WHAT'S HOT: OIL PRICES REBOUND AS MARKETS ANTICIPATE TIGHTNESS

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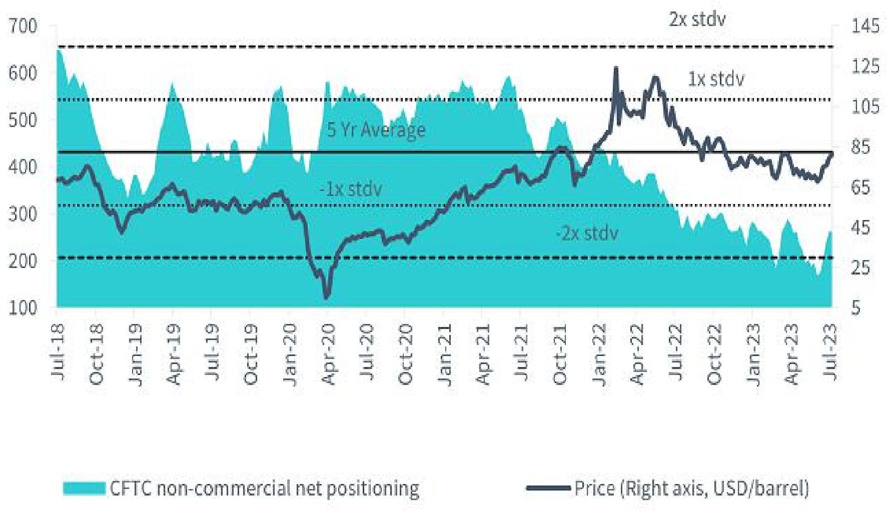
After remaining rangebound for nearly three months, oil prices recently gained momentum and reached their highest level since April. Markets are beginning to expect tightness in oil markets for the remainder of the year on account of resilient supply cuts from The Organization of the Petroleum Exporting Countries and its partners (OPEC+) and relatively steady demand from major economies.

Sentiment could go much further

Net speculative positioning in oil futures is a useful measure of investor sentiment. As the chart shows below, sentiment in WTI Crude Oil futures has been trending down for the last two years. In recent weeks, it has turned slightly but remains meaningfully supressed at around 2 standard deviations below the 5-year average. This suggests that investor sentiment could go much further if markets continue to anticipate tightness in oil supply.

Figure: Price versus net speculative positioning in WTI Crude Oil futures



Source: WisdomTree, Bloomberg, data as of 01 August 2023. CFTC is the Commodity Futures Trading Commission.

Historical performance is not an indication of future performance and any investments may go down in value.

Markets starting to take OPEC+ seriously

In our recently published Commodity Monthly Monitor, we highlight that markets have come to the realisation that the pledge from OPEC+ to tighten the oil market is not just empty rhetoric.

In May 2023, OPEC+ production fell by 670,000 barrels per day (b/d) to a 19-month low, with seven countries joining Russia in implementing voluntary cuts until the end of 2023. Saudi Arabia initially announced an additional 1 million b/d cut for July and August and later extended it to September, while Russia, which had already pledged a 500,000 b/d cut, committed to lowering crude oil exports by 500,000 b/d in August. These measures aim to tighten the market and support oil prices, which have been affected by weak global economic indicators. OPEC+ ministers are on standby for an extraordinary meeting if market conditions require one before their scheduled meeting on 26 November.

In June, OPEC's 13 countries increased output by 70,000 b/d to 28.23 million b/d, led by Iran, Iraq, Nigeria, and Venezuela. However, non-OPEC members of the coalition reduced production by 60,000 b/d, resulting in a net OPEC+ increase of only 10,000 b/d, a modest increase following the significant drop of 670,000 b/d in May. The group's efforts aim to stabilise the oil market amid ongoing economic uncertainties.

The IEA maintains a bullish demand outlook

In its July Oil Market Report, the International Energy Agency (IEA) has, yet again, endorsed a bullish demand outlook for oil suggesting that global oil demand is expected to rise by 2.2 mb/d in 2023, reaching a record of 102.1 mb/d. This is despite the IEA's slight downward revision of 220,000 b/d to allow for macroeconomic headwinds. According to the IEA, China will lead the increase in demand, accounting for 70% of global gains, while OECD[1] consumption remains weak.

For much of this year, markets have been disappointed by the economic recovery in China following its much-awaited reopening from Covid lockdowns. China's Manufacturing Purchasing Managers' Index fell back into slightly contractionary territory with a reading of 49.2 (with 50 being flat, over 50 being expansionary and under 50 being contractionary activity month-over-month). This return to contractionary activity after two months of expansionary readings is keeping market expectations from China in check despite a healthy second quarter GDP growth figure of 6.3%[2]. Market sentiment may receive a boost if China introduces fiscal stimulus in the second half of the year. And if the US has still not gone into a recession by then, this could lift oil prices further.

Other commodities in the energy basket also up

Oil has not been alone in the recent rally. Other commodities in the energy basket have also made gains in recent weeks. This includes Henry Hub Natural Gas, Gasoline, and Heating Oil. As of 03 August, the Bloomberg Energy Subindex Total Return is up 10.57% over the past month (Source: Bloomberg), although it is yet to recover its losses fully from earlier in the year. Also, as of 03 August, WTI Oil, Brent Oil, Henry Hub Natural Gas, Gasoline, and Heating Oil are all in slight backwardation at the front end of their futures curves giving investors an additional benefit of a slightly positive roll yield[3].

Don't rule out the bears

For most of this year, economic tailwinds have trumped production cuts to weigh oil prices down. Small rallies throughout the year have been halted by the hawkishness of central banks. While there is a growing sense that we are approaching the end of the rate tightening cycle from major central banks, particularly the US Federal Reserve, if central banks surprise markets by remaining hawkish for longer, this may yet again put a cap on oil prices.

Sources

[1]The Organisation for Economic Co-operation and Development

[2] National Bureau of Statistics of China. GDP is gross domestic product.

[3] Backwardation is when spot prices are higher than futures prices giving investors at the front end of the futures curves a positive roll return.

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