FAR Limited

May 2018

The Oil Patch

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Oil gets a "7" handle on rising geopolitical tensions:

It has been a slog but oil prices finally have a "7'' in front of them after a month of strong gains in response to a trifecta of rising geopolitical tensions, on-going supply cuts by OPEC, and shrinking global stockpiles.

Much to the delight of the global exploration and production industry which is still shaking off the effects of oil's collapse to below $US30/bbl a little more than two years ago, the price for the global benchmark Brent had a month-on-month gain of 10.3%, carrying it to a post 2014 high of $79.28/bbl (May 17).

Reflecting some supply bottlenecks and rising shale oil output in the US, the gain for WTI was a lesser but still impressive 7% increase to $71.55/bbl. WTI has now risen by 67% since June last year when oil was a still challenging $US42.70/bbl.

At this stage, there are only two clear downsides for the E & P industry from oil's dramatic price recovery.

The first has been the increase in hedging losses for those producers which for one reason or another sought price protection when oil was at its lower levels. The "losses" could amount to more than $US7 billion in 2018 alone by one estimate.

The second is the impact the sharp increase in prices will have on demand, and broader economic activity in the big economies. In its May oil market update, the International Energy Agency trimmed its global demand growth forecast, but ever so slightly from 1.5mb/d to 1.4mb/d.

"While recent data confirms strong growth in the first quarter of 2018 and the start of second quarter of 2018, we expect a slowdown in the second half of 2018, largely attributable to higher oil prices. World oil demand is expected to average 99.2 mb/d in 2018,'' the IEA said.

Clear winners from oil's march to $US70/bbl-plus prices are the established producers. That has been reflected in the strong share price gains in the year-to-date for the leading ASX-listed producers. But explorers and developers not yet in production are also benefitting.

Higher oil prices mean greater investor support for their exploration efforts and increased valuations of undeveloped oil, making projects easier to finance on the promise of greater returns, with the tough cost-out lessons of oil's lean years providing additional leverage to the upside.

The biggest driver in last month's gains for oil was the May 8 announcement by Donald Trump that the United States was quitting the Iran nuclear deal, and that any country aiding the country to obtain nuclear weapons would be "strongly sanctioned.''

"Neither Venezuela nor Mexico can raise output in the short term, but some of the 1.5 mb/d that has been cut by other producers under (OPEC's and Russia's) Vienna Agreement might be available to keep markets well supplied,'' the IEA said.

Oil with “8” and “9” handles on the way?

Investment analysts have been playing catch-up in their oil “price decks’’ used to assess market values in the E & P sector.

Upgrades of oil price decks have been coming thick and fast as the recent step up in geopolitical risks has taken oil well beyond where most analysts thought it would be based on the easier to assess supply/demand fundamentals.

Investment bank Morgan Stanley joined the fray on May 15, upgrading its Brent forecasts for the first quarter of 2019 from $US65/bbl to $US80/bbl, and for the first quarter of 2020 from $US65/bbl to $US90/bbl. Its long-term forecast was increased from $US65/bbl to $US70/bbl.

Reasons for the upgrade were listed as strong global demand, US shale production being dominated by natural gas liquids and condensates, which refiners can't use easily process for diesel/jet fuel, and low sulphur regulations potentially boosting demand by another 1.5mb/d in 2020.

Demand underpins pins higher prices:

While the flare-up in geopolitics has fuelled oil’s recent price spurt, the key price support remains tight supply/demand fundamentals in the physical market.

The physical market has been on a rebalancing pathway for the last 18-months, with global commercial inventory falling from a peak of 3.1bn barrels down to 2.85bn.

The inventory fall continued in the March quarter towards the 5-year average, considered to reflect a market in balance.

Robust global demand growth – particularly in India, Brazil, the Middle East and Russia - is behind the rebalancing, positioning oil to spike higher on any geopolitical supply shocks.

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