Oil, a tense market under strain

The conflict between Israel and Hamas that broke out in early October is first and foremost a humanitarian tragedy. Although it is still very difficult to quantify the impact of the escalation on the world economy, what is clear is that one of the main focuses of attention falls on the oil market, given the location of the conflict and the risk of it spreading to involve more countries in the Middle East. So far, the financial markets have reacted relatively cautiously, although volatility has increased. In the crude oil market, there has been some upward pressure on prices. However, in order to better understand the outlook for this market, we must first take a step back, given that some of the stress in oil prices has been apparent since the summer.

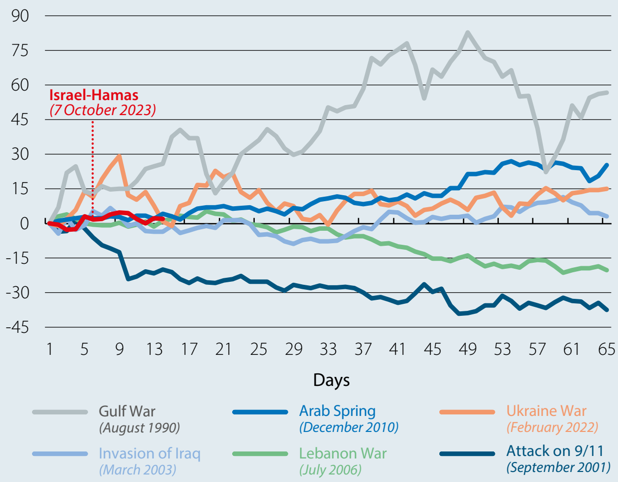
Mismatches between supply and demand

Global crude oil markets began to tighten notably in mid-July, as the balance between supply and demand began to show signs of instability. The nervousness increased after Saudi Arabia[1] made the surprise announcement in early September that it would extend its voluntary production cuts – in addition to the OPEC agreements – of 1 million barrels a day (b/d) until the end of the year. With this measure, its production would remain around 9 million b/d through to the end of 2023, the lowest level in several years. In parallel, Russia,[2] an OPEC ally, also extended the reduction of its exports by 300,000 b/d. Both of these measures were in addition to the production cuts that OPEC and its allies had already established and which in June were extended until the end of 2024. Moreover, they came at a time when crude and distillate inventories in the US (the world's leading producer) were at exceptionally low levels,[3] as well as when global oil demand was on track to reach record levels,[4] despite the doubts surrounding China's economic growth.[5]

1. Saudi Arabia is the leading producer country in OPEC, accounting for an estimated 32.2% of the organisation's total current production. Globally, it is the second largest producer behind the US, and in 2022 its production amounted to 12.1 million b/d.
2. Russia is the third largest oil producer in the world (11.2 million b/d in 2022). It is estimated that the joint market share of Saudi Arabia and Russia exceeds 40% of the total production of OPEC and its allies.
3. Although its production amounted to 17.7 million b/d in 2022, the US is a net importer of crude oil because its refineries are not set up to process the new forms of oil that the country produces, which are lighter and contain lower levels of sulphur (shale).
4. OPEC and the IEA estimate that in 2023 global oil demand will be around 102 million b/d, driven largely by demand from non-OECD countries (mainly China and India) and the consumption of aviation fuel (kerosene).
5. Despite the slowing pace of growth in its economy, China's imports of oil, including refined products, have risen by 19% year-on-year between January and September, driven by increased passenger traffic, industry and household consumption.

Impact of geopolitical events on the price of oil

Change (%)



Note: *Data as of 25 October 2023.*
Source: *CaixaBank Research, based on data from Bloomberg.*

The sum of these circumstances applied upward pressure on the Brent barrel price between July and September, pushing it up to 96 dollars. This was more than a 20% increase and placed the price at its highest level since November 2022. Furthermore, this rally was accompanied by an upward shift across the entire oil futures price curve. However, at the beginning of Q4 2023, the «higher for longer» rhetoric of the major central banks cooled some of the buying euphoria and prices eased by around 10 dollars a barrel.

