Oil stuck in US$40-55/bbl range

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Summary

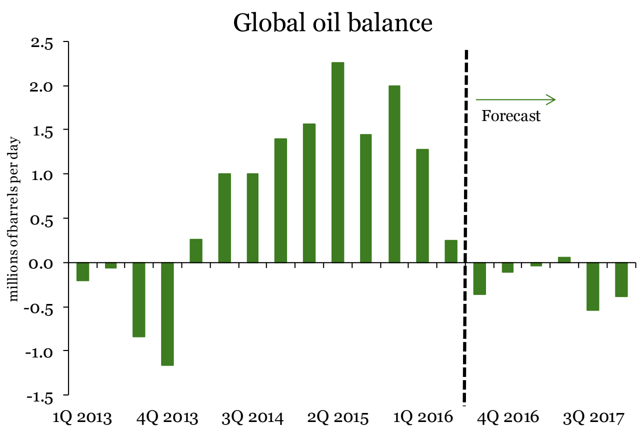
Oil and gas industry has announced US$1trn of capex and exploration cuts, which will bite into supply, with a lag.

Without new capex investment, OPEC will struggle to raise production substantially.

Falling costs have brought breakevens down, but to ensure future production, prices are unlikely to fall sustainably below US$40/bbl.

Crude oil has had a volatile quarter. When oil prices reached over US$52/bbl in July, US oil rigs started to switch back on and inventory of refined products remained elevated, acting as a drag on price. At the same time, OPEC continued to increase production and unplanned outages reduced. Oil fell below US$40/bbl at the beginning of August under these strains, only to recover to US$50/bbl within three weeks. We believe this range-trading will define oil markets over the coming quarters, until the substantial cuts in capex bite into supply.

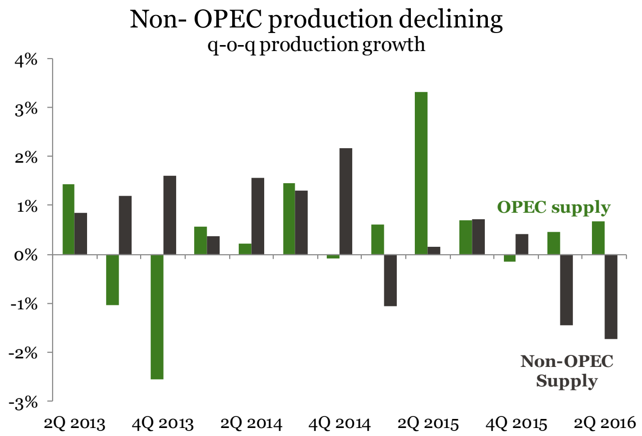
After two and half years of supply surplus, in Q3 2016, we entered a supply deficit. We are likely to remain in a modest deficit for most of the coming year. That will help eat into the high levels of crude inventory, but a more substantial cutback in supply will be needed to sustainably break-through US55/bbl.



Source: IEA, ETF Securities, August 2016

Non-OPEC cuts back

As a result of the collapse in oil prices in November 2014, the oil and gas industry has announced close to US$740bn of capex cuts between 2015 and 2020, according to Wood Mackenzie's field analysis. When including the cuts to conventional exploration investment, the figure increases to over US$1trn. The US will see the quickest and deepest cuts (of US$125bn between 2016-17 and a further US$200bn until 2020). The 80% decline in US rig counts has driven the largest portion of the non-OPEC production decline so far. The tight oil industry which dominates the US is very nimble and production can respond to price changes quicker than conventional oil. Conventional oil supply takes time to respond to price changes. For example, in the North Sea, where investment has been cut by 36% since 2014 (US$27.5bn), Jan to May production in 2016 has outpaced production over the same period in 2015 and 2014. But 140 fields are expected to close in the UK over the next 5 years (50 just in 2016 alone) and production for the remainder of the year is expected to be below that of 2015.



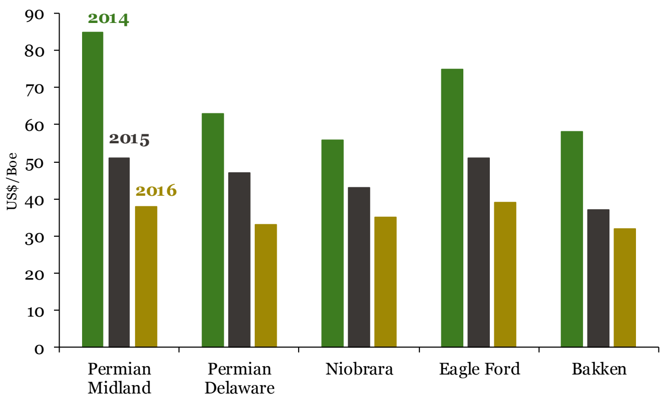
Source: IEA, ETF Securities, August 2016

OPEC production trending lower

Although the number of trackable outages has fallen in OPEC in recent months, production in the block outside of Iran has failed to reach the highs reached in October 2015. While Iranian production is nearing its pre-sanction levels of 3.7mb/d very quickly, we doubt that it can substantially raise production further without a large injection of foreign investment. The country is hoping to attract US$70bn of investment under a new Iran Petroleum Contract (IPC). This plan is a modification of the previous buy-back plan that was unpopular with foreign investors due to its tight returns, rigidity and limited time span.

