Energy Strategy

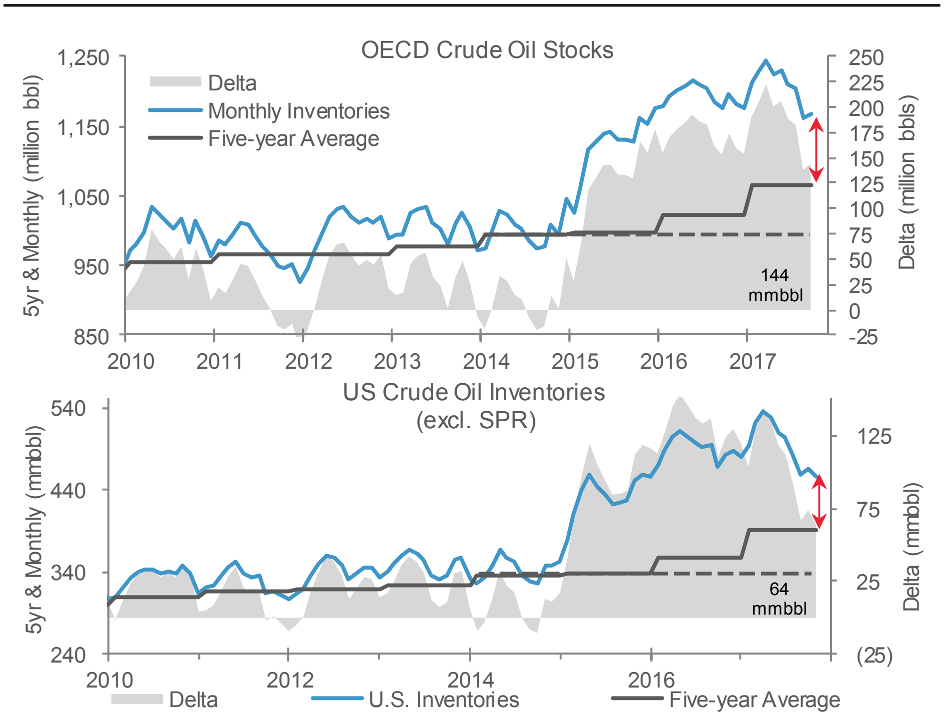
OPEC+ Extends Through 2018 | Now What?

OUR TAKE: The OPEC/non-OPEC group, formally known as the Declaration of Cooperation ("OPEC+" for short), agreed to extend supply caps through the end of 2018. Consequently, the outcome from the 173rd OPEC meeting in Vienna was in line with the market's and our expectations, thus leaving Brent prices largely flat on the day. But what does this mean for crude oil futures prices going forward?

While there are a handful of factors affecting crude oil markets that are outside the purview of this event, we think crude oil futures will gradually rise over the course of 2018, with a small hiccup earlier in the year. While both Brent and WTI are expected to pull-back modestly in the next few months, it's possible Brent may test $70 bbl by this time next year. This sentiment comes with a number of caveats that even Saudi Arabia's Khalid Al-Falih alludes to multiple times during the public address. We breakdown these most important points to consider from today's event.

- **The crude oil stock overhang appears to be falling like a rock.** According to OPEC, *the OECD stock overhang was 280 million barrels above the moving five-year average* [in May]*, but it has since fallen by almost 50 percent to 140 million barrels for the month of October.* If we were to take Al-Falih's words for granted, this means that the global supply-demand oil market was undersupplied by a little over ~900 kbbld from June through October. Indeed U.S. stockpile overhang nearly halved during this time frame as well, falling over 55 mmbbl. Does this mean there's only another five, maybe six months left? Not quite…

