Energy Monitor January

Oil: Volatile stability

Group Economics
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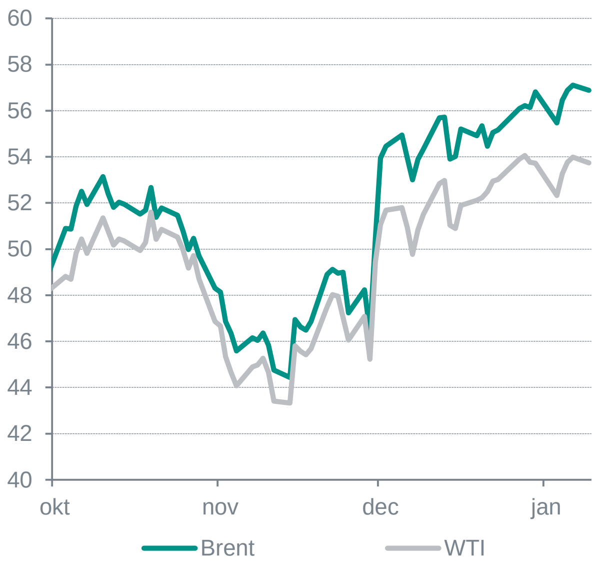
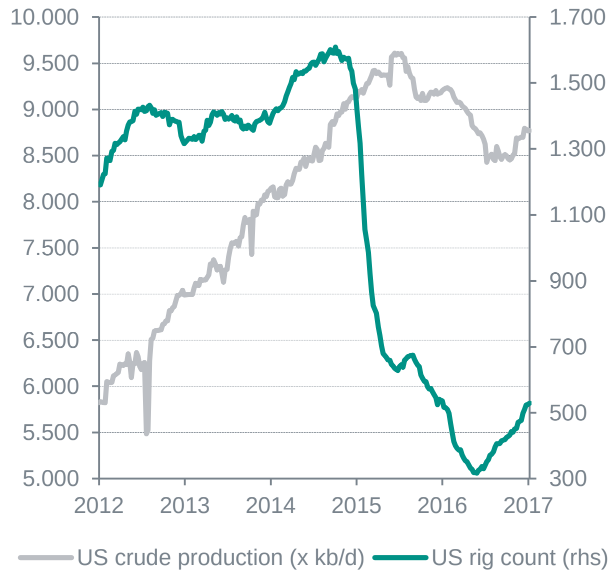
- **Conflicting signals keep oil prices trading in narrow ranges during H1 2017**
- **Base case scenario (50%): oil trading between USD 50-60/bbl, some more upside potential afterwards**
- **Risk scenario: higher oil prices due to a lack of investments resulting in a shortage (35%); oil prices remain low for longer due to oversupply and a stronger US dollar (15%)**

Figure 1: Oil prices remain volatile (x USD/bbl)



Source: Thomson Reuters

Figure 2: More US drilling rigs triggers a modest recovery in US crude production (x kb/d)



Source: Thomson Reuters

Positive start to the year

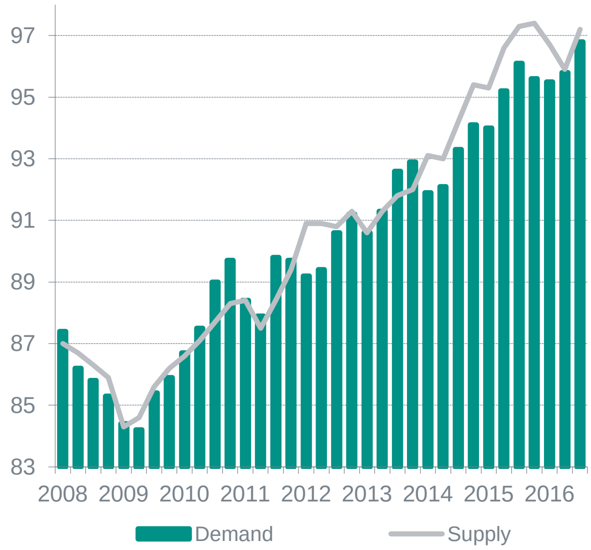
Tuesday 4 January was the first trading day for oil prices in the new year. In the morning, the oil price still received substantial support (+2.5%) after Kuwait and Oman reported that they had cut production as part of a broader agreement among OPEC and several non-OPEC oil producers. But the optimism was short-lived: in the afternoon, stronger-than-expected output data from the US boosted the dollar and dollar-denominated commodities – including oil – came under new pressure. In short, it was a very volatile day, and one that possibly set the tone for the coming weeks and months because the current oil landscape has all the makings of a sustained period of market volatility. This is due to conflicting signals that influence the positions of speculators, investors and capital providers – and hence the oil price.

