

July 8, 2020



Nigeria Strategy Report

H2 2020

Global Economy and Markets

Crude Oil: Cast in COVID-19 Shadows

Executive Summary

In what would seem like ages ago, we had started the year with some optimism for oil markets, following the resolution of the 2-year US-China trade war, with an oil price forecast of \$63/bbl. for FY 2020. However, in an unprecedented move, global economic activities were grounded to a halt and country borders were shut; all due to the outbreak of the coronavirus. However, prior to the full-scale impact of the pandemic, a rift between the OPEC+ de facto leaders – Saudi Arabia and Russia – caused a price war wherein the leading suppliers ramped up production in a bid to recover lost market share. A sum of the foregoing factors led to a historic glut in the oil market and a crash in Brent oil prices to a two-decade low of \$19.33/bbl., while WTI confounded known theories to touch negative territory with a trough of -\$34/bbl – both in April. Over H1 20, oil prices were down 37% to \$41/bbl in June, with average oil price printing at \$42/bbl over H1 20, compared to \$62/bbl over H2 19.

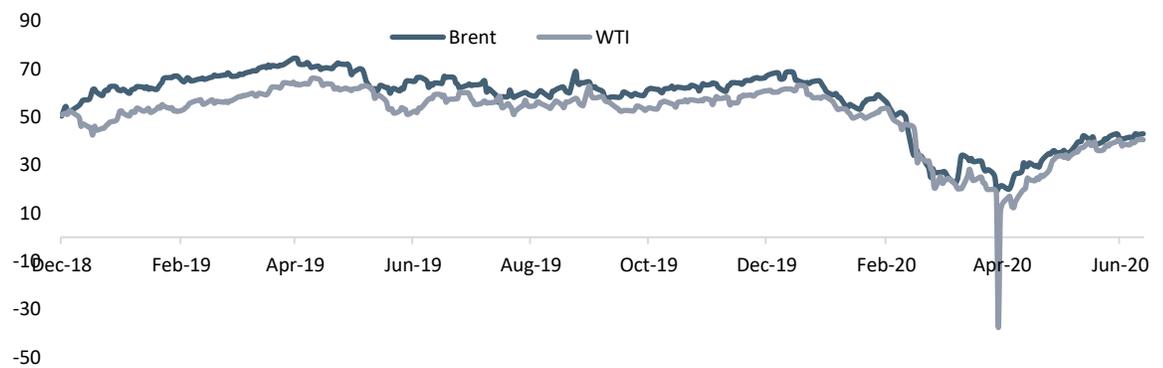
For the rest of 2020, our forecast points to likelihood of a net deficit in market balance. With demand expected to print at an average of 95.9mbpd and supply at 92.7mbpd, the oil market could be in a net deficit position of 3.2mbpd over H2 20 from a net surplus of 7.6mbpd in H1. That said, while we could see some recovery in prices, we think it is unlikely prices return to the highs of \$60-70 levels as it did at the start of the year. Thus, we project oil prices could print at an average of \$40 over H2 20 and we leave our FY 20 oil price forecast unchanged from our last update of \$40.5. Overall, we project oil prices could print within a range of \$33-\$42 for FY 20, with our base case printing at \$40.5. That said, the threat of a second wave of the pandemic is a key downside risk to our forecast.

In this report, we review major drivers in Global oil markets in H1 2020 and convey our outlook for the rest of 2020.

The historic oil price crash

In what would seem like ages ago, we had started the year with some optimism for oil markets, following the resolution of the 2-year US-China trade war, with an oil price forecast of \$63/bbl. for FY 2020. However, in an unprecedented move, global economic activities were ground to a halt and country borders were shut; all due to the outbreak of the coronavirus. With this came a crash in global oil demand at a historic landslide pace. However, prior to the full scale impact of the pandemic (which started to weigh heavily on oil prices in April), a rift between the OPEC+ de facto leaders – Saudi Arabia and Russia – caused a price war wherein the leading suppliers ramped up production in a bid to recover lost market share.

A sum of the foregoing factors led to a crash in Brent oil prices to a two-decade low of \$19.33/bbl., while WTI confounded known theories to touch negative territory with a trough of -\$34/bbl – both in April. This led to a 62% drop in oil prices over January – April 2020 to \$25. However, as economies began to reopen; demand improved. Also, oil production curbs by OPEC and other producers, further improved oil market dynamics. Thus, there has been some steady recovery in oil prices, with the oil prices increasing 63% from the end of April to \$41 in June. That said, overall, oil prices were still down 37% from the start of the year to \$41/bbl in June, with average oil price printing at \$42/bbl over H1 20, compared to \$62/bbl over H2 19.

Figure 1: Brent and WTI prices (\$/bbl.)

