# Oil Price Update Q2 2016

*Are oil prices near their equilibrium?*

*April 2016*

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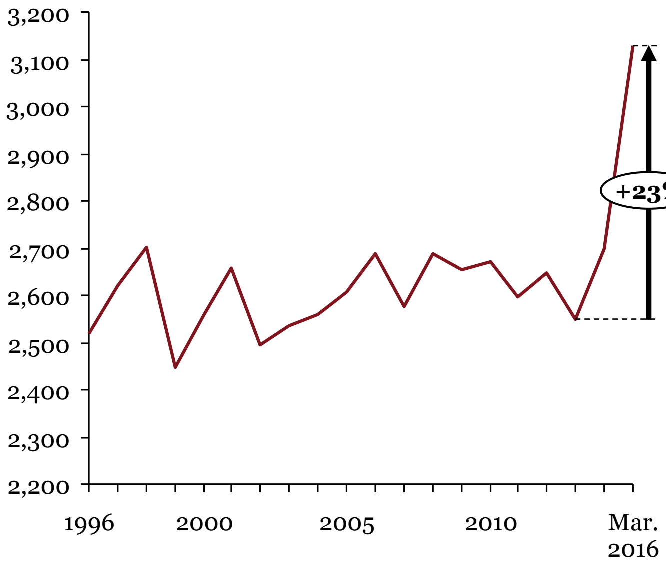
## Are oil prices near their equilibrium?

### *Global supply and demand*

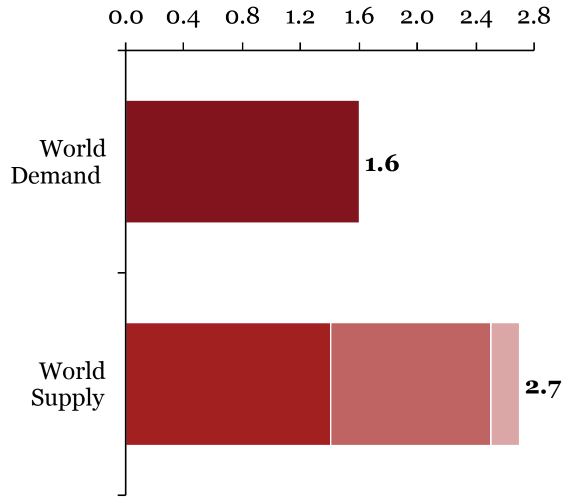
Global oil prices have recovered by some 40% in recent weeks suggesting that perhaps the decline in oil prices may have bottomed out. After a prolonged period of bearish sentiment about oil prices (lower for longer), markets have regained some confidence. In 2015 supply outstripped demand with surplus production bolstering stocks, and prices crashing below US$27 in February 2016. In the first half of 2016, markets are expected to still remain oversupplied as US crude production is only beginning to ease off (5% down to date), major Middle East producers are maintaining output and output from Iran is growing.

Both Iraq and Saudi Arabia (KSA) continue to pump at high levels, and despite security issues in Iraq output has grown to 4.4 m barrels per day. Saudi production levelled off at 10.2 m barrels per day as KSA focuses on market share and meeting domestic demand. Iranian production is already up by 400 k barrels per day since January 2016 with a government objective of delivering 500 k barrels per day to world markets. Libyan output remains strained at 330 k barrels per day due to the war between the officially recognised government in the east and the Libya Dawn administration in Tripoli as major operations at strategic oil terminals and fields remain closed. In the past week, Kuwait's output dropped to 1.1 m barrels per day (from 2.8 m) due to a worker's strike.

