WHAT'S HOT: GEOPOLITICAL TENSIONS SET THE TONE FOR THE FINAL OPEC MEETING OF 2021

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On December 2nd, the Organisation of the Petroleum Exporting Countries (OPEC) and its partner countries (together, OPEC+) will meet to decide on production quotas for January 2022 and beyond. The group, which controls close to half of the world's crude oil output, are under increasing international pressure to raise production as oil markets are currently very tight. The tightness in oil markets has driven up crude oil prices by 69% in the past twelve months[1], and several governments of oil-importing countries have sought to release Strategic Petroleum Reserves (SPR)[2] in an attempt to dampen price increases.

Rubber-stamping announced policy?

In July 2021, OPEC+ decided to move its Ministerial policy meetings to a monthly basis and pre-committed to raising oil production by 400,000 barrels per day (b/d) each month from August 2021 to September 2022 (i.e. until pre-crisis production levels are restored). One would be forgiven for thinking that these monthly meetings should become a rubber-stamping affair. But that is so far from reality. The July pact resulted from a compromise after the United Arab Emirates threatened to walk away from discussions if its baseline production value was not increased (from which production cuts are calculated). The UAE is an example of a member that is itching to raise its production. On the flip side, several countries fail to produce enough to meet their allotted quota. Saudi Arabia and Russia, the two largest members of the alliance, are not keen to raise production.

Geopolitics takes another turn

The oil crisis of 2020 was a geopolitical crisis: when Saudi Arabia and Russia failed to agree on policy, they engaged in a price war at a time when oil demand was plummeting. Fast forward to today, while Saudi Arabia and Russia may be more aligned on policy and demand has recovered strongly, the release of SPR has irked the OPEC+ hegemons. Several market speculators believe that OPEC+ will increase production by less than 400,000 barrels in retaliation (or, in other words, conclude that because more oil is in the market, the call on OPEC+ is lower). We believe that it will be a mistake for OPEC+ to engage in this battle as oil-importing countries may react by withholding trade in other goods and services. That could spiral the global economy back into a tit-for-tat trade war. The scars of the last trade war in 2018 to 2019, followed by the Covid 19 pandemic, are still visible today with severely disrupted supply chains. But as the oil crisis of 2020 highlights, we can't always expect OPEC+ to make logical decisions.

Bullish or bearish on oil demand?

The pace of the economic expansion we have seen in the past year has been impressive. According to International Energy Agency forecasts, 2021 oil demand has risen 5.5 million barrels per day (following an 8.8 mb/d decline in 2020). Yet supply is not growing anywhere near as strongly. This tightness in the market has pushed up oil prices as we eat into existing oil inventory. While composite leading indicators and purchasing managers indices point to peak growth having passed, they are still consistent with strong economic growth. So, the demand for oil is likely to remain robust for the coming year. Oil importing countries are screaming for more supply for this reason.

However, OPEC+ seem to be focusing on some of the downside risks to demand. Covid rates are surging in various parts of the world, and some countries are experiencing renewed lockdowns. On 26th November a number of countries halted travel to South Africa and a number of neighbouring countries due to a concerning new variant of the coronavirus. At the time of writing, this has pressured oil prices lower (Brent fell 4.9% between midnight and 9.30am on 26/11/2021). The effect of elevated consumer prices could start to dampen economic demand. Supply chain issues have not been resolved as quickly as many had hoped and therefore are slowing down manufacturing activity. Many members of OPEC+ claim they want to exercise caution in raising production for these reasons.

Whatever comes out of the meeting, we don't expect the conclusion to be swift. Energy-hungry countries will be watching with bated breath and hope that OPEC+ will use its supply capacity in a flexible manner.

Sources

[1] Brent oil price, 25/11/2020 to 25/11/2021, Bloomberg data

[2] The US is releasing 32 million barrels in terms of loans by 30 April 2022 and selling 18 million barrels outright over the next "several months". India will release 5mn million barrels. The UK has authorised 1.5 million barrels release. China, Japan and South Korea also plan to join, but have not provided any details yet.

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