Crude Oil Prices- Volatility surging again?

Three years of drastic cuts to upstream spending because of the meltdown in oil prices could result in a shortage of oil supply in a few years, according to a new report from the International Energy Agency. When oil prices collapsed in 2014, oil producers quickly took an ax to their spending. Global oil and gas investment dropped by a quarter in 2015 and by an additional 26% last year, the IEA estimates. Long lists of projects, particularly very large ones, were put on ice. Because many of these projects take years to develop, the sharp slowdown between 2014 and 2016 could result in very few sources of new supply hitting the market towards the end of the decade.

The post-OPEC agreement honeymoon period for oil seems to be over as the price of crude futures retreats below $50. Last week was one of the worst weeks for oil since November with a 9.1% decline with crude settling at $48.49.

The main trigger for the sharp decline last week was the US crude oil inventories report released by the energy department. Crude oil stocks in the US, the world's top oil consumer, has surged to 528.4 million barrels, an all-time high and up 8.2 million barrels in a week, well above forecasts of a two million-barrel build, according to Bloomberg. Preceding the data release, the net-long speculative positions in oil were also at their peaks. As traders got surprised by the data, a major sell-off was initiated.

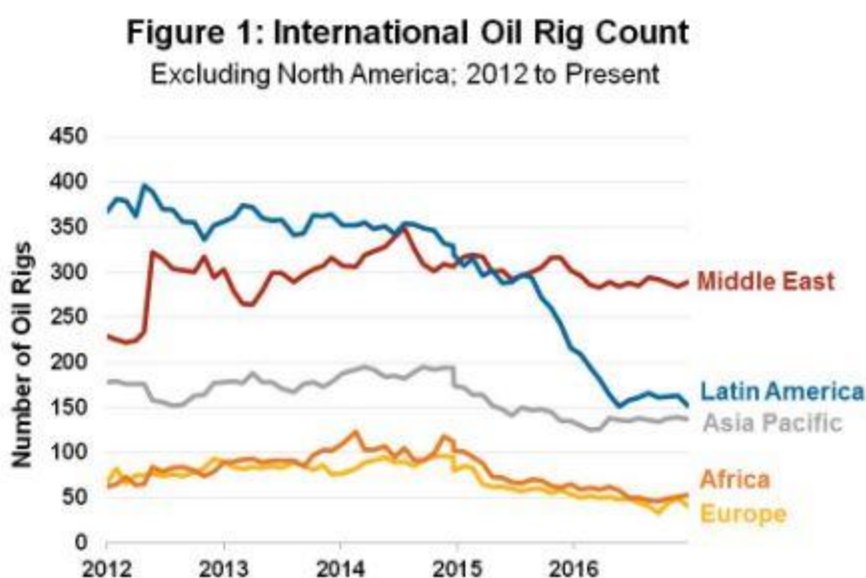
The inventory build-up in the US which has now risen to historic levels is a major concern for OPEC and negates the argument of shale being not profitable at lower levels. With advancement in technology and focus on efficiency, the shale producers have now taken their break-even prices much lower to what was anticipated by the cartel. For example, breakeven oil price for Bakken shale in US was $98 in 2013 and currently it is $39. That is a decline of more than 50% and the same pattern can be seen with other major shale plays.

On the other hand, OPEC has lost its teeth with only Saudi Arabia fully adhering to the output cuts and even covering for other members. Currently OPEC has been able to achieve 70% of its 1.2 million barrels a day output-cut target agreed by the members at the end of last year. This percentage would have been severely low had the Saudis not gone 57% above their pledged cuts.

With Iran, Iraq and Libya stepping up production which was agreed previously, the case for higher oil prices looks bleak and retest of $40-45 cannot be ruled out.

Rigs in the Asia-Pacific region have stopped falling at the 135 mark too, down from 195. Not very exciting and hard to make a case that current oil prices are enough to open corporate wallets, even after all the hoopla about declining service costs. Ditto for European and African drilling; both regional oil-targeted rig counts are holding in the 40 to 50 range with no upward inclination in the absence of higher prices per barrel.

Most interesting is the Middle East region. Drilling was active in the deserts through to the end of 2015, which contributed to the mother of all price wars in early 2016. Over the past 12 months a gentle decline in activity is noticeable, off an average 15 rigs down to the 290 mark. Capital is being husbanded in these countries, recognizing that $50 a barrel doesn't kick off enough cash flow to warrant incremental re-investment. Stated more bluntly, state-owned oil companies don't have a lot of extra money for drilling after the necessity of paying cash dividends to their states.



The 12-member cartel's activity is down nearly 20% from 2014 levels and holding for the moment around 300. Non-OPEC activity (excluding U.S. and Canada) is still falling but not as steeply as last year.