**OECD stocks: Million bbls**



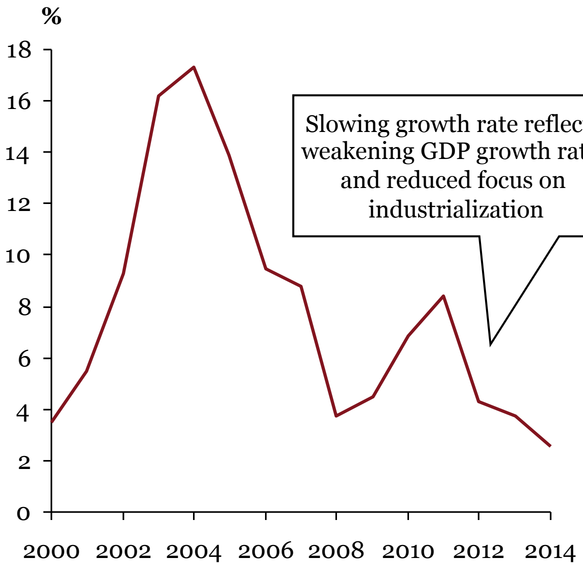

**Supply and demand Million bbls/ day**



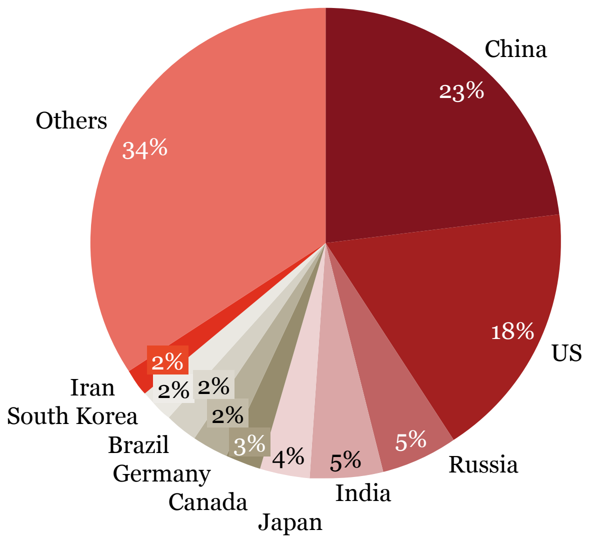

In 2015 supply outstripped demand with surplus production bolstering OECD stocks to historic highs.

Demand is forecast to strengthen gradually in the second half of 2016 underpinned by Asian oil net importers. In a long-term perspective however, global absolute demand for oil has risen, but year on year demand growth has been in decline. Significant price increases are unlikely in the near term as global economic growth remains sluggish. In this context China's economic malaise – GDP predicted at 6.5% in 2016 – remain a significant factor given the country's consumption of energy. Long-term GDP growth is predicted at 5.9% in 2020, and the negative impact on demand growth is further reinforced by a decoupling of energy demand and GDP growth.

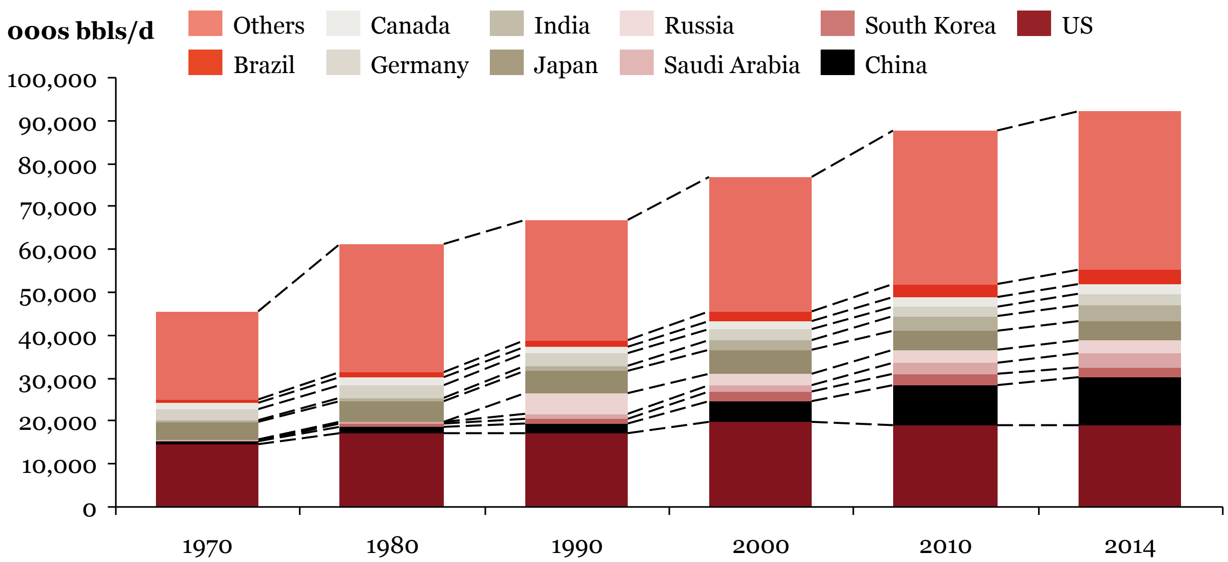
**Chinese Energy Demand** Annual % change




