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CRUDE RALLIES TO FOUR-MONTH HIGHS BUT FURTHER UPSIDE MAY BE LIMITED

Crude futures hit successive new four-month highs through the second half of March, but the ascent was jagged, with each price surge bringing a wave of sell-off in its wake.

Prices are in a tug-of-war between lingering global growth concerns on the one hand, and supportive supply fundamentals on the other, as OPEC and allies tighten supply.

The saga of the US-China trade negotiations continues to dominate investor sentiment but much of an imminent agreement has already been priced in, through growing optimism.

The two countries were set for two more rounds of high-level talks — over March 28-29 in Beijing and in the week of April 1 in Washington — with a final agreement expected to be singed in late-April, as we wrote this report.

While both Washington and Beijing are said to be keen on getting a deal wrapped up soon, plenty of big hurdles remain to be cleared even in the final stages of negotiations. A major one is the enforcement mechanism, which is said to have created a chasm between the two sides. If the US leaves some or most of its annual import tariffs on $250 billion worth of Chinese goods in place even after the deal is signed to make sure that China is complying with its commitments, as Trump warned on March 20, it may erode some of the cheer premium in the markets on account of the rapprochement.

Even if the agreement removes all tariffs, it could provide a short-lived boost to the stock markets as well as oil, but attention would likely turn soon after to monitoring the effects on the Chinese economy, with a wary eye on the possibility of things turning sour again if the implementation does not proceed smoothly.

Disappointing macroeconomic data may continue to trickle in for a few months, particularly from China and Europe, reviving bouts of risk aversion. All in, investors are likely to remain cautious if not downright nervous even after a US-China trade deal.

The US Federal Reserve caught the markets by surprise with a major dovish turn, with Chairman Jerome Powell saying on March 20 that the central bank will hold interest rates steady through 2019, while tapering and ending the runoff of its asset portfolio this year.

Instead of being relieved, the markets despaired because the Fed had also downgraded its economic growth forecasts for the US. The 10-year US Treasury yield slipped below the three-month yield, an inversion commonly seen as a harbinger of a US recession. Investors dumped risky assets in a rush to safe havens, and the US dollar rallied.

The dollar has been highly volatile in recent weeks, but has not directly impacted crude. The conventional negative correlation between the greenback and crude prices has broken down since the start of this year. The US Dollar Index and Brent actually show a moderate positive correlation to date in 2019.

An OPEC/non-OPEC extraordinary ministerial meeting scheduled for April 17-18 has been canceled. The decision, taken at a joint committee meeting in the Azeri capital of Baku chaired by the Saudi and Russian energy ministers on March 18 was unexpected but logical. The producers would have likely ended up confirming the duration of the cuts to end-June at the meeting, but wouldn't have had enough information by then to take a call on the second-half of the year. The next ministerial meeting is set for June 25-26 in Vienna.

Saudi Energy Minister Khalid al-Falih has turned hawkish of late, saying that the oil market is oversupplied and inventories have been rising, as a result of which the 1.2 million b/d of OPEC/non-OPEC cuts would likely have to be extended into the second half of 2019.

Russian Energy Minister Alexander Novak, however, struck a different if not a discordant note, telling the media in Baku that the second half of the year looked uncertain in view of the possible supply shocks on account of Venezuela and Iran.

The US Energy Information Administration in March downgraded its forecast for 2019 and 2020 domestic crude output from its February report. Given the persistent steep slide in US oil rig count since the start of the year, we expect more downward revisions.

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HAWKISH SAUDI ARABIA BALANCES DOVISH RUSSIA

The Saudis have traditionally not been the "price hawks" within OPEC. That label was typically reserved for fellow members Venezuela, Iran, Libya and Algeria. The Kingdom has historically moderated demands for deeper cuts and higher prices.

The recent hawkish shift in Saudi minister Al-Falih's stance could be aimed at offsetting Russia's dovish position on production cuts. It also points to the evolving power dynamics in the enlarged alliance of 24 producers, in which Moscow represents a major new power centre.

Though it is hard to imagine Saudi Arabia's position as the de facto OPEC leader being challenged, given that it holds about a third of the group's production capacity and is the world's only major swing producer, the Kingdom can ill-afford a perception that it may be losing its sway to Russia in the OPEC and non-OPEC alliance.

That suggestion was hard to fight last December, when OPEC failed to agree an output reduction at its meeting on December 6 despite a broad consensus, until Russia had come on board with its cuts the following day.