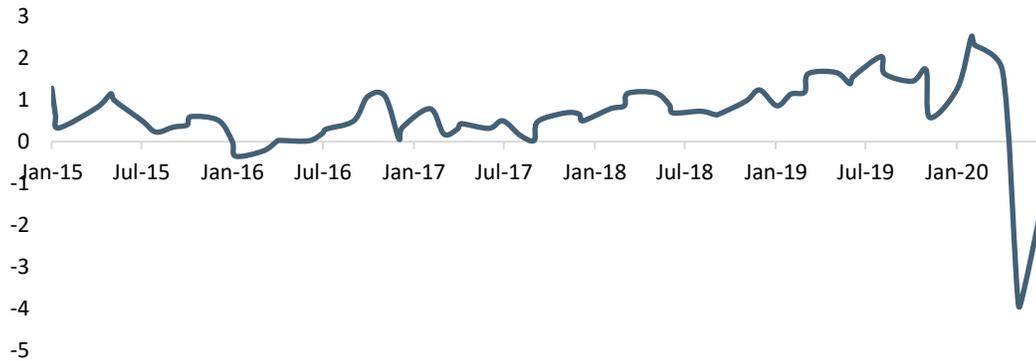
Source: Bloomberg, ARM Research

The devastating plunge in US WTI oil prices to negative territory crystallized as crude oil inventory piled up, particularly in the Cushing region¹, where inventory approached its maximum capacity. Thus, as demand disappeared and inventories touched near full capacities in April, holders of the front month oil contracts who lacked storage capacities and unable to sell to consumers panicked and were willing to sell at huge discounts before the contract expired. Hence the negative pricing of May contracts as it drew close to expiration on April 28th.

¹ U.S' primary locale for storing crude.

Bringing it home, even Nigeria’s Bonny Light crude grade traded at a discount to the Brent for the first time since 2016, and the biggest discount on available record since 2015. (avg. April to June: -\$2.8) as opposed to the premium spread (2019 avg: \$1.59). This occurred as Nigeria’s crude, like many other producers, were stuck on sea due to limited off takers. Again, depicting how fast demand dissipated during the period.

Figure 2: Bonny light vs Brent spread (\$/bbl)

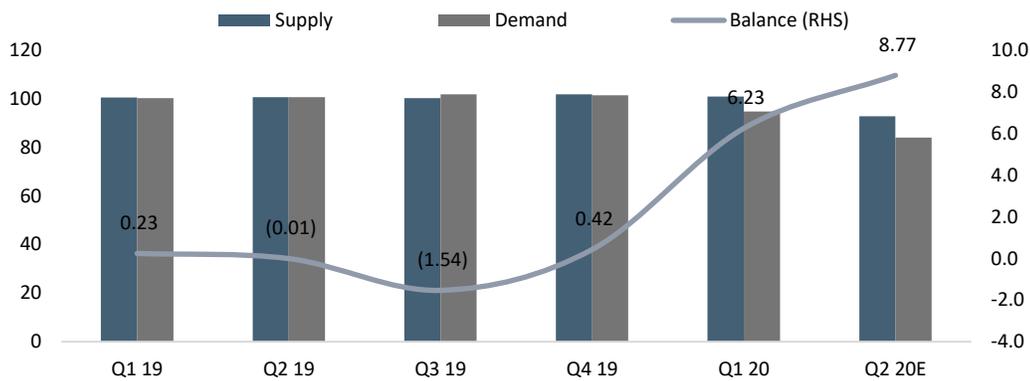


Source: Bloomberg, ARM Research

The jaw dropping glut

The oil market has been in a net surplus position in all the months so far this year, with the average market surplus over the period (Jan to May) printing at 9.4mbpd, according to EIA’s data. A bulk of the oversupply occurred in April, when market recorded a record-high net surplus of 20.5mbpd. The surplus in April was due to the steep decline in demand (during the crux of the global lockdown) by 10.8mbpd while supply, rather than follow suit, actually rose in the month by 0.3mbpd owing to the rift in OPEC. Over the 5M period, average demand dropped by 6.6mbpd (-12%) to 89mbpd, while supply dropped by only 2.4mbpd (2%) to 98.5mbpd, compared to H2 19.