**Primary Energy Consumption** Major Countries 2014




**World Oil Demand by Leading Countries** 1970 - 2014



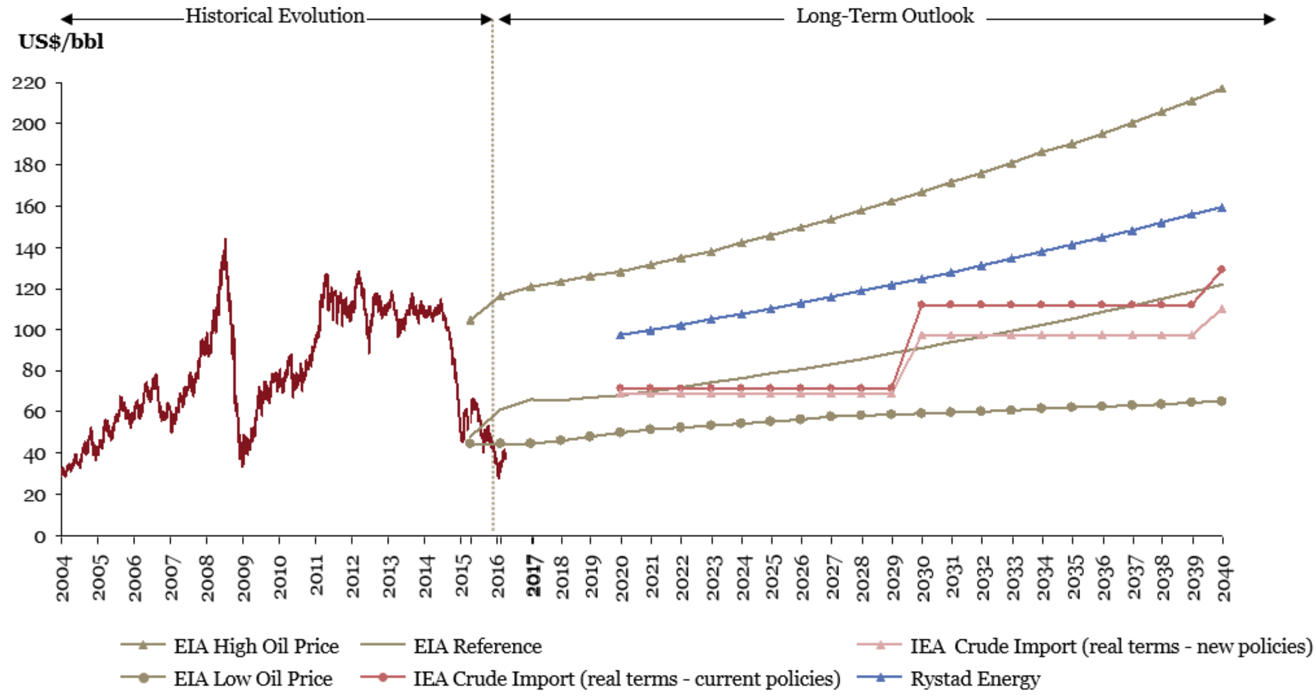
# OPEC's waning influence

As for OPEC, its influence continues to wane. The block's 17 April 2016 meeting failed to deliver a production freeze. In November 2014 and December 2015 OPEC decided not to cut production in favour of KSA's strategy to retain market share. The result is hardly surprising as Saudi recommendation to freeze production at January's levels, has been seen mostly as a political stage show to revamp OPEC's relevance, and Iran was not represented at Sunday's meeting. The next OPEC meeting is scheduled for June 2016.

Nonetheless, the current environment is a predicament to all OPEC producers which continue to struggle financially. In order to balance budgets some have taken to unorthodox measures, the most radical of which would be Saudi Arabia's floating of 5% of the shares in Saudi Aramco in 2017.

Against this back-drop, long term future oil price forecasts are varied.

