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The Oil Patch

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Oil spikes higher on Middle East tensions:

The return of a risk premium for geopolitical tensions at a time of continued tightening in supplies has pushed oil prices to their highest levels in 40 months.

The key factor in oil's near 10% price spike between mid-March and mid-April was the missile raid by Western powers on chemical weapons facilities in Syria in retaliation for an earlier suspected poison gas attack in Douma.

While Syria's oil exports have been negligible during its 7-year civil war, the April 14 missile strikes by the US, Britain and France against the Assad regime nevertheless raised geopolitical tensions in the Middle East.

The missile strikes also angered Russia, already smarting from US President Donald Trump's sanctions against Russian business oligarchs close to President Vladimir Putin, and threats of more sanctions to come, possibly roping in the country's oil oligarchs.

Potentially more telling for oil markets is the fallout from President Trump's May 12 deadline for tougher conditions to be imposed on the 2015 deal limiting Iran's nuclear capabilities.

Unlike Syria, both Russia and Iran are major oil producers, and how they respond to Trump tightening the screws on them can be expected to be a key factor in determining the near-term direction of oil prices.

As it was, oil prices rose strongly in the days leading up to the Syria raids, easing only slightly in following days on the basis that, as the Western powers put it, the missile raids had been surgical and that the job had been done.

WTI was trading at $US66.84/bbl on April 16, a 9.2% increase on its level in mid-March, while Brent was trading at $US71.87/bbl or 10.4% higher.

The higher prices are not all about the rise of geopolitical tensions.

Brent at more than $US70/bbl – in the absence of significant geopolitical fears - was a feature in the opening months of 2018 and reflected the situation where global supplies were tightening in response to OPEC-led supply cuts and the collapse of output in Venezuela.

Mission accomplished

Just days before the Syria missile strikes, the International Energy Agency said OPEC's production cuts – both planned and unplanned – meant the 2016 Vienna agreement to get supply/demand back in to balance was nearing "mission accomplished'' status.

"It is not for us to declare on behalf of the Vienna agreement countries that it is 'mission accomplished,' but if our outlook is accurate, it certainly looks very much like it," the IEA said in its April monthly report.

"As far as the OPEC/non-OPEC output cuts are concerned, some countries party to the 2016 Vienna agreement, have, for different reasons, seen production fall by more than they promised. These extra cutbacks total over 800,000b/d. To all intents and purposes, more than a second Saudi Arabia has been added to the output agreement,'' the IEA said.

Oil more susceptible to geopolitics

Morgan Stanley's energy desk estimates that the global supply needs to increase by 2mb/d to balance the market.

"With OPEC and Russia likely flat, all of this would fall on the rest of the world. Despite US production growing 1.2mb/d, on our estimates, and Canada and Brazil another 0.5mb/d combined, we do not expect this gap to be closed.''

As a result, the investment bank believes a global deficit of about 0.3mb/d, concentrated in second to fourth quarters, is likely.

"With inventories already low, geopolitical risk is exacerbated. Expressed in days of demand cover, observable global inventories are already at the bottom end of the five-year range. With the inventory cushion largely gone, oil prices will likely be more sensitive to geopolitical risk factors again. Several 'hot spots' could provide ongoing price support,'' Morgan Stanley said.

But not all risks are to the upside

The Commonwealth Bank's commodities desk and others warn that while ongoing price support has improved oil's outlook, there are risks to the downside that could emerge.

It said that the US (and other non-OPEC) supply could lift significantly in response to the higher oil prices, and that while infrastructure constraints in the key US shale oil basin might be a constraint on output today, it was unlikely to persist.

Then there is the prospect that OPEC and its allies could break away from the Vienna pact.

"The OPEC-led deal requires cooperation, and if enough countries like Russia, Iran and Iraq break away from the accord, we could see prices fall notably,'' the bank warned.

It also cited the possibility of trade tensions between US and China escalating, weighing on global economic growth and oil consumption.

M & A to remain buoyant

Oil's price recovery from last year's annual average of $US54/bbl (Brent) has continued to stoke merger and acquisition activity.

The standout in the last month on the M & A front was Harbour Energy's $13.5 billion or $6.50-a-share takeover proposal for Santos.

The private US group is carrying out due diligence on the offer, a process expected to be finished in May. While the proposed offer represents a big premium to Santos' pre-bid price, the reaction of Santos' two big Chinese shareholders remains uncertain.

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