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THEMATIC

In this report:

Can crude oil go beyond US$80?

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Can crude oil go beyond US$80?

The Covid-19 pandemic and the unprecedented measures that followed it in 2020 have significantly impacted oil prices with the prices for Brent and WTI averaging at just US$38 and US$35 per barrel in 1H2020.

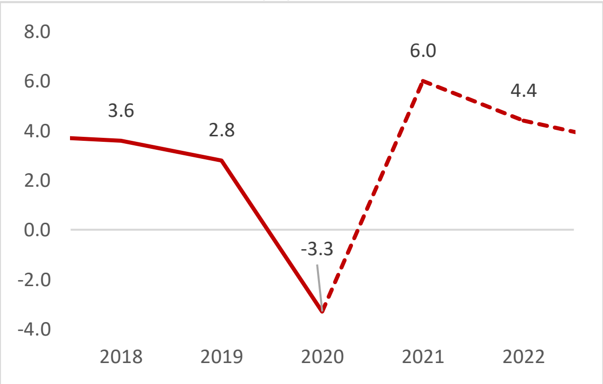
In 2H2020, both Brent and WTI average prices improved to US$44 and US$42 per barrel, supported by the reopening of the economy, improving economic activities, and rising confidence as vaccinations were rolled out.

The 2021 outlook for Brent is around US$68–US$70 a barrel, underpinned by an improving global economy with Brent and WTI reaching average prices of US$66 and US$62 per barrel, respectively in 1H2021. Year to date, the average prices of Brent and WTI were US$67 and US$64 per barrel, respectively.

A. Global recovery driven by vaccination progress

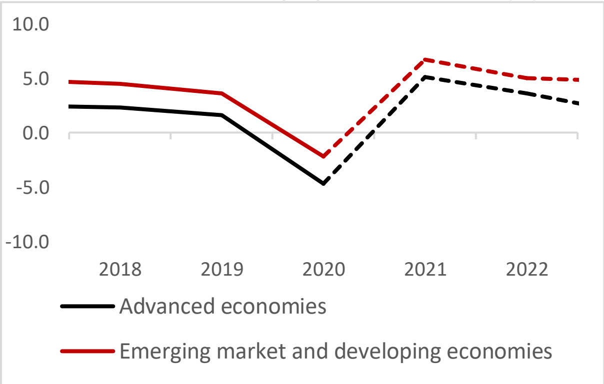
- The Covid-19-battered global economy slid into a severe recession in 2020, contracting by 3.3% as global markets turned more sensitive with high volatility seen in risky assets (notably stocks) to safe havens such as gold (Chart 1).

Chart 1: Global GDP (% y/y)



Source: IMF/AmBank Research

Chart 2: Advance & Emerging Market GDP (% y/y)



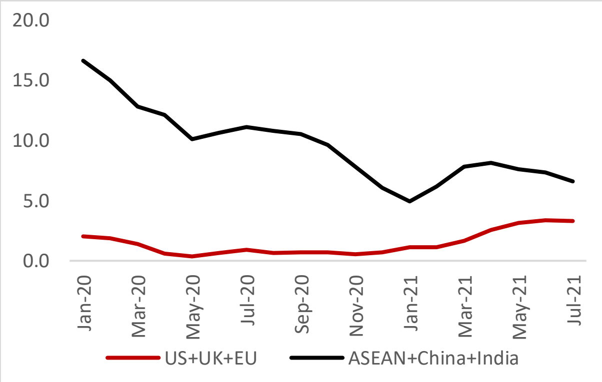
Source: IMF/AmBank Research

- Stepping into 2021, with the development and distribution of vaccines, acceleration in vaccinations, increasing effectiveness of vaccines on new variants of the virus, coupled with stimulus measures, global growth is projected at 6.0% albeit the widening gap between advanced economies and many emerging market and developing economies (Chart 1).