While the new plan alleviates some concerns with the previous programme, companies would be bound to the contract even if the UN restores sanctions, and hence we believe it will be difficult for Iran to attract sufficient funds. Interest in the new contract has been underwhelming and hampered by the fact the full details have not yet been disclosed.

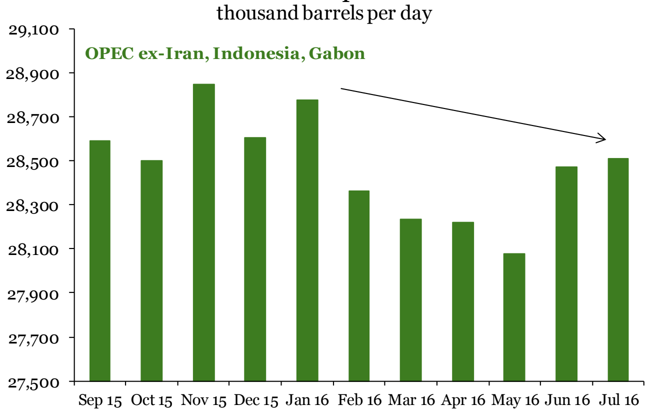
US wellhead breakeven by play and spud year



Source: Rystad, ETF Securities, July 2016

The increase in Saudi Arabian oil production in the last two months has been to cater for its own seasonal increase in consumption. In fact, Saudi Arabia has drawn down on stocks at a rate of 285kb/d during January-April compared to an average of 40kb/d during the same period in 2015, highlighting it is not ramping up production as fast as it is selling it.

OPEC ex-Iran production
thousand barrels per day



Source: OPEC, ETF Securities, August 2016

The market has been encouraged by recent discussions about market stabilization by Russia and Saudi Arabia ahead of an informal OPEC meeting expected in late September. However, the lack of success with such discussions in the past lead us to expect that OPEC supply will continue to modestly increase. We expect a global supply deficit despite this modest increase in OPEC supply.

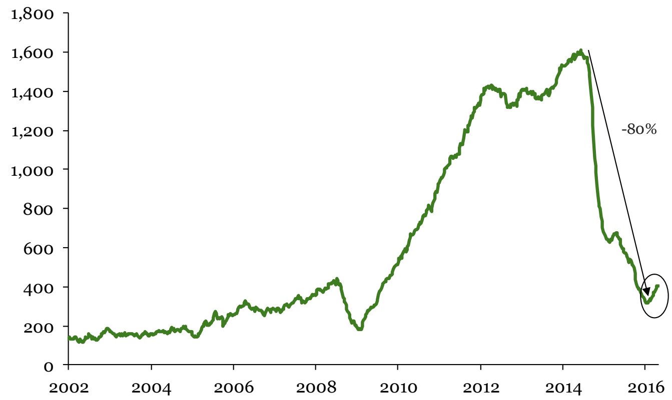
Meanwhile Venezuela, which has been struggling with an economic and political crisis, has seen its supply decline by 170kb/d as electricity shortages disrupted production. According to the IEA a year-on-year drop of 200kb/d looks unavoidable as foreign oil service companies reduce their activity and international oil companies face repayment issues.

Floor at US$40, cap at US$55

In this era of low prices, oil companies have been slashing their costs to remain profitable. Breakeven oil prices have thus tumbled. For example, US tight oil breakevens have fallen from over US$80/bbl in 2014 to under US$40/bbl in 2016.

In Saudi Arabia, the fiscal breakeven (the price of oil for the government to balance its spending and tax revenue), has fallen from US$105.7/bbl in 2014 to US$66.7/bbl in 2016 according to the IMF.

US oil rig counts

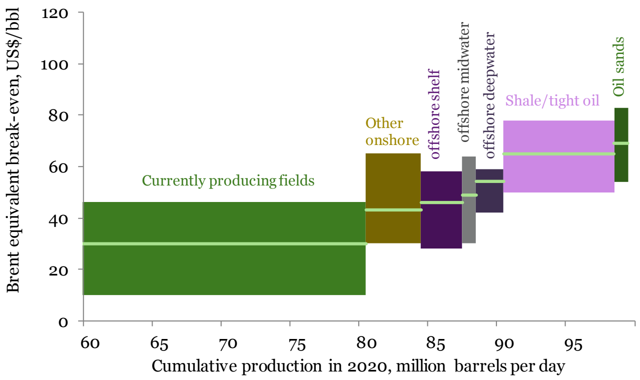


Source: Bloomberg, ETF Securities as of close 09 September 2016

As oil can be profitably produced at lower prices, we believe that US$55/bbl represents a short-term cap as we expect production in the nimble US market to increase. In fact, over the past 8 weeks, rig counts in the US have been rising, indicating that tight oil produced from those rigs are likely to be profitable at today's price.

However, to ensure future production of oil meets global demand, we don't think that prices can fall that much lower than US$40/bbl. For example, the breakeven for most new onshore oil is $43/bbl and for new tight oil is US$65/bbl.

Global liquids cost curve



Source: Rystad Energy research, March 2016