It is worth recalling that Al-Falih had reportedly wanted Moscow to take a 300,000 b/d cut, while his Russian counterpart had come to the Vienna meeting only prepared to yield 150,000 b/d. After some tense hours and Al-Falih saying that he was prepared to leave without a deal, Russia settled for a reduction of about 230,000 b/d — a compromise midpoint.

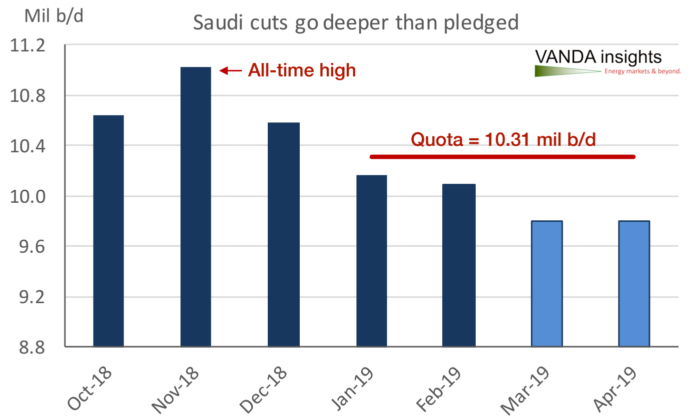
It is also worth noting that President Trump has taken to calling up Saudi King Salman and singling out the Kingdom in his tweets when exhorting OPEC to open the spigots, leaving Russia alone.

The picture of the Kingdom being under the influence of two forces pulling or coaxing it in the same direction — to put more barrels into the market — could erode its status as OPEC's leader and the perception that it holds the reins of the supply management strategy in place since January 2017.

Finally, the significance of oil revenues in the government budget varies a great deal for Saudi Arabia and Russia.

Moscow has budgeted an average price of $63.40/barrel for its benchmark sour crude grade Urals in 2019, down from the 2018 average of $70/barrel. It expects a federal budget surplus of 1.8% of GDP this year.

Saudi Arabia does not disclose a budget oil price assumption, but the International Monetary Fund estimates it needs a crude price of $80-85/barrel* to balance its 2019 budget.



Source: OPEC monthly oil market reports for Oct-Feb output. Mar-Apr 2019 planned production as indicated by the energy minister.

King Salman last December announced the highest-ever spending of Saudi Riyal 1.11 trillion ($230 billion) in 2019, surpassing the 2018 record spending of SR 1.03 trillion. The expected budget deficit of 4.2% of GDP would be the sixth straight year of deficit for Saudi Arabia.

The budget projects oil revenues ***rising*** to Saudi Riyal 662 billion in 2019, compared with SR 607 billion in 2018. Saudi Arabia's new production quota of 10.31 million b/d is, coincidentally, the same as its actual average output in 2018. But with crude prices expected to be lower in 2019 versus 2018, it looks difficult for the Kingdom to realise higher oil revenues this year. That would apply all the more if Saudi Arabia continues to pump way below its quota, as it has been doing since the start of January.

(The IMF uses a simple average of Brent, Dubai and WTI prices.)*

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Though the planned initial public offering of Saudi Aramco has been postponed to 2021, the company is preparing its first international bond sale to raise around $10-15 billion in the second quarter of this year. The money is expected to part-fund Aramco's purchase of domestic petrochemicals giant Sabic. Oil prices will be a key factor in determining the success of the bond issue, just as they would in an IPO.

The fact that Al-Falih and Novak are presenting divergent outlooks on the second half of this year is in tune with the differences they had last December and does not mean there are cracks appearing in the alliance.

The Russians would not have stuck out this long in the collaborated cuts if they didn't want to, and at the end of the day, the coordinated supply management strategy has the blessings of President Vladimir Putin and King Salman. **Opposing viewpoints are to be expected along the way, but they will likely be resolved through negotiations and compromise.**

OPEC CUTS DOUBLE THE PLEDGED AMOUNT

OPEC's 14 members collectively ended up taking much more supply out of the market in February than the 812,000 b/d reduction from last October's levels that the group had pledged in its December pact.