- The outlook for emerging market and developing economies (EMDE) and, in particular, emerging Asia in 2021 is more challenging compared to the advanced economies (AE). This is mainly due to pandemic developments and changes in policy support (Chart 2). On that note, there is more downside risk to growth in this region compared to more upside in the advanced economies, particularly the US, as more fiscal measures were deployed in the second half of 2021, coupled with improved health metrics across the group.

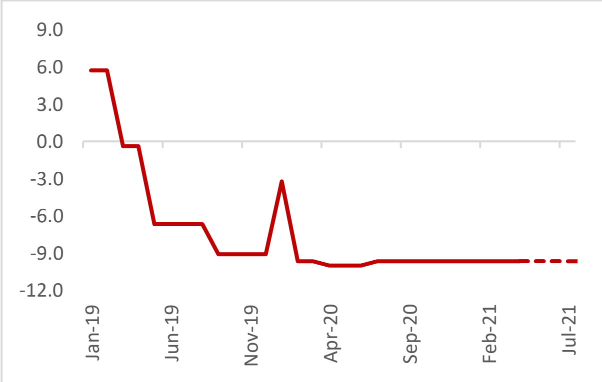
- Recently, price pressures were seen due to the pandemic-related developments and transitory supply-demand mismatches. Inflation should return to its pre-pandemic levels in most countries in 2022. It will take place once the current disturbances work their way through prices although uncertainty remains high. Inflation is poised to stay elevated in some EMDE due to high food prices (Chart 3).

Chart 3: Global Inflation (Monthly %)



Source: CEIC/AmBank Research

Chart 4: Global Monetary Tracker



Source: CFR/AmBank Research

- Hence, global central banks should examine the transitory inflation pressures and avoid tightening until there is more clarity on the underlying price dynamics. Clear communication from global central banks on their outlook for monetary policy will help shape inflation expectations and safeguard against premature tightening of financial conditions. But there is a risk that transitory inflationary pressures could become more persistent and central banks may need to take preemptive action (Chart 4).

- Meanwhile, the global economic outlook for 2022 remains positive. Global GDP is projected at 4.9% (Chart 1). This is based on the view that multilateral action will continue to ensure rapid, global access to vaccines, diagnostics and therapeutics. By end-2021, around 40% of the global population are expected to be vaccinated and around 60% by mid-2022 based on the World Health Organization, World Bank and World Trade Organization. Nevertheless, uncertainty remains as new virus mutations could spark another wave of infections during the vaccination campaigns or even prove resistant to the vaccines currently deployed.

- Notwithstanding the uncertainties, the positive global outlook has helped allay fears in global markets. While the world economy will recover from the slump in 2020, the impact of the ravaging Covid-19 cannot be underestimated. Also, global trade is being reshaped by geopolitical risks. These factors stoked widespread concerns among investors about the prices of the four major assets – gold (safe haven for investors); the US dollar (will it remain strong), crude oil (how high will prices go) and stocks (will the surge continue).

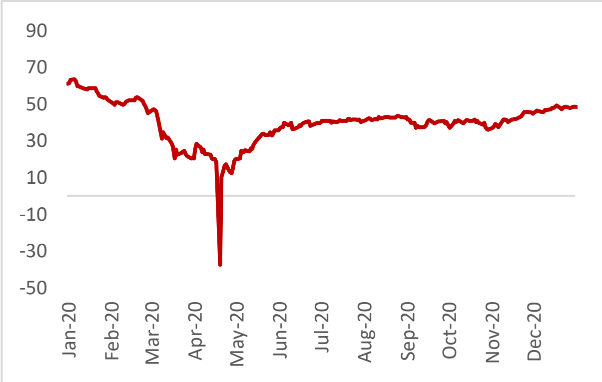
B. V-shaped recovery in 2020 crude oil price

- Oil prices started on a strong note in January 2020. It came close to US$70 per barrel for the first time in over three months following jitters over the escalating military tensions between Iran and the US. This came about after the US killed Iranian Gen. Qassem Soleimani. The Brent ended at US$68.60 a barrel on 3 January, the highest since the mid-September attack on Saudi oil facilities. Eventually tensions eased (Chart 5).