A risk barely anticipated

In the first 20 days of the conflict between Israel and Hamas, the oil price has risen by around 7%, driven up by risk premiums linked to the uncertainty triggered by the war, placing it at around 90 dollars a barrel. However, in comparison to previous episodes of geopolitical tensions directly involving Middle Eastern countries, the initial reaction of the oil price was rather «contained». In part, this «containment» reflects the fact that, since the 1973 crisis, the share of production by countries such as the US and Russia has increased to the detriment of OPEC countries, as well as reflecting the improvements in recent years in the trade and diplomatic relations that many Gulf countries maintain with Israel.[6]

6. In 2020, the United Arab Emirates, Bahrain, Sudan and Morocco, together with Israel, signed the Abraham Agreements, normalising their diplomatic and trade relations. In the weeks leading up to the war, Saudi Arabia was also close to formalising its trade relations with Israel.

However, the current situation has highlighted a geopolitical risk that has barely been taken into account in recent years. Neither Israel nor Palestine are major oil producers, but Iran's links to Hamas[7] highlights the significant risks posed to the energy scenario in the event of an escalation of the conflict involving more countries. One of the scenarios that arouses the greatest concern among investors and analysts is Iran becoming involved in the conflict, as its geographical location means that it dominates the Strait of Hormuz, through which between 30% and 40% of the all the world's oil that is exported by sea passes (between 15% and 20% of global production), as does around 20%-25% of the global maritime trade in liquefied natural gas.

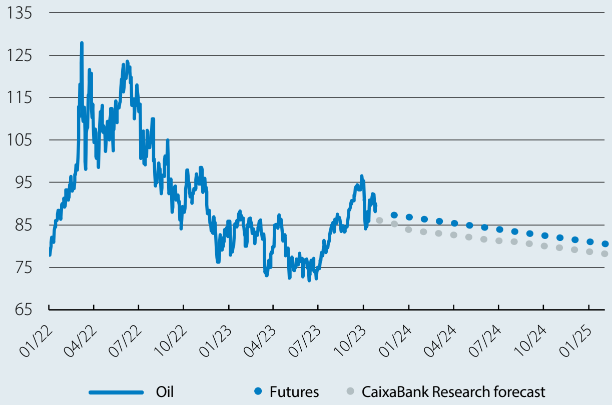
Oil prices will remain «higher for longer»

In addition to the ongoing diplomatic efforts by countries and international organisations to resolve the conflict, the main players in the oil market are trying to implement measures to cushion the potential effects that an escalation of the war could have on oil prices. The US has temporarily lifted its oil sanctions on Venezuela,[8] for at least six months. The US Department of Energy has also announced that, in order to increase the country's strategic reserves, it plans to purchase 6 million barrels at 79 dollars a barrel. On the other hand, Saudi Arabia has said that it has no plans to extend its production cuts and that it has enough idle capacity to relaunch supply. However, at the time of writing, investors did not seem to consider the measures announced to be sufficient and the risk premiums applied to prices remained high.

In short, looking ahead to next year, all the indicators suggest that crude oil barrel prices will remain high. The pressure on global oil inventories, which was already palpable before the war, is likely to persist until at least early 2024, when producing countries could recover their extraction quotas. However, it should also be borne in mind that demand from China will continue to support the growth of global demand.[9] Thus, the futures markets indicate prices just over 80 dollars for 2024 as a whole. Nevertheless, these figures are highly sensitive to developments in the war in the Middle East, and if the conflict were prolonged or were to spread to more countries, it would intensify the pressures on supply and the risk premiums on the price of oil futures.

Beatriz Villafranca

Brent oil price
(Dollars/barrel)



Note: *Data as of 25 October 2023.*
Source: *CaixaBank Research, based on data from Bloomberg.*

7. Iran is the eighth largest oil producer in the world and accounts for 11% of all OPEC production. In 2023 its production has increased significantly (+20% up to September) as a result of a slight easing of the sanctions which the US imposed on Iran in 2016.
8. Some of the sanctions imposed in 2017 will be lifted in exchange for compliance with certain constitutional guarantees ahead of Venezuela's 2024 elections. The consensus of analysts estimates that, in the short term, Venezuela's production would only reach 200,000 b/d, given the lack of investment and the obsolescence of its industry.
9. The IEA estimates that the growth in global oil demand in 2024 will be almost 102 million b/d, of which 77% is expected to correspond to China.