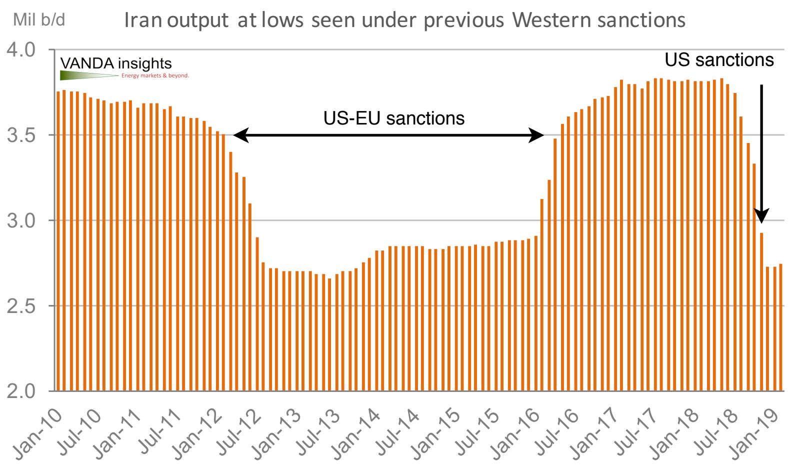
That was because production from all three countries exempted from the cuts — Iran, Libya and Venezuela — has declined sharply. The cumulative reduction from the three, compared with last October, was 1 million b/d.

In other words, OPEC-14 production plunged by around 1.8 million b/d in February compared with last October.

Though Libyan production is expected to recover with the early-March restart of its 315,000 b/d Sharara oil field, which was forced shut by armed intruders on December 9, the outlook for output from Iran and Venezuela is negative. Iranian crude supply could drop substantially if the US reduces the permitted lifting volumes under its sanction waivers to buyers of Iranian crude from May, while US oil sanctions against Venezuela have dealt a body blow to that country's oil industry.

US OFFICIALS SQUABBLE OVER IRAN WAIVERS

OPEC will need to be careful not to over-tighten the market, as happened through the first half of last year, which ultimately led to it making two tricky policy U-turns in six months. In that regard, it especially needs to keep a close eye on how the situations in Venezuela and Iran evolve.



Source: OPEC monthly reports, Platts

The 180-day waivers that the US granted to importers of Iranian crude expire at the beginning of May, and the administration is understood to have been in talks for renewals. China and India have remained the biggest buyers of Iranian crude.

Three of the eight countries that received the waivers — Taiwan, Italy and Greece — have not used them since the imposition of US sanctions on Iran's oil and shipping sectors last November.

Meanwhile, an ugly fight is brewing in Trump's team over the sanction waivers, with some hardliners pushing for the US to make good on its threat of squashing Iranian exports to zero, according to media reports. That stance appears to be coming primarily from US National Security Advisor and a known Iran hawk, Michael Bolton.

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The State Department, led by Michael Pompeo and including Iran Special Representative Brian Hook, has cautioned that removing 1 million b/d of Iranian crude from the market could cause a spike, even if current crude prices are relatively benign.

While the Trump administration has been unable to force Iran to the negotiating table over its demands related to the Islamic Republic's missile development and alleged sponsoring of militant groups in the Middle East, which would warrant Washington taking a tougher stance, the US President clearly abhors a spike in pump prices at home.

The OPEC/non-OPEC combine's cancellation of the April ministerial meeting was an acknowledgment that the producers need to wait for the outcome of the expiry of the current round of Iran sanction waivers before deciding on its output policy for the second half of the year.

VENEZUELA OUTPUT IN JEOPARDY

Meanwhile, the political crisis that flared up in Venezuela in January has turned into an impasse.

The situation in Caracas could continue simmering for months, though embattled President Nicolas Maduro's hold on power could progressively weaken along with the country's shrinking oil revenues.

State-owed oil company PDVSA has been locked out of its US refining subsidiary Citgo's funds after coming under US sanctions on January 28.

Meanwhile, PDVSA's crude exports are drying up, bit by bit. US imports of Venezuelan crude, which have slumped since the sanctions, crashed to zero in the week to March 15. A week of no crude imports from Venezuela is a first in at least nine years, based on EIA data, which goes back to mid-2010.

Venezuelan oil minister Manuel Quevedo, who attended the OPEC/non-OPEC Joint Ministerial Monitoring Committee meeting in Baku, told reporters on March 19 that his country would try to ship additional oil to Rosneft, diverting crude that would have gone to the US, to Russia.