**Brent Crude Price Historic and Outlook** Various Sources



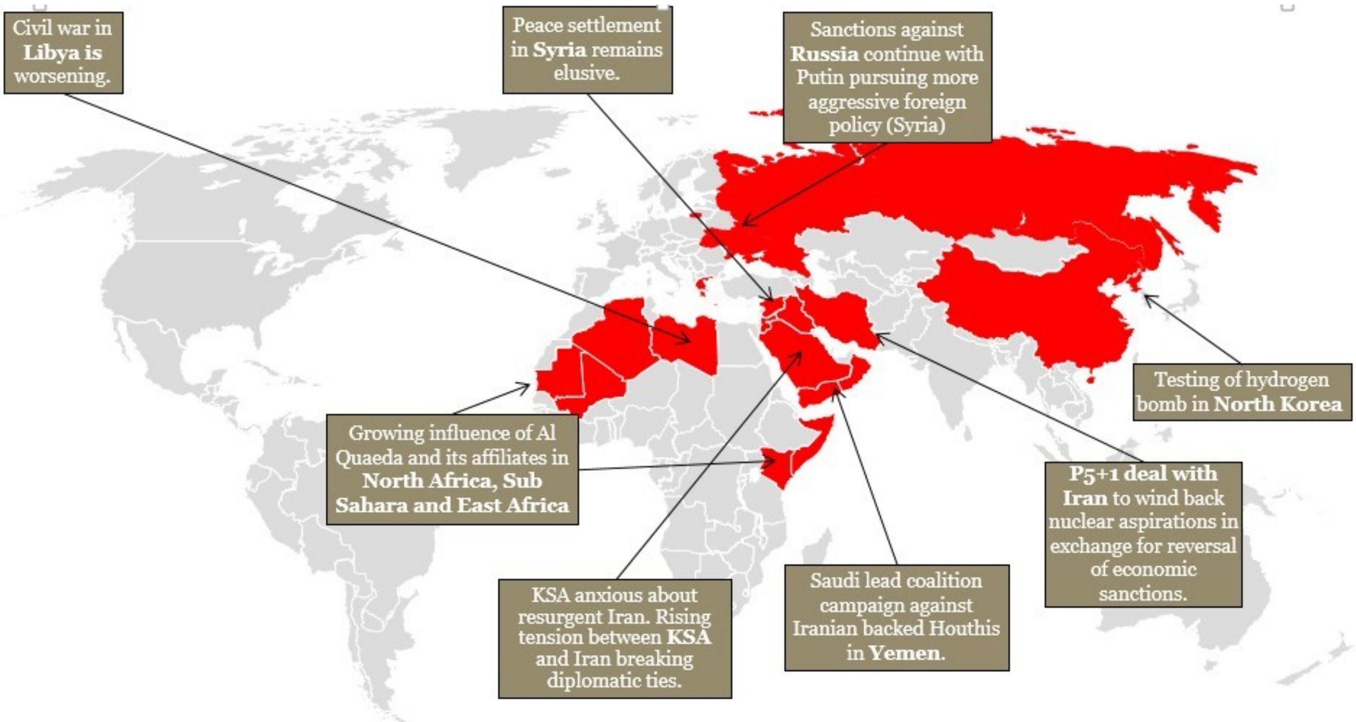

*Source: Deutsche Bank; Press Search; Eurasia Group; Strategy& research*

# *The geopolitical game*

Geopolitical risks are also abundant. The civil war in Libya is worsening with Libyan exports at minimal levels. The struggle for control between the officially recognised government in the east and the Libya Dawn administration in Tripoli is expected to continue throughout 2016. The Islamic State is growing its military presence in Syria and the peace settlement remains elusive. Russian interventions have escalated tension, although we are now seeing a partial withdrawing of troops.

In the Gulf, rising tension between KSA and Iran has increased geopolitical risk in the region. Saudi Arabia is concerned by the US détente with Iran which will encourage the latter to play a greater regional role. The catalyst for recent escalations, however, was Saudi Arabia's execution of prominent Shia cleric Sheikh Nimr al-Nimr in January 2016. This led Iranian regime to warn of "divine revenge" and protesters in Tehran to torch the Saudi embassy, causing KSA to remove its diplomats and break off relations. Both countries were already fighting proxy conflicts in Syria, Iraq, Yemen, Bahrain and Lebanon.