More or less production?

Many uncertainties lie ahead, particularly in terms of oil production. For one thing, the recent agreement reached by the OPEC members as well as several non-OPEC oil producers to cut output has already pushed the oil price higher. The aim of the agreement is to restore the balance between supply and demand in the oil market. As yet, not everyone is convinced of the resolve of these oil producers. This means that the oil price could advance further if the targeted cuts are actually achieved and supply and demand regain equilibrium. An additional uncertainty, however, is that certain OPEC members (Libya, Nigeria, Iran) have negotiated exemptions and may still maintain or even raise their output. A further complication is that a structurally higher oil price could also lead to more oil production. US shale oil producers are already making use of the rising prices of futures contracts. This is reflected, for instance, in the growing number of drilling rigs being deployed to search for new oil wells in the US. Moreover, the decline in oil production in the US has halted and a nascent recovery is visible. Some fear that a prolonged price spike could fuel a rapid rise in US oil output, thus cancelling out the effects of the OPEC-led agreement. We believe that North American oil producers will in fact step up production, with increased efficiencies enabling them to achieve higher output with fewer rigs. Even so, growth during this recovery will be slower than in the 2011-2014 boom period. Credit remains cheap, but the existence of high oil and oil product stocks, the increased risk awareness among investors and the prospect of higher interest rates will temper oil production growth in the US.

All things considered, an increase in production in the US is probably a good thing given that investments in the oil sector remain under pressure worldwide. The depressed oil price is still causing a lot of pain, notably among non-OPEC and non-shale oil producers. And although

Figure 3: IEA global supply versus global demand (x mb/d)



Source: IEA

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

Price	Q1 2017	Q2 2017	Q3 2017	2017*	2018*
Brent	55	55	60	60	65
WTI	50	50	55	55	60
HH **	3.00	2.75	2.60	2.80	3.30
TTF ***	17.00	16.00	15.00	16.25	18.00

Source: ABN AMRO Group Economics

* Annual average ** Henry Hub *** Title Transfer Facility

the oil price has already doubled compared to its recent low point in January 2016, many projects are still not economically viable at the current price level. The oil market was therefore already edging its way back towards a new supply/demand balance even before the recent production cuts were announced. In view of this trend, more oil production in the US may actually be desirable to prevent larger shortages in the future.

Other factors of importance

Other factors that can influence the oil price this year are the dollar, economic growth (and, hence, demand for oil), and the potentially shifting geopolitical landscape. As the first trading day of the year made all too clear, the dollar can exert a strong influence on the direction of the oil price. Persistent uncertainties in the eurozone and more interest rate rises in the pipeline in the US, should push the EUR/USD even lower to 0.95 in the course of the year. This dollar strength can significantly constrain the upward potential of the oil price.

To assess the future demand for oil, the main factor we must look at is economic growth. Demand for oil in Europe has been under pressure for years due to efficiency and substitution. In the US, by contrast, demand for oil is rising again on the back of the accelerating economy. And the announced plans of President-elect Trump suggest that demand for oil in the US can only gather momentum pace in 2017. That said, to most observers China and India remain the main protagonists when it comes to the rising demand for energy, including oil. The International Energy Agency (IEA) expects global demand for oil to rise by 1.2 million barrels per day in 2017. The accuracy of this forecast depends largely on how the Chinese and Indian economies fare this year. For the time being, however, we are adopting this forecast of a moderate increase in demand for oil.

A final factor is the expected reshaping of the geopolitical landscape. New relations between the US and Russia and between the US and oil-producing countries in the Middle East in particular could potentially aggravate or alleviate the tensions around oil production. Any deterioration in relations would come on top of the existing unrest in e.g. Syria, Libya, Nigeria and Iraq. Clearly, it is impossible to make forecasts on the basis of political contingencies. However, it would be wise to remember that adverse political events, and the ensuing uncertainties about future oil production, regularly lead to higher risk premiums on the oil price.