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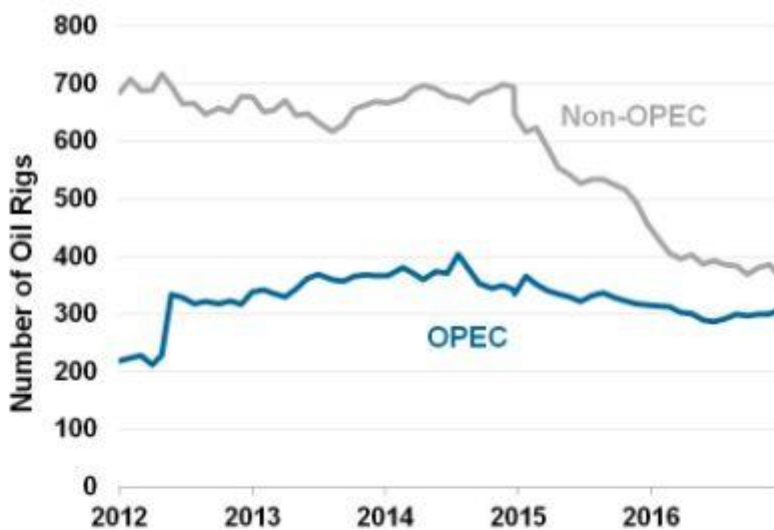

On the local bourse here at the Pakistan Stock Exchange, oil stocks also took a hit as crude breached $50. Stocks like OGDC, PPL, POL, MARI and PSO saw extensive selling during the week. With the benchmark PSX-100 index being heavily loaded towards oil, these stocks were also the major index laggards of the week.

However, low oil prices will come as another timely relief for the government. The external account has been under pressure lately with exports falling and imports increasing. Ideally, the government should hold onto the current domestic petrol and diesel prices but in the midst of a heated political situation, a cut in petrol prices cannot be ruled out.

So, could the plunge in the price of oil last week be the start of a reversal in prices which have been on the mend since the pledged production cut in January?

While some think these could be the current support levels, others do not discount further downside, especially as traders, caught in record long positions, rush for cover.

The risk is there as we move into the second quarter. The deal to cut oil production between the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC is only for the first half; it is extendable by another six months, subject to the outcome of their meeting in May.

With assumption of an average of US$ 55 per barrel is based on a full year deal to counter rising US shale output. Oil speculators may drive prices much lower if they get stopped out of their record long positions. A stampede to cover these long positions may cause a sudden and steep drop. US light crude has dropped below US$ 50 per barrel for the first time this year.

Shale production volumes could very well recover at current price levels and put a cap on any further meaningful price runs. There are likely to be uneven price spikes during the year that are news driven with supply conditions at fairly ample levels," said Thomas Yong, CEO of Fortress Capital.

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Oil price may hover between US$50 and US$60 per barrel fundamentally and will be affected (it may possible overshoot the price range), by speculative force. It may plunge further but should not drop below US$35 per barrel. Oil price may not suffer a prolonged decline but it looks like the age of OPEC dictating price is over with the arrival of shale oil. It may be hard for oil to persistently stay above US$55 per barrel.

Prices could fall to US$40 per barrel if OPEC doesn't extend its existing agreement to cut production.

Amid lingering concerns over supply, and continued adjustments in inventory relative to demand, what could drive the current oil price volatility is the strength of global demand, as well as US dollar and interest rate outlook.

A stronger dollar rally backed by higher than expected US rate hikes would result in higher borrowing costs for traders to build speculative positions. There is a risk of demand not rising as much.

China's policy direction suggests acceptance for slower growth as authorities focus on financial stability risk which signals tighter monetary and banking policies.

From shale companies to deep water and conventional, US oil companies are working hard to drive down breakeven costs to survive the wild ride in oil prices, according to Bloomberg. In fact, the wellhead breakeven costs for US shale plays declined 46% between 2014 and 2016.

The IEA warns that unless a wave of new upstream projects are given the green light by exploration companies, OPEC's spare capacity will fall to low levels and oil prices will rise sharply. One of the more eye-opening predictions from the IEA is that oil demand will continue to rise without interruption. The agency noted that global oil demand grew by a whopping 2 mb/d in 2015 because of low prices, then by another strong 1.6 mb/d in 2016. Moving forward, demand rises steadily, year after year, by an average of 1.2 mb/d through 2022. India takes over as the largest source of demand growth, a mantle long-held by China. The problem with that figure is that demand is expected to rise by 7.2 mb/d over that same timeframe. The end result will be a strain on OPEC supplies. In light of these numbers, the IEA issued a warning, emphasizing an important message: more investment is needed in oil production capacity to avoid the risk of a sharp increase in oil prices by the early 2020s.