Chart 5: Daily Brent Oil Price (US$/barrel)

Source: Bloomberg/CEIC/AmBank Research

Chart 6: Daily WTI Oil Price (US$/barrel)



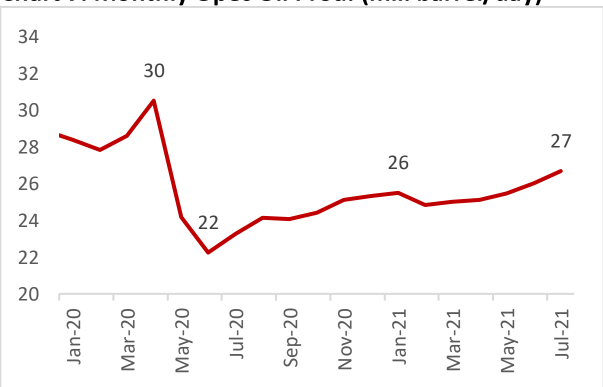
Source: Bloomberg/CEIC/AmBank Research

- However, the short-lived calm was shattered when Covid-19 was declared as a pandemic on March 11. It triggered an unprecedented demand shock in the oil industry. Drastic measures taken to contain the virus spread led to a historic market collapse in oil prices. Demand for oil cratered as governments around the world shuttered businesses, issued stay-at-home mandates and restricted travel. Reduced economic activities created excess supply and hammered oil prices. This is despite the Opec's agreement to reduce production levels.

- On 20 April, the May 2020 contract futures price for West Texas Intermediate (WTI) plunged from US$18 a barrel to around -US$37 barrel. (See Chart 6) This was followed by Brent crude oil tumbling to US$9.12 a barrel on 21 April, a far cry from the US$70 a barrel fetched at the start of the year (Chart 5).

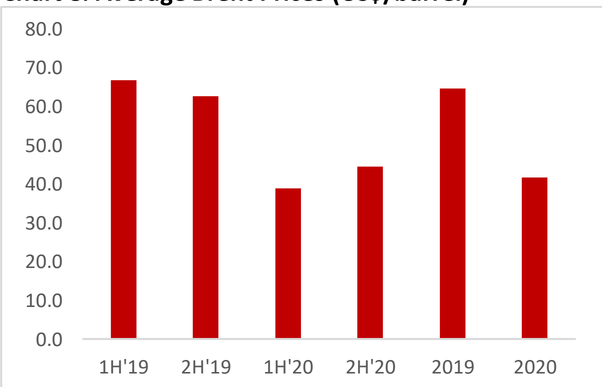
- Adding to the free fall in oil prices was the oil price war between Saudi Arabia and Russia. It broke out on 8 March after the two countries failed to agree on oil production levels. The month-long price war ended in April when Opec and its allies agreed to cut overall crude oil production by 9.7 million barrels per day for an initial period of two months starting 1 May. It is the single largest output cut in history. Oil production was limited to 7.7 million barrels per day from 1 July and continued through 31 December 2020.

Chart 7: Monthly Opec Oil Prod. (mil. barrel/day)



Source: CEIC/AmBank Research

Chart 8: Average Brent Prices (US$/barrel)



Source: Bloomberg/AmBank Research

- As summer approached, oil markets started to shift as nations began to emerge from lockdowns. With the year progressing in 2H2020, market expectations grew that Opec would continue to limit or delay production increases slated for 2021. Improving economic activities with confidence from the rollout of vaccines and the Opec+ announcement on 3 December that they would adjust production by 0.5 million barrels from 7.7 million barrels to 7.2 million barrels per day starting January 2021 buoyed the market. (Chart 7).