From an oil perspective, Iran is keen to increase production and exports to generate more revenue as sanctions are lifted. This reduces the likelihood of Iran and KSA co-operating to cut production to bolster the oil price.

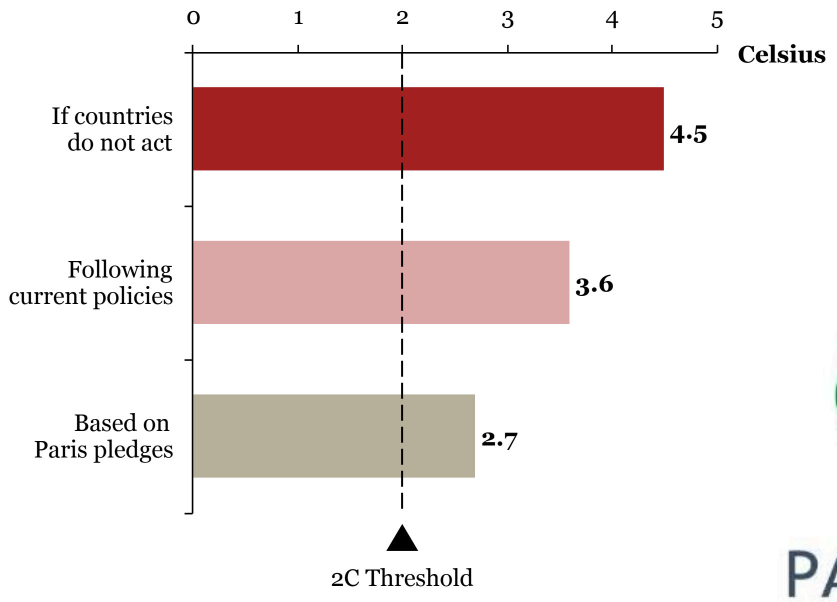



*Source: Deutsche Bank; Press Search; Eurasia Group; Strategy& research*

# *The Low Carbon agenda*

At the same time the G7 are making historic progress to phase out fossil fuel emissions to combat climate change. Worldwide, governments reached an unprecedented global agreement on decarbonisation at COP21 in Paris. It is the first of its kind where all countries are on board to cut carbon emissions. The agreement is partly legally binding and partly voluntary. The deal will come into effect in 2020, but ccountries are urged to start reducing greenhouse gas emissions as soon as possible and to achieve balance between sources and sinks of greenhouse gases in the second half of this century. Follow-up actions are taken including US$ 100bn per annum in climate finance for developing countries. This will lead to significant changes in the global energy system and have consequences for the oil and gas sector.