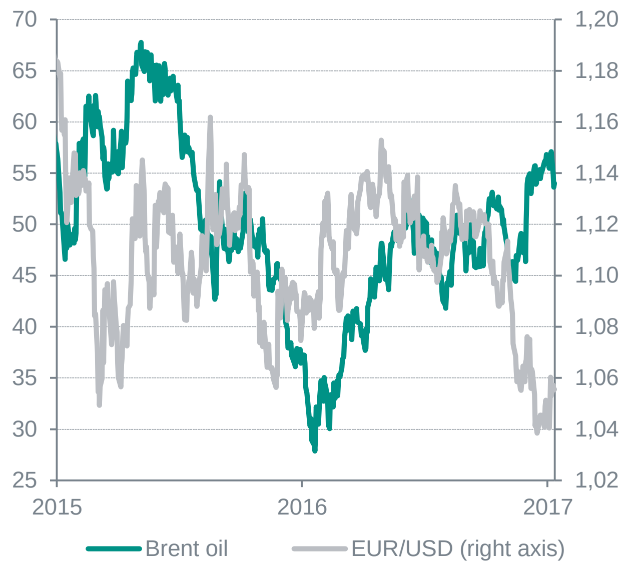
Baseline scenario: volatile but relatively stable

Above, we sketched our baseline scenario for oil prices. We assign this scenario a probability of 50%. The uncertainty surrounding oil production in particular – with conflicting forces cancelling each other out – is expected to keep oil prices within a bandwidth of about USD 50-60 in the first half of the year. The prevailing uncertainty and conflicting reports will prompt capital providers and investors to change positions regularly. This could lead to sustained high volatility, with price swings of several dollars per day by no means qualifying as an exception.

Risk scenarios: higher oil price not inconceivable

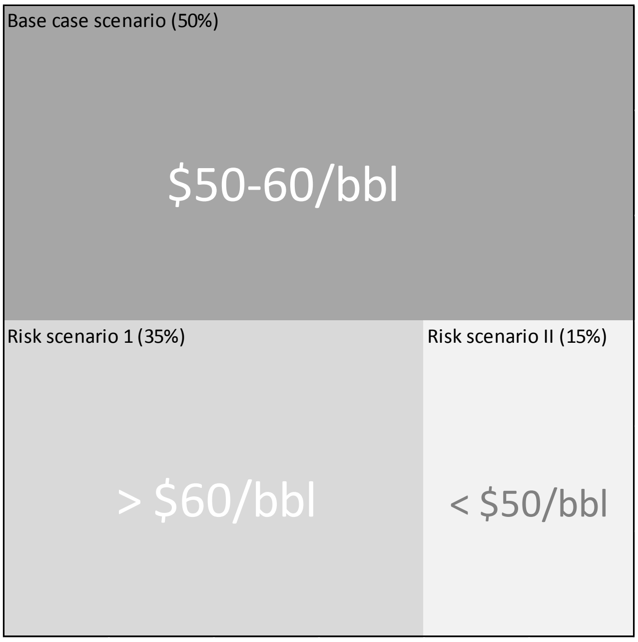
Alongside our baseline scenario, we also develop risk scenarios. Usually, we only present our baseline scenario. This time, however, we will also briefly set out the risk scenarios. As mentioned, we assign a

Figure 4: Oil prices (x USD/bbl) versus EUR/USD



Source: Thomson Reuters

Figure 5: Oil price scenario's for H1 2017



Source: ABN AMRO Group Economics

50% probability to our baseline scenario. However, depending on how specific risks and uncertainties play out, the oil price could remain low for longer or, by contrast, rise faster than expected. That is why we have developed two risk scenarios.

The first risk scenario – with the highest probability – sees the oil price climbing faster than in our baseline scenario. This scenario (35%) assumes an earlier balance between supply and demand in the market. Demand for oil continues to grow steadily by 1.2 to 1.5 million barrels per day. In addition, oil producers reduce output as agreed and the effect of these cuts is not entirely cancelled out by extra shale oil production in the US. Owing to the sharp decline in investments in the sector, oil output outside the OPEC and the US comes under further pressure. As a result, the oversupply in the market is not entirely eliminated, but the excessively high stocks do rapidly decrease and the market turns towards a prolonged period of shortages. As soon as speculators/investors anticipate such shortages and start to build up substantial long positions, the oil price will receive a further upward impulse. The anticipated stronger dollar will only have a limited impact.

A second risk scenario (15%) starts from a lower oil price. This scenario is dominated by downward risks. Economic growth – particularly in emerging countries in Asia – is disappointing and oil demand forecasts are lowered. In addition, the oil price recovery triggers a rapid increase in shale oil production. President Trump's regulatory relaxation for such items as oil products will contribute to this. Finally, the OPEC-led production reduction agreement proves to be less solid than hoped and several oil producers step up production against expectations.

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