Exhibit 1: Halfway There? Five-Year Averages Continually Revised Higher



Source: IEA; Scotiabank GBM

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ENERGY STRATEGY

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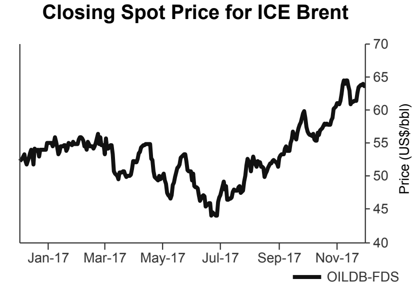
MARKET DATA

Spot ICE Brent (US$/bbl)	$63.57

FORECAST DATA

	2016A	2017E	2018E
ICE Brent (US$/bbl)			
Current	45.13	53.14	56.00
NYMEX WTI (US$bbl)			
Current	43.47	49.79	52.00
WCC Heavy Oil (C$/bbl)			
Current	39.09	48.13	41.94

Closing Spot Price for ICE Brent

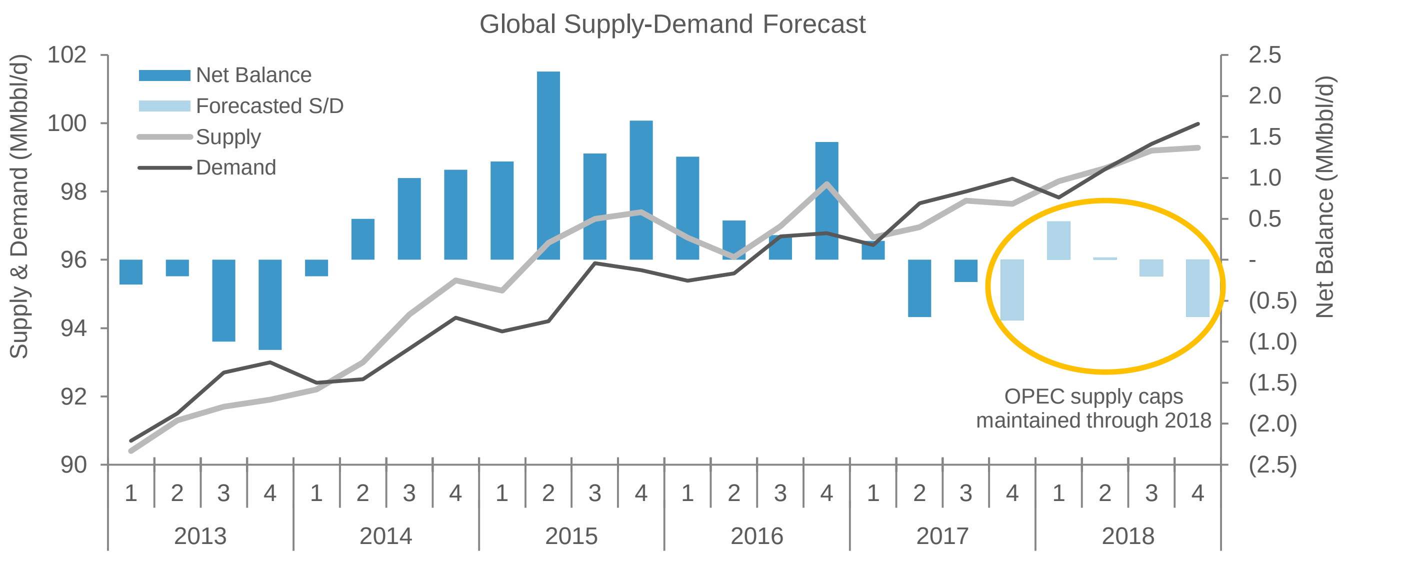


Source: FactSet.

Importantly, the five-year average has increased nearly as much as inventories have fallen more recently. By our calculations, the trending five-year average benchmark has been upward revised by 72.7 mmbbl with the U.S. equivalent contributing 55.1 mmbbl of that figure since the commodity market rout began in 2014. Progress has been made on inventories; consequently, we'll give the OPEC+ group gratitude, however, it's been far less than advertised. We still have an enormous overhang to deal with going forward, in our view.

