Energy Monitor January

Revised oil price forecast

Group Economics
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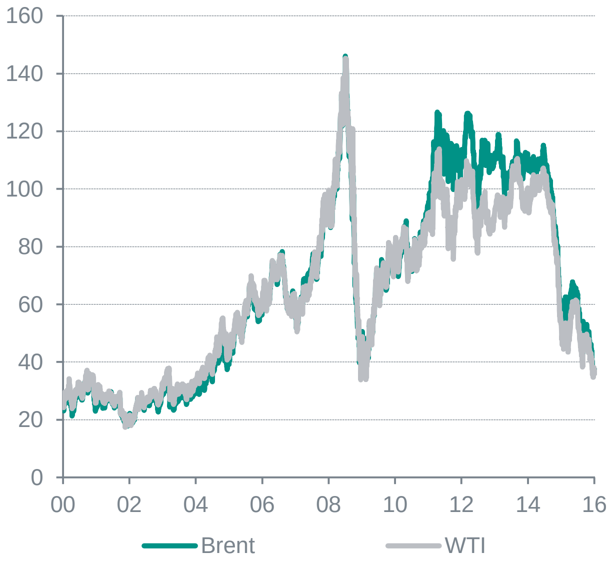
- **Oil prices continue to fall as a result of lingering oversupply, while…**
- **… geopolitical tensions and the lifting of the US crude export ban also weighed**
- **We have revised our oil price forecasts down: Brent and WTI now seen at USD 55/bbl at year-end 2016**

Figure 1: Oil prices dropped to lowest level in 11 years (in USD/barrel)



Source: Thomson Reuters

Oil price dropped to the lowest level in almost 12 years

Oil prices fell under heavy pressure again in November and December, and continued their slide into the new year. Disappointing demand, a continuous focus on the oil oversupply and the build of speculative short positions (speculation on price depreciation) kept overall sentiment towards oil prices extremely negative. Increased geopolitical tensions resulted in a short-lived recovery. However, after investors realised that the tensions between Saudi Arabia and Iran would not hurt actual oil production in both countries, but could even lead to an increased production, oil prices were pushed lower once again. As a result, Brent oil prices dropped below USD 33/bbl, the lowest level in almost 12 years (Figure 1).

Investors revised their forecasts on lower demand expectations due to disappointing industrial production data – especially in the US and China. On the other hand, global oil production increased against expectations. Production rose in Saudi Arabia, Iraq and – unexpectedly – in Russia, while US crude production stabilised after a drop in Q3 2015. Iran increased oil production to meet increased Asian demand. Also US crude inventories returned to the spotlight after these rose to new record levels. This contributed to the already very negative sentiment. Finally, the number of speculative short positions gained by 120% between mid-June and mid-December (to 270.000 contracts).

Table 1: ABN AMRO oil and gas price forecast (oil prices in USD/barrel, HH in USD/mmBtu, TTF in EUR/MWh)

Price	Q1 2016	Q2 2016	Q3 2016	2016*	2017*
Brent	40	45	50	50	60
WTI	40	45	50	50	60
HH **	2.50	2.75	3.00	2.75	3.25
TTF ***	17	18	16	16	15

Source: ABN AMRO Group Economics

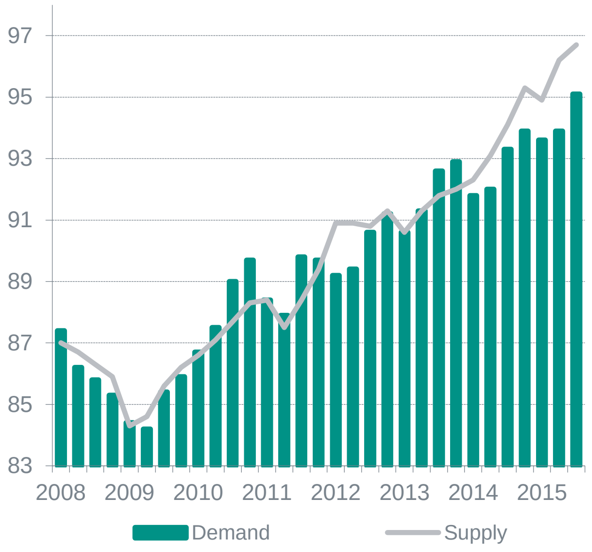
* year average ** Henry Hub *** Title Transfer Facility

Downward revision oil pries

We have lowered our oil price projections (see Table 1). Oil prices will remain lower for longer. We still expect a moderate appreciation in the course of 2016. This recovery is based on several factors:

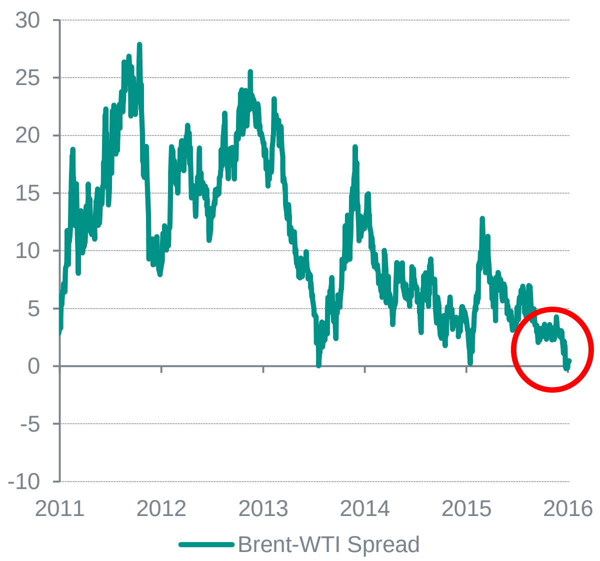
a) Due to economic expansion in the US, Europe and especially Asia (mainly China and India), oil demand will continue to show moderate growth.
b) As a result of low oil prices, investments in the energy sector have been cut dramatically which will have a negative effect on global oil production in the end. This includes US crude production.
c) The market is positioned for further price declines as markets have more than price in supply-demand imbalance. We expect over the coming year that, as soon as the market becomes convinced that downward risks start to diminish, closure of those speculative short positions will lead to some upward pressure.
d) We expect a further appreciation of the US dollar during the first half of 2016. After that, the US dollar will no longer hinder an oil price recovery.

Figure 2: Global demand versus supply (x mb/d)



Source: International Energy Agency (IEA)

Figure 3: Brent-WTI spread diminished (in USD/bbl)



Source: Thomson Reuters

It is extremely difficult to pinpoint the exact timing of the expected oil price recovery. In the near term, the news flow is mainly dominated by the development of US crude inventories, geopolitical tensions and the OPEC policy. This leads to ongoing high volatility of the oil price. During periods of high volatility with sometimes irrational movements of the markets, oil prices can show unexpected strong rallies or declines.

The next OPEC meeting is on 2 June 2016. Given that tensions between two crucial OPEC members (Saudi Arabia and Iran) have increased the chance that OPEC will change its policy significantly has been reduced further. Neither country will take the first step to cut its production in order to stabilise, or even support oil prices due to the risk of losing market share. Lowering the global oversupply will therefore not be serviced by OPEC. Geopolitical tensions will only lead to a higher risk premium (and thus higher oil prices) if production in one of the oil producing countries actually declines. For the moment, this seems not very likely.

In the longer term, the lack of investments in the oil sector will become visible in output numbers. Besides the approximately 5 million barrels per day (mb/d) of crude which needs to be found annually to replace the 'normal' depletion of oil wells, also the annual growth in demand (+1.5 mb/d on average) needs to be met. Therefore, about 6.5 mb/d of new oil needs to be exploited every year. This requires large investments. Investments which are currently at very low levels, and will most likely fall under more pressure in the course of 2016. As a result, the current oversupply could flip to shortages in the longer term, which also may lead to significantly higher oil prices. The main focus for the OPEC is this longer term horizon, while US crude producers are more short term focused.

Brent-WTI spread evaporates on US oil exports

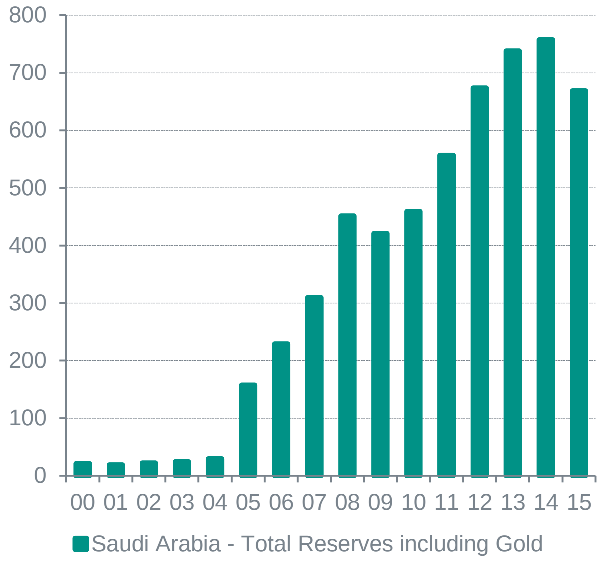
In December, the US lifted its 40-year old ban to export crude oil. It was already allowed to export crude products, but now it is also possible to export the raw commodity itself as well. After the oil crisis, the US decided to accept a law which no longer allowed commodity exports. After the rise of shale oil and – gas, the US was confronted with huge oil and gas inventories. For economic reasons, oil and gas producers lobbied to lift the export ban. After strong negotiations, the US government conceded in exchange of a package of strong measure to promote the use of renewable energy in the US.