**Average Warming Projected by 2100**

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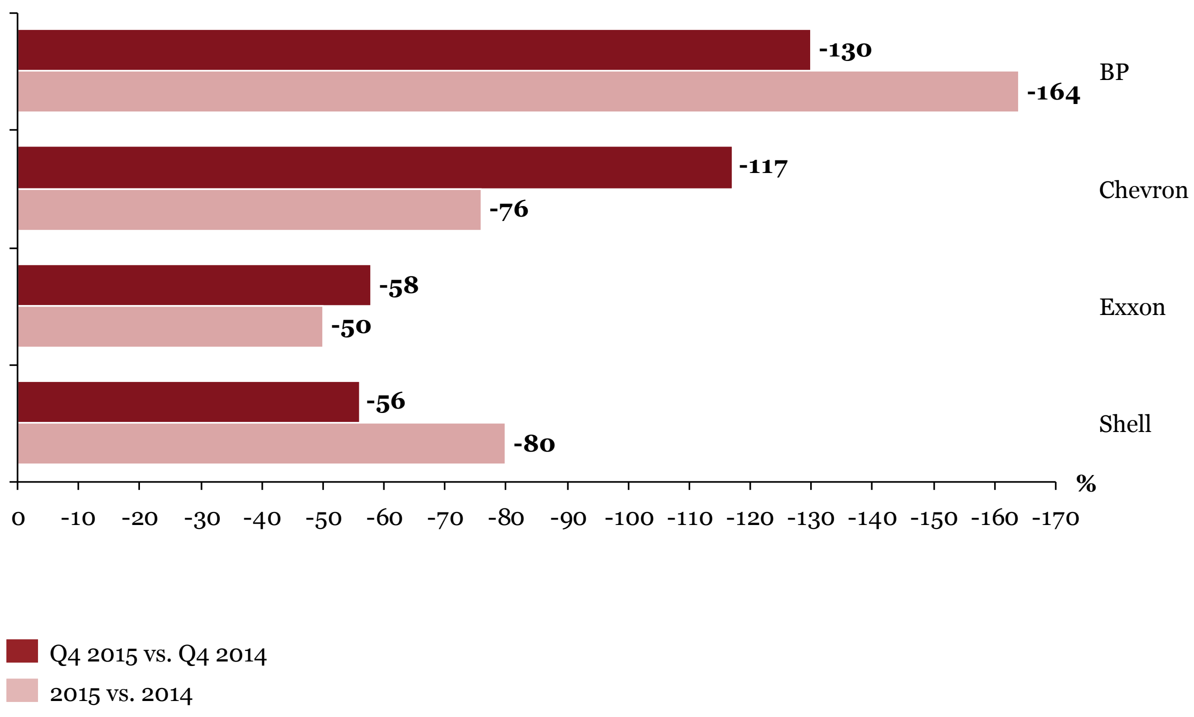
# *Cost-cutting is the only game in town*

As a result of the volatile external environment, all oil majors reported decline in earnings, albeit to varying degrees. Companies are pulling multiple cost reduction levers in an over-supplied market. Since September 2015 oil and gas companies have explored diverse efficiency improvements, cut capex spending, deferred or cancelled major projects and frontier activity is being ended or cut. While investments are expected to fall further in 2016, companies will be expected to borrow more to preserve the dividends demanded by investors.

Some 230,000 jobs were lost in the oil and gas sector in 2015 with oil services making the severest cuts, and it is expected that 2016 will see oil operators make more dramatic cuts. The segments most affected are engineering, procurement and construction, subcontractors and contingent labour. Announcements by CEOs suggests oil fundamentals will improve in the medium-term as will price. Nonetheless, M&A deal values are down by approx. 35% as a price volatility makes it harder for sellers and buyers to agree on valuations.

**Decline in Earnings Among Majors** Q4 2015 and Full Year 2015



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