- **Demand is cooling off due to normal seasonality.** The first quarter of each year historically exhibits weaker demand; in fact, Al-Falih explicitly stated this trend during the Q&A. While the pace of growth recently has been very strong, 2018 is no exception to weather and seasonal woes. We expected global supply-demand balances to slip into oversupplied early into Q1/18, which may **soften crude markets on a *temporary* basis** (Exhibit 2). Likewise, we may actually witness builds in global stockpiles, which we fear the market may not interpret favourably. If OPEC manages to maintain supply caps through 2018, balances are likely to shift once again back into undersupplied at some point in Q2/18, drawing down on inventories and lifting market pricing, in our view. We believe this is part-and-parcel to the OPEC+ strategy and rationale for extending cuts through 2018. They likely recognize a few Headwinds on the Horizon and will wait for the storm to calm before releasing the spinnaker (i.e., supply-caps in this analogy).

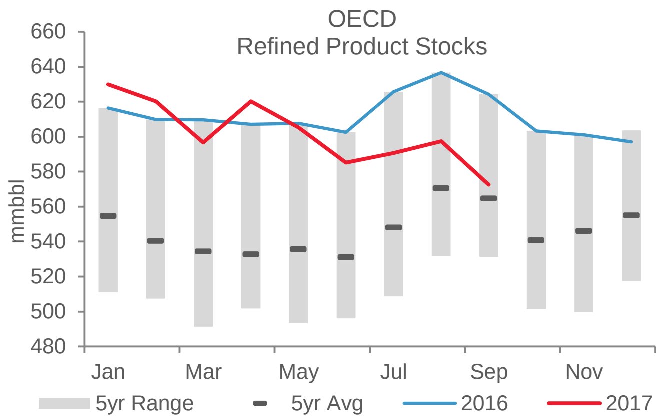
Exhibit 2: Look Past the Temporary Hiccup in Global Balances

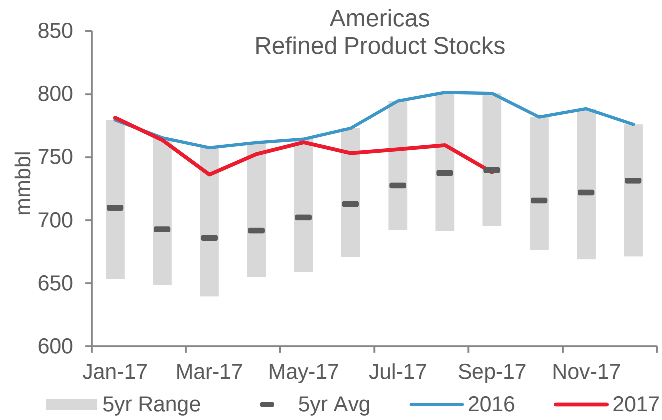


Note: comprises crude oil, condensates, NGLs, and other sources.
Source: IEA; DOE EIA; JODI; OPEC; Scotiabank GBM estimates.

- **Products inventories are now through five-year averages, but crude oil stock draws might have been even greater if it were not for Harvey & Nate** (Exhibit 3). Al-Falih was quick to point out that *crude in floating storage is also down by an estimated 50 million barrels since June, and the drawdown applies broadly to all regions, including both crude and products. In fact, products are already at their five-year average.* We would concur with this sentiment, but with a small caveat. Hurricanes Harvey and Nate knocked over 3.6 million barrels per day of crude oil demand offline as refineries grappled with pending storms. The lack of refined products production during this period took a sizable chunk out of refined product inventories, albeit while building crude oil stocks at the same time. Nonetheless, demand is (at present) robust to say the least. We're simply concerned about this refined products-led market when it cools off temporarily next quarter. **It's possible the market looks through this seasonal blimp; we can't fault anyone for taking this stance, in fact, <u>we might even encourage it</u>.**

Exhibit 3: Refined Products Nearing Five-Year Averages, but Partially Due to Hurricanes Harvey/Nate





Note: comprises crude oil, condensates, NGLs, and other sources.
Source: IEA; Scotiabank GBM.

