The oil price roller coaster: up, down and what next?

- **The oil price seems to have boarded a roller coaster, and this makes it very difficult to predict its future trend. In the early stages of the year, oil production limits implemented by the OPEC countries and the recovery in investor sentiment kept the oil price afloat.**
- **However, the surge in uncertainty brought about by trade tensions, among other factors, led to new episodes of volatility and notable reductions in the oil price.**
- **Over the coming quarters, the stabilisation of global growth together with the restrictive policies of the OPEC countries should keep the Brent oil price in line with current levels. Nevertheless, in the medium term, growth in the supply of shale oil is expected to drive the price somewhat lower.**

At the start of 2019, the oil price was recovering from several months of turbulence. In mid-December 2018, it had fallen by more than 33% relative to the 85-dollar high point reached in September. This decline was the result of a combination of risk aversion in the financial markets and doubts over global economic growth, which led to fears of a potential oversupply of oil (a fear that also contributed to the US' decision to grant exemptions to the sanctions on Iranian crude oil). In this context, the OPEC announced in December new cuts to oil production.

OPEC and the end of the financial turbulence supported the oil price at the beginning of 2019

The oil price experienced a significant recovery during the early stages of 2019. Between January and the end of April it surged by 30%, reaching 75 dollars. This was driven by both supply factors and, above all, demand factors (see first chart).

With regard to demand, the rise in price was supported by:

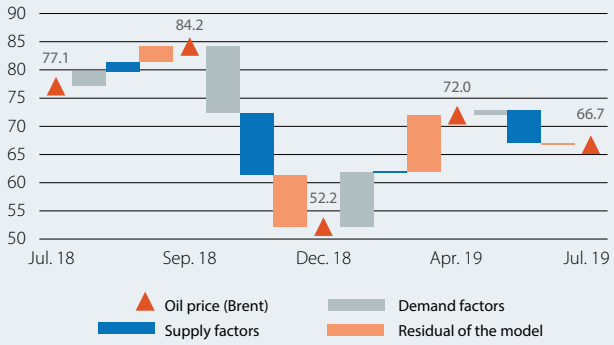
- ***A positive tone in the financial markets.*** At the beginning of the year, the outlook regarding the trade tensions between the US and China became more favourable, leading to improved expectations for global economic activity. This improvement was accompanied by relative calm in financial markets, which performed encouragingly across the board.

On the supply side, the factors that favoured the price rise were as follows:

- ***The oil production cuts agreed by OPEC and their partners*** on 6 December 2018 reduced global inventories, which allowed supply factors to drive the price down. Specifically, OPEC and its partners announced a production cut during the first half of 2019 of 1.2 million barrels per day (bpd) compared to the levels of October 2018.[1] Furthermore, as shown in the second chart, production has been cut by even more than the amount agreed, which has contributed to a significant reduction in the global supply of oil.[2]
- ***Production stoppages in Iran and Venezuela.*** In April, the US announced the end of exemptions benefiting

Contribution of supply and demand factors to the change in oil price *

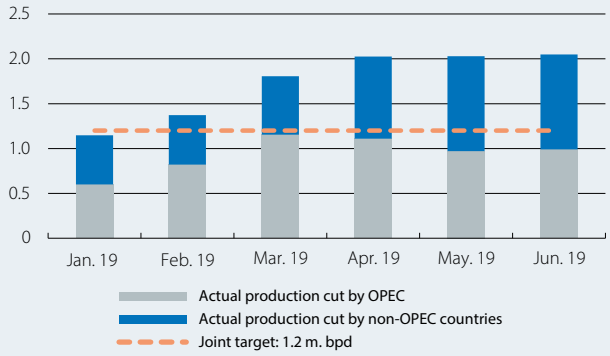
Dollars per barrel



Note: ** Contributions of supply factors, demand factors and residual according to the model by the Federal Reserve Bank of New York.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of New York and Bloomberg.*

Oil production cut agreement: degree of compliance

Million barrels per day (m. bpd)



Note: *OPEC's target stands at 0.8 m. bps, while that of the partners not belonging to the group amounts to 0.4 m. bpd.*
Source: *CaixaBank Research, based on data from Bloomberg.*

1. OPEC agreed to cut production by 0.8 million bpd, and non-members, led by Russia, by 0.4 million bpd.

2. Of particular note is Saudi Arabia, which on average has a monthly compliance rate of around 240%.

some importers of Iranian crude oil, which entailed a 68% reduction in its exports from that month onwards. On the other hand, Venezuelan production, affected by US sanctions and political instability in the country, has fallen to levels not seen since 2003.

