commodity focus

St.Galler Kantonalbank

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Fragile oil price recovery

Oil's plunge below USD 30 per barrel this February marked a multi-year low. The oil market has since trended higher. There are some clear parallels with last year, when tentative moves toward a sustained recovery failed.

This spring's price recovery was initially driven by sentiment and momentum, but recently oil prices have benefited from two factors on the supply side. Firstly, there were some unscheduled production outages, while secondly the continuing decline in US oil production is also contributing to the positive price trend.

Focus on supply disruptions

Global supply disruptions, which EIA estimates show have reached their highest level since January 2011 (start of data collection), are currently a dominant theme on the crude oil markets. There are supply outages – such as when the forest fires in Alberta impacted on Canadian oil output from shale sand areas. OPEC countries such as Nigeria and Libya, which have seen their output fall due to continuing attacks on their oil infrastructure, have also contributed to the unplanned production losses.

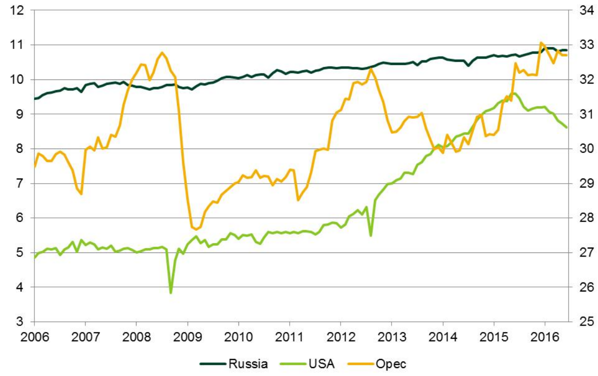
OPEC: maintaining the status quo

Despite these disruptions, there is no supply shortage in the oil market. One reason for this is that a major producer in the form of Iran has been been able and willing to step into the breach, while Saudi and Iraqi output is also running at high levels. As a result, June's bi-annual OPEC meeting produced few surprises. The oil price trend will have eased some of the pressure on the oil ministers, particularly as the price of crude oil has advanced from less than USD 30 per barrel to USD 50 since the beginning of the year. The expansionary production strategy is being maintained. A joint production ceiling therefore does not so far appear to be on the agenda among the 13 countries.

US shale oil: flash in the pan or comeback?

The development of non-OPEC oil production is therefore playing an important part in evening out the oversupply. Attention is particularly focusing on US oil production which has expanded greatly over the years. The Baker Hughes rig count reports are a widely heeded source of information future US oil production trends. These weekly figures on the number of rigs currently producing oil in the USA had already dipped sharply. Since peaking in autumn 2014, the rig count has fallen by 80%. June's nationwide total of 316 active oil rigs is the lowest figure since 2009 and is now making itself felt in US production statistics. However, for the first time this year recent weeks have seen some shale oil producers return to the market following the latest price rally, although it would be premature to speak of a turnaround. This raises the question of what price level would persuade more producers to return. As the oil companies are dependent on borrowed capital, the future financing environment will be a crucial criterion as well as the trend of oil prices.

Declining oil production in the USA



Source: Bloomberg

Return to equilibrium

Although we expect oil prices to rise in the medium term, «black gold» remains vulnerable to price setbacks after the sharp recovery, particularly if the extraordinary production losses normalize again. So in addition to the present more upbeat mood on the oil market there is an urgent need for further improvements in the fundamentals, especially as daily production quantities currently still exceed demand. The glut of stockpiled oil also stands in the way of any significant increase in prices. This adjustment on the oil market takes time, limiting the upside potential.

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