- **When the market rebalances, OPEC will start to discuss an exit strategy; we anticipate this may pop up at the next official meeting in late June.** *It's too early to talk about exit strategies*, both Novak and Al-Falih noted at the conference Thursday. The OPEC+ group is expected to review the current status of global inventories and deliberate on strategy every three months going forward. However, given the timing to season demand weakness in Q1/18, it's unlikely the group will decide supply caps are unnecessary at that point in time. Demand is expected to pick up and should be skipping along above 2017 levels, just in time for the June 22, 2018, meeting, which is scheduled approximately a month later than the usual late-May meeting, by coincidence we presume. The big question is whether or not we will care whether OPEC+ supply caps are in place by this point in the cycle. There are a number of geopolitical risks to supply that may creep into the picture, as we've observed throughout 2H/17, cutting available supply, and requiring OPEC actually dipping into spare capacity to produce more. Like many blackswan events, forecasting geopolitical flare-ups is near *improbable*, but we would note that global supply-risk premiums appear to be on the rise (WTI-Brent Gap Widens on Middle East/African Geopolitics & U.S. Pipeline Dynamics).
- From memory, the market has witnessed at least a half-dozen significant geopolitical events occurring in and around major oil-producing regions that could eventually affect the security of supply:
    - Nigeria's Delta Avengers threatened to end the ceasefire that has held since August 2016. Recall, the NDA was responsible for disrupting nearly 500 kbbld, a quarter of Nigeria's oil production, in early 2016 over disputed resource payments.
    - The Kurdistan independence referendum reportedly saw a voter turnout of roughly 72% of the 8.4 million Iraqi Kurdish population, which voted overwhelmingly in favour of secession from Iraq. The event spurred threats and even military manoeuvers from Turkish, Iraqi, and Iranian officials, leading to the KRG's leader, President Massoud Barzani, stepping down from power.
    - Saudi Arabia, UAE, and Bahrain sever diplomatic ties and blockade Qatar over claims of terrorist financing and cooperation with neighbouring Iran.
    - Nearly a dozen Saudi princes were arrested, including Prince Alwaleed, with a handful of government ministers and dozens of prominent businessmen and officials. While the move was publicized as part of an anti-corruption probe orchestrated by the Saudi Crown Prince, Mohammad Bin Salman, some view the shake-up as a consolidation of power for the rising prince.

- Yemeni Houthis ballistic missiles were fired, and intercepted, near Riyadh, the Saudi Arabian capital. Col. Turki Al-Maliki has made claims that Riyadh has *evidence to prove the full complicity of the Tehran regime in the Yemen conflict*.
- Prime Minister Saad Hariri of Lebanon resigns while visiting Riyadh due to concerns for his life/assassination, leading to another power vacuum in Lebanon.

Bottom line: Geopolitical supply risk is on the rise and made relevant due to global supply-deficits resulting from voluntary and involuntary OPEC+ supply caps. Global balances are forecasted to tip into oversupplied early into 2018; while futures pricing may soften (modestly) we would suggest looking past near-term bearish fundamentals as the medium and longer-term appears much more constructive.

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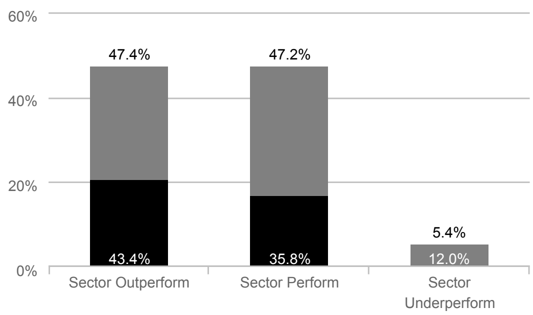

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