Uncertainty and volatility, protagonists of Q2 2019

As can be seen in the first chart, in April, after exceeding 70 dollars, the price fell to the 60-65-dollar range. This price moderation can be explained by various factors:

- ***The resurgence of trade tensions between China and the US***, which damaged economic sentiment and increased uncertainty over the outlook for global economic growth. In this context, both major financial institutions and OPEC revised their forecasts for global demand in 2019 downwards.
- ***The increase in US oil inventories***, which occurred at a time of year when they normally decline,[3] indicated a greater weakness in demand and drove the price down.
- ***The intensification of geopolitical tensions.*** The closing stages of the second quarter of the year saw a rise in tensions in the Middle East due, among other factors, to the attacks on oil tankers in the Strait of Hormuz (a strategic area through which 20% of the world's oil passes). This increased concerns of possible interruptions in the supply of oil, which partially offset the downward pressure on price.

OPEC and the stabilisation of demand will sustain the price during the closing months of the year

In the remainder of the year, the oil price will be supported by:

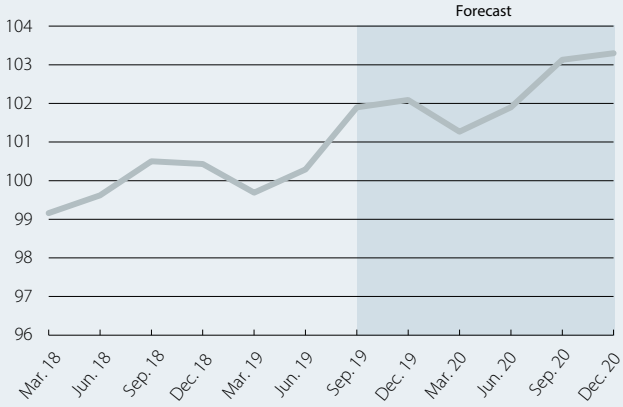
- ***The stabilisation of global demand.*** The main institutions forecast a stabilisation in oil consumption in the second half of the year (see third chart). Nevertheless, the risks remain biased to the downside in relation to global economic activity.
- ***The extension of the OPEC production cut agreement.*** On 1 and 2 July, OPEC and its partners decided to maintain the agreement on production cuts until March 2020. In doing so, they will continue to support the moderation of global supply in order to shore up the price.
- ***The persistence of geopolitical tensions.*** The recent rise in tensions in the Persian Gulf and concerns over disruptions to supply will continue to support the price.

However, the supply of shale oil in the US is expected to continue to grow as the bottlenecks that have affected production are removed. In fact, shale production is

3. US inventories of crude oil increased by 8.4% between January and May.

Expectations of oil consumption

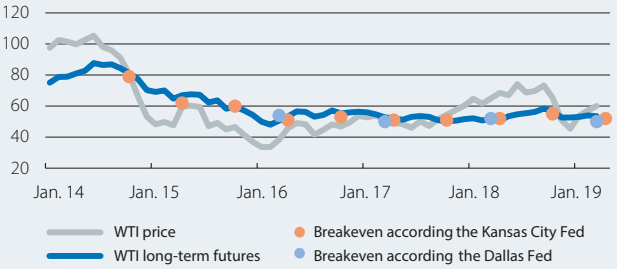
Million barrels per day



Source: *CaixaBank Research, based on data from the US Energy Information Administration (EIA).*

Breakeven price for US oil companies * and price of WTI futures *

Dollars per barrel



Note: ** The Federal Reserve Banks of Dallas and Kansas City conduct a quarterly survey that gathers the perspectives of oil producers and of executives in the oil extraction sector. Respondents point out the main trends in the marginal cost of supply in the oil market and indicate what their breakeven price is. ** The price of West Texas Intermediate (WTI) long-term* futures is based on a 60-month contract. All prices are month-end.
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of Dallas.*

playing an important role in anchoring oil prices over the medium term:[4]

- In the last chart we can see how the oil price that is expected in the long term is highly anchored to the breakeven price[5] of US oil companies. Furthermore, this threshold, which had steadily declined as shale gained prominence, has once again declined in 2019, suggesting that oil prices will remain within a limited range in the future.

Therefore, in the medium term, shale production should prevent the price from rising above 70 dollars in the absence of supply shocks.

Hanna Andersson

4. M. Plante and K. Patel (2019). «Breakeven Oil Prices Underscore Shale's Impact on the Market». Federal Reserve Bank of Dallas.
5. The price that oil companies require in order to drill new wells and turn a profit.