Meanwhile, Venezuela has suspended crude exports to India, Quevedo said, adding that he viewed Russia and China as the main markets. The US had started "persecuting" and "threatening" Venezuela's long-term commercial partners, said the minister, who is the current OPEC president.

Rosneft receives Venezuelan crude and products as repayment under oil-for-loan contracts and diverts some of it to Indian private-owned refiner Nayara Energy.

PDVSA reportedly owed Rosneft $2.3 billion at the end of 2018.

It is unclear how Rosneft would be able to dispose of the additional barrels, as refiners and traders in Europe have also backed off from Venezuelan oil.

Russia, China, Turkey and Cuba continue to recognise Maduro as Venezuela's president, while most of the Western world is supporting opposition leader and Maduro's main challenger, Juan Guaido.

Venezuela reported average crude production of 1.43 million b/d for February to the OPEC secretariat, but independent "secondary sources" which OPEC itself prefers to follow, pegged the output at 1 million b/d. The country has lost critical diluent supply from the US, which it needs to help its thick, viscous crude flow through pipelines.

With its markets fast shrinking, Venezuelan barrels with no home have piled up as floating storage, which Bloomberg tallied at around 14.8 million barrels as of March 21.

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EIA LOWERS US OUTPUT FORECAST, MORE TO COME?

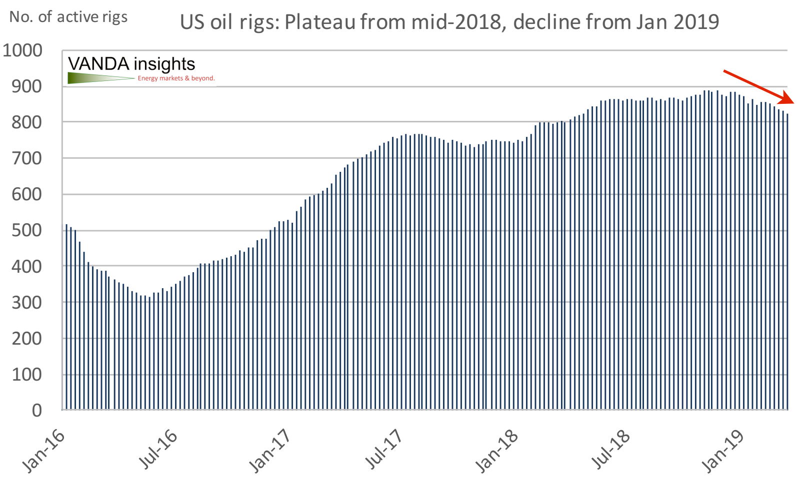
The Energy Information Administration's downward revision of projected US crude production in 2019 and 2020 took some in the oil market by surprise. But not our readers — they know we have been predicting this would happen.

The Baker Hughes data has been serving as a reminder nearly every Friday of the now well-entrenched decline in the number of oil rigs operating in the US.

US producers had let go of 61 oil rigs between the start of this year and March 22, in contrast to a net addition of 57 oil rigs in the same period of last year, according to our calculation from the weekly data.

US crude production would average 12.29 million b/d in 2019, up 1.34 million b/d from 2018, the EIA said in its March Short Term Energy Outlook. That forecast was lowered from 12.41 million b/d of output and 1.46 million b/d of growth predicted by the agency in February.

The EIA reported a month-on-month drop of 40,000 b/d in February crude production to 11.88 million b/d, which made shale optimists sit up and take notice. Prior to this, monthly output had shown a decline only twice over a one-year period: In December and May 2018.



Source: Baker Hughes weekly data

Though US shale players typically talk up the prospects of their sector, there are a few sobering voices that have consistently been pointing at the hidden underbelly of the beast.

Among them is shale pioneer Mark Papa, currently CEO of mid-cap producer Centennial Resource Development. Speaking at the CERAWeek conference in Houston in March, Papa highlighted the major hurdles in shale growth: Most drillers have exploited the good "tier 1" geological spots through the 2015-2016 oil price downturn and are left with less cost-efficient areas in their acreage; the parent-child well interference issues, which reduce overall oil recovery, are continuing to linger; and investors are demanding better returns, forcing the independents to tighten their purse strings.

PERMIAN RIG NUMBERS SLUMP

The number of oil rigs drilling in the Permian, the powerhouse of US shale and overall crude production growth, declined for the first time in December after 31 consecutive monthly hikes, according to EIA data. It dropped from 490 at the end of November to 485 at the end of December.

