalid al-Falih saying Aramco is ready to resume work on its IPO with an eye on a listing in 2020 or 2021.

The concentration of decision-making powers for the 24-member alliance in the hands of Saudi Arabia and Russia is unavoidable. The two giants account for 44% of the collective OPEC+ production.

Their being on board with any cuts, needless to say, makes for a smoother deal.

It is also probably easier for Moscow to hand down output limits to the state-owned Russian producers (Rosneft is a major detractor) when they are seen as an agreement at the highest levels of political leadership (President Vladimir Putin being aligned with the Saudi King or the Crown Prince) than a decision by OPEC oil ministers, with Russia simply toeing the line.

OPEC ministers would also want to avoid the perception when they return home with the decisions that they effectively took orders from Saudi Arabia and Russia.

In that light, Iranian Minister Bijan Zanganeh’s concerns, which are shared by some of the other OPEC ministers, were valid and needed to be aired. How Saudi Arabia and Russia will manage the shifting power dynamics remains to be seen.

Aiming to drain OECD oil stocks to the average levels of 2010-2014, something Saudi Arabia and Russia seem to have agreed upon, would not only underpin OPEC/non-OPEC output restraints for a longer term, but also justify deliberate over-compliance with the pledged cuts by the Kingdom.

Our analysis of International Energy Agency data shows that commercial OECD oil stocks, which were sitting around 2.88 billion barrels at the end of April, were about 230 million barrels above the 2010-2014 average. However, they were only about 16 million barrels above the rolling five-year average.

The draft Charter of Cooperation was agreed after delays of over a year, but there were no details. It needs to be approved by the member countries’ governments.

The sensitivity around the structure is understandable. Russia and other non-OPEC countries in the alliance would want to step carefully around any anti-trust and cartelisation concerns, especially in the US.

Some members of the US Congress launched a renewed push last year for a “NOPEC” (No Oil Producing and Exporting Cartels) Act, which would end sovereign immunity for OPEC countries against US anti-trust regulations.

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The Aramco IPO is back on track. Al-Falih spoke about a 2020 timeline in his media interviews on the sidelines of the OPEC/non-OPEC meetings in Vienna week, while Crown Prince Mohammed bin Salman had said a few weeks ago that it could happen at the end of next year or early 2021.

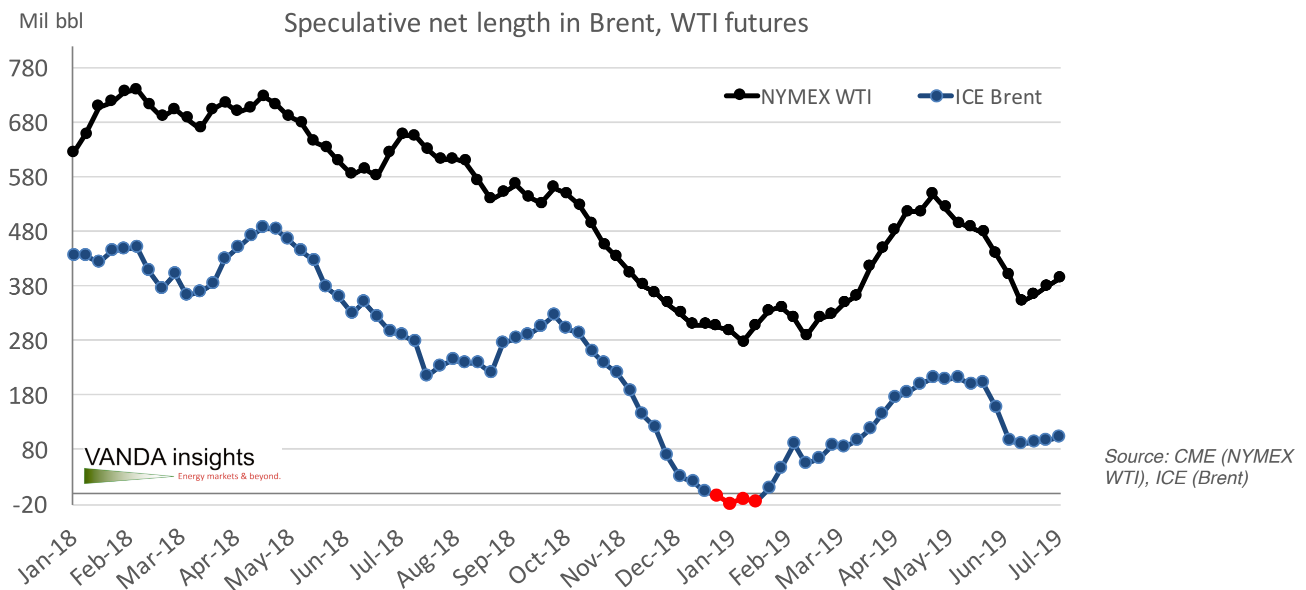
Despite a suspension of the public offering, which was initially planned for 2018, Aramco appears to have continued getting ready for it.

The company has been boosting its refining and petrochemicals footprint at home with the acquisition of Sabic and overseas, by taking equity stakes in existing and planned projects.

In January, Saudi Arabia released the results of an independent audit of its oil and gas reserves. In April, Aramco sold its maiden international bonds, raising $12 billion against more than $100 billion in orders.

The bond prospectus revealed key financial, operational and resource details of the Saudi oil giant. In another first, the company is expected to hold an earnings call in August to discuss its financial results for the first half of 2019.

SMART MONEY IS PLAYING SAFE



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

There has been an uptick in bullish bets by speculative players in NYMEX WTI and ICE Brent crude futures since mid-June, spurred by heightening geopolitical tensions in the Middle East. Two oil tankers were attacked in the Gulf of Oman on June 13, similar to the sabotage of four ships off the UAE port of Fujairah on May 12. Iran shot down an unmanned US surveillance drone on June 20. However, the rise in net length of hedge funds and other major speculators in crude futures has been cautious and relatively small, compared with the fall from the year-to-date highs recorded around mid-April. The bullish bets are also well below the historic peaks hit in February 2018.

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