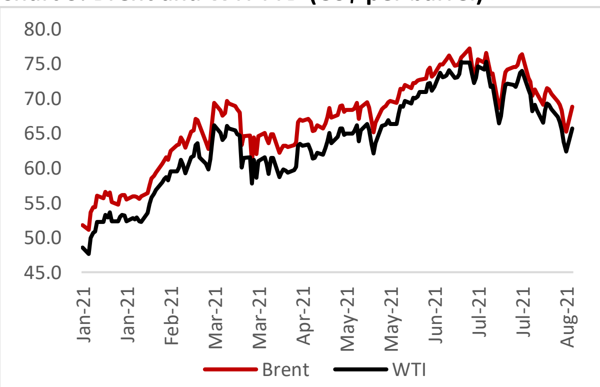
- Brent and WTI price a barrel averaged at US$44 and US$41, respectively in 2H2020 versus US$42 and US$37 a barrel, respectively in 1H2020. For the full year, WTI and Brent averaged at US$39 and US$43 a barrel, respectively (Chart 8).

C. How high will crude oil go in 2021?

- For the first seven months of 2021, on average, Brent oil prices surged more than 50%, rallying towards US$80 a barrel for the first time in more than two and a half years. But the uptrend in oil prices was halted when prices skidded for six consecutive days starting 12 August (Chart 9).

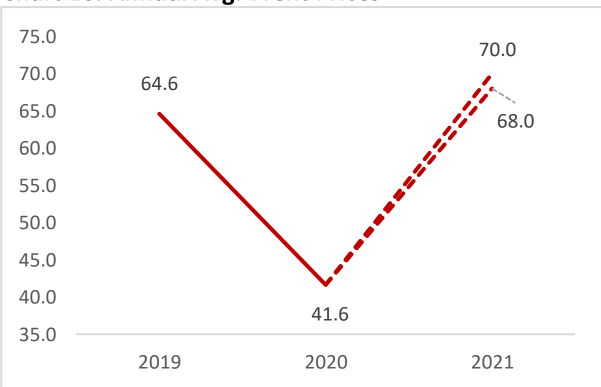
- Investors are worried about the outlook for fuel demand as Covid-19 cases surged worldwide just as more supply reaches the market from large global producers, including the US. Brent crude ended down at US$68.23 a barrel. The global benchmark has lost 14% starting from the end of July until 20 August. WTI fell by 15% to US$62 a barrel over the same period (Chart 9).

Chart 9: Brent and WTI YTD (US$ per barrel)



Source: Bloomberg/CEIC/AmBank Research

Chart 10: Annual Avg. Brent Prices



Source: Bloomberg/CEIC/AmBank Research

- The positive oil price trend could come to an abrupt end if global central banks start to raise interest rates unexpectedly driven by inflation fears. It could also happen if Opec raises output above demand or fails to absorb the extra Iranian barrels (2.5mil barrels per day) when the Persian Gulf Opec member returns to the market. Nevertheless, it looks likely that Opec+ will be able to absorb the additional Iran's oil exports.

- Other uncertainties could also cloud the oil price outlook. The spread of the Delta Covid-19 variant worldwide has raised concerns over a potential setback to oil demand. Also, renewed lockdown measures to contain the virus spread plus higher costs have already dampened factory growth in China.

- However, despite a more positive sentiment in financial markets, China has made progress to contain the fast-spreading Delta variant, bringing their local cases down to zero. We also expect Opec+ to fully comply with the agreement during 2H21. Opec's crude oil output would remain lower than calls through 3Q2021 and 4Q2021 This quarter, demand for Opec's oil will exceed output by 1.0 million bpd. But this difference will drop to 300,000 in 4Q2021. The cartel's output would average around 33.0 million bpd in 2H2021.

- Meanwhile, we feel the crude oil market would test the price levels that the market can tolerate before they could put a lid on demand growth. This is something that is tough to gauge. Our estimation is around US$80 a barrel. Anything above that will have adverse implications for economic growth as there a fair bit of demand destruction could kick in.

- Thus, we expect Brent to briefly test a high of US$70s a barrel before European buying start to wane and the potential return of Iranian barrels. That should see Brent price retracing to the low US$70s level. We expect Opec to hold prices above US$70 per barrel in 2021. Nevertheless, our forward curve suggests the fair value to be slightly below US$70 a barrel i.e. around US$68 a barrel (Chart 10).

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