The count was stable in January but had slipped to 475 by the end of February. It was poised for another drop by the end of March, according to our estimate based on the weekly numbers.

The December drop in rig count followed crude's nosedive from the second week of October. WTI crude futures, the benchmark for US shale producers, had slumped from a three-year high settle of $76.41/barrel on October 3, to an 18-month nadir of $42.53/barrel on December 24.

The number of active drilling rigs in the US typically responds to changes in crude prices within four months, according to the EIA. The change in the rig count shows up in production volumes in about two months. The bottomline is, US shale producers respond predictably and swiftly to major shifts in crude prices.

HOUSTON, WE HAVE A SOLUTION

The Chicago Mercantile Exchange, home to benchmark NYMEX WTI crude futures, broke new ground in March with a spot auction of a cargo of WTI Midland, a light sweet crude stream from the giant Permian basin.

The electronic auction held on March 5 saw 17 international participants bidding for crude offered by the US midstream player Enterprise Product Partners, loading at its Houston Ship Channel terminal.

Glencore bought the parcel at 46 cents/barrel premium to the average of April WTI Houston Crude Oil Futures (HCL) quotes.

Enterprise had offered 650,000-850,000 barrels of WTI Midland, giving the buyer the option to nominate a volume in that range. The optionality was aimed at providing the buyer the flexibility of loading the cargo on an Aframax or using it to aggregate to a VLCC, which can carry up to 2 million barrels. A VLCC would need to be loaded through reverse-lightering, as the biggest tanker the Houston terminal can fully load is an Aframax.

A second online auction for spot WTI had been scheduled for April 4.

A majority of physical crude parcels are typically bought and sold in the international spot market through private, bilateral negotiations. A smaller proportion transacts through “buy tenders”, a common practice with Asian state-owned oil companies, with other venues of sale being physical settlement of contracts on futures exchanges such as the Dubai Mercantile Exchange, and the Platts market-on-close or MOC process.

Spot crude cargo auctions on futures exchanges are relatively new. The DME, which is part-owned by the CME, debuted spot crude auctions in 2017, which have since been used by Iraq’s State Oil Marketing Organisation a few times to sell Iraqi barrels in the international market.

CANADA EASES OUTPUT CUTS AGAIN

Canada’s Alberta province has eased its mandated production cuts again, raising the ceiling to 3.68 million b/d for May and 3.71 million b/d for June.

Alberta began by imposing a 325,000 b/d cut in raw crude oil and bitumen production starting January 2019, as its export pipeline capacity was maxed out, leading to bloated inventories and plunging prices.

The cuts are being pared back by 25,000 b/d each in May and June, as warmer weather requires less diluent to move the heavy, viscous crude through pipelines, freeing up some space.

Following earlier reductions in the curtailment, the total cuts will have been reduced to 175,000 b/d in June.

The strategy is a first for Canada and has stirred up a lot of controversy among local producers. It has, however, bumped up Canadian crude prices. Alberta’s benchmark Western Canadian Select averaged $43.10/barrel in February, according to Canada’s National Energy Board, crunching the discount to the US benchmark WTI to $11.91/barrel, the narrowest in 15 months.

WCS recorded its biggest-ever discount to WTI, of $45.57/barrel, last November.

Canadian crude-by-rail shipments to the US surged to an all-time high of 354,000 b/d last December, according to NEB data, easing slightly to 325,500 b/d in January. Despite the spike, exports by rail accounted for only about 9% of total Canadian crude shipments to the US.

The Alberta government has leased 4,400 rail cars to help ship the province’s crude to refiners in the US. Rail shipments under the program are set to begin at 20,000 b/d by July, ramping up to 120,000 b/d by 2020.

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CRUDE'S RALLY AT A CROSSROADS

Crude's rally to successive four-month highs has reached a make-or-break point, based on an analysis of the moving averages typically used to gauge major shifts in price direction and momentum. The 50-day moving average of front-month NYMEX WTI crude futures climbed above the 100 DMA on March 21, for the first time since the relationship inverted on December 6. The occurrence, known as a "golden cross", is usually a buy signal for the market, though not always respected. In a price uptrend, a 50 DMA or a 100 DMA can also act as a support level in the event of dips. The 50 DMA support level is indicated around $54.33/barrel for WTI.

Data source for chart: CME (NYMEX WTI)