As a result of this decision, the spread of Brent versus WTI diminished. Although prices already traded with just a narrow spread – reflecting differences in quality and transportation costs – the spread increased massively due to high inventories in the US versus increased tensions in the Middle East (risk premium). Now both Brent and WTI can be (physically) traded all around the globe – and therefore both function as a global benchmark – the spread narrowed. The first shipment of crude left the US and is heading towards Europe. Nevertheless, we believe that the actual export will remain limited for now as the low oil price and the relatively high cost of transportation towards Europe and/or Asia will make US crude exports unprofitable.

Saudi Arabia claims the centre stage

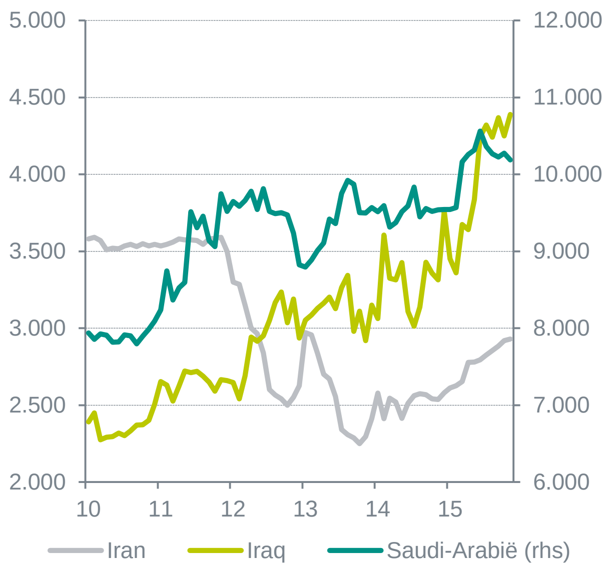
In recent weeks, Saudi Arabia was taking the centre stage in the headlines. Being one of the worlds' biggest oil producers, Saudi Arabia

Figure 4: SWF Reserves Saudi Arabia (x billion USD)



Source: SWF Institute, SAMA

Figure 5: Oil production Iran, Iraq and Saudi Arabia (x kb/d)



Source: Energy Intelligence

is seen as the driver behind the current OPEC policy to flush the oil markets. At the end of December, Saudi Arabia announced measures to cut its government spending and reform its finances. As a result of low oil prices, Saudi Arabia was confronted with a record annual budget deficit. Therefore, Saudi Arabia reduced its subsidies on water, electricity and gasoline, as well as increased taxes and planned budget cuts on its 2016 budget.

Saudi Arabia has large reserves in Sovereign Wealth Funds (Figure 4). These reserves were built in recent years – with high oil prices – in order to bridge periods with low oil prices. This did not mean that Saudi Arabia can continue its current spending pattern for longer if oil prices remain low for longer. The benefit of having low oil prices is that it is easier to reduce subsidies on for instance gasoline as consumers will not be hit too hard. Although the Saudis are not used to (higher) taxes and lower subsidies, the first reactions seem to be modest as these measures were already announced some time ago. Saudi Arabia cutting its budget it is a strong signal to the world. It suggests that the Saudi authorities assume that oil prices will remain low for longer. And that the current OPEC (read Saudi Arabia) strategy of focussing on market share will remain unchanged for the time being.

During the first week of 2016, Saudi Arabia claimed the centre stage again by executing 47 prisoners, including a Shia cleric. This lead to hefty reactions in Shia Iran which in the end resulted in the cutting of economic and diplomatic ties between the countries. As the market anticipated a possible further escalation – and thus formed a threat to oil production in the region – oil prices gained somewhat due to an increased risk premium. However, the oil price rise was short lived and switched to pressure on oil prices instead. The increased pressure can be explained by the view that increased tensions between the both countries will make cutting production to support prices more difficult to agree. This will probably keep OPEC policy in tact of producing more oil than 'the call on OPEC' requires.

Tensions between Saudi Arabia and Iran go back for a long time, but they have increased in recent months. This was a result of Saudi Arabia and Iran supporting different parties in civil wars in Syria, Iraq and Yemen. Also the nuclear deal between Iran and some western countries was a blow to Saudi Arabia. After all, by lowering the sanctions the role of Iran in the region could change. On top of that, Iran shows that it is busy bringing back its oil production to pre-sanction levels (Figure 5). Lowering sanctions would ease oil deliveries towards Europe and the west, and therefore form a new threat to Saudi Arabia's market share. A significant part of the recovery of lost Iranian oil production is yet reality, and therefore already priced in.

The transition of power to the next generation in Saudi Arabia coincides increased dissatisfaction among the locals, increased government spending and increased tensions in the Gulf region. This, combined with a low oil price, could lead to uncertainty about Saudi Arabia's stability, and therefore to higher volatility of the oil price.

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