25 May 2017

Flash Comment International

OPEC supply cut extension disappoints the oil market

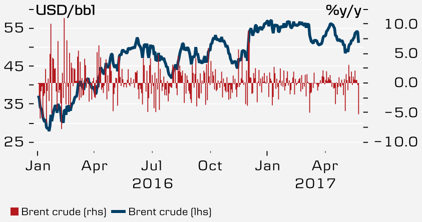
- **OPEC has decided to extend supply cuts until March 2018.**
- **That left the market disappointed, leading to the biggest daily plunge in oil prices since the start of 2016.**
- **We keep a short-term neutral stance on the oil price, while we remain medium-term positive, maintaining our USD60/bl 2018 forecast for Brent crude.**

Today, the Organisation of Petroleum Exporting Countries (OPEC) decided to extend the deal to cut oil production agreed on last November for another nine months with effect from 1 July. 11 non-OPEC countries including Russia are said to back the decision, which means that the group of 22 oil-producing countries will maintain 1.8m bpd of supply cuts until March 2018. The decision follows the recommendation from the Joint OPEC-Non-OPEC Ministerial Monitoring Committee (JMMC) from yesterday. The nine-month extension goes further than the original deal from last November, which included an option for extending supply cuts by six months.

JMMC further reported yesterday that compliance to the deal was 102% in April. Hence, OPEC and its allies outside the cartel have delivered on their part. However, it has only had little overall impact on the oil market. Firstly, the output cuts have been mitigated by expected production increases in the US (chart 2). Hence, overall production remains unscathed, but market shares have shifted from OPEC and Russia to the US. Secondly, oil stocks remains high. For example, US crude stocks remain around the levels from 2016 when taking into account seasonal fluctuations (chart 3). While they have fallen back in recent weeks, it most likely reflects an adjustment following the surprisingly strong build at the beginning of the year. Thirdly, the Brent crude spot price is around USD5/bl higher than before the supply cuts were announced last year. However, the price on longer-dated forward contracts is now lower. For example, the calendar 2019 average Brent swap is around USD52/bl, more than USD2/bl lower than last November. It suggests that the supply cuts should not lead to a tighter oil market over the longer run.

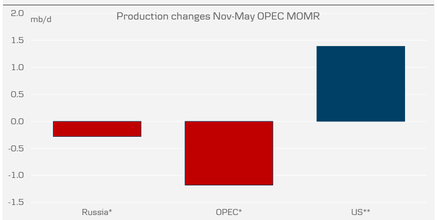
Following the announcement, the price on Brent crude has dropped more than 5% to close USD51/bl. It is the largest daily drop since the selloff at the beginning of 2016 (chart 1). Hence, the oil market is disappointed that OPEC did not deliver more today, either in terms of deeper production cuts or a longer extension. Speculative positioning before the meeting was net long (see *IMM Positioning Update: GBP positioning at highest level since March 2016*), which has likely exacerbated the market reaction. In our view, there is likely a degree of immediate overreaction in oil market and we could see prices recover slightly in the coming days. That said, we maintain a neutral stance on the oil price near term and highlight important downside risks from a potentially more hawkish Federal Reserve, which is set to meet in June. This could lead the USD higher (we forecast EUR/USD at 1.09 in 3M), a further deterioration of the recent financial stress in China and the global business cycle beginning to turn lower in the coming months. Medium term, we remain positive on the oil price and forecast the price on Brent crude to average USD60/bl in 2018 on the back of a lower USD and somewhat tighter oil market.

Chart 1. Biggest daily drop since beginning of 2016



Source: Macrobond Financial

Chart 2. Expected US production rise has mitigated OPEC and Russia's cuts

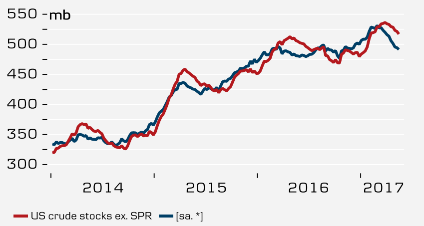


Source: OPEC MOMR

** Changes from Q4 16 to Q1 17*

*** Changes in Q4 17 forecast from November report to May report*

Chart 3. US oil stocks back down to 2016 level



Source: Macrobond Financial

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None.

Date of first publication

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