Figure 3: Global market demand, supply and net balance (mbpd)

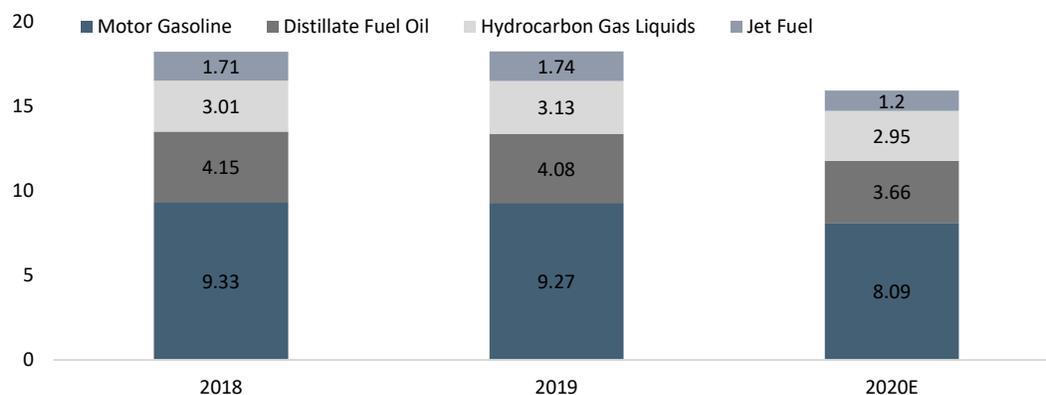


Source: EIA, ARM Research

The Great Lockdown thinned out Demand

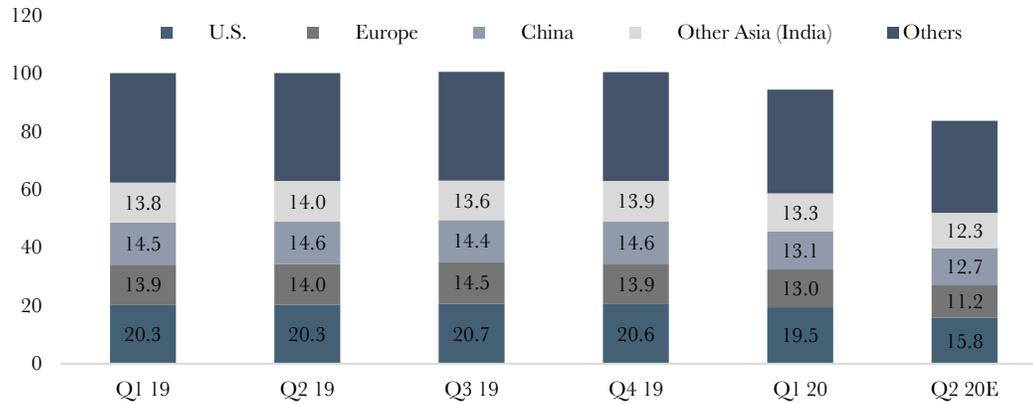
On an annual basis, average global oil demand dropped by 11% YoY to 89mbpd over 5M 20. The decline in global oil demand came as global economies ground to a halt, owing to the COVID 19 lockdown. Countries also shut their borders leading to a 62% drop in total flights globally in April, from a year before. Over the 6M period, flights are down 29% compared to 2019, inevitably affecting demand for jet fuels. In the US, EIA estimates jet fuel consumption could drop 31% in 2020, owing to impact of the lockdown, Gasoline (-13%), Distillate Fuel (-10%), and Hydrocarbon gas liquids (-6%) all posting declines in the period as well.

It is worth stating that while the biggest drop in demand occurred in March (-7mbpd) and April (-11mbpd) – when most countries began to enforce strict lockdown measures -- signs of depleting demand had begun as early as January wherein demand dropped 5mbpd. Of course, the biggest culprit at the time was China (-1.5mbpd), where the coronavirus originated, and a statewide lockdown was already in place.

Figure 4: US fuels consumption (mbpd)

Source: EIA, ARM Research

The OECD region recorded bulk of the decline in global oil demand over the period. Precisely, oil consumption in the region dropped 14% YoY to 41mbpd. The US and Europe recorded the biggest declines, dropping by 14% YoY and 15% YoY to 17.6mbpd and 12mbpd, respectively. On the other hand, crude oil consumption in the non-OECD region dropped 11% YoY to 48mbpd. Unsurprisingly, the Asian region was down the most by 9% YoY to 26mbpd, with China's demand receding by 1.6mbpd (-11% YoY) to 12.8mbpd.

Figure 5: Global oil demand (mbpd)

Source: EIA, ARM Research

Supply Shut-ins ensued, but at a little too late

Compared to the 11mbpd oil demand lost over 5M 20, only 2mbpd was recorded as decline in global oil supply during the period, with average oil supply printing at 98.5mbpd. Over Q1, when demand was already dwindling, crude oil supply had barely moved the needle, printing only 1% lower than the previous quarter. However, further exasperating the market's over supply was the conflict between the OPEC+ de facto leaders at the March meeting², which led to a ramp up in supply by both countries.

Thus, while some producers had begun cutting production in April, given the unfavorable economics, due to plunge in oil prices, the OPEC+ producers drove global supply higher in the month. Thus, global supply rose 0.26mbpd in April to 100.6mbpd, instigated solely by over 2mbpd increase in OPEC+ producers. Specifically, Saudi Arabia (+1.8mbpd to 11.8mbpd³), which was already producing below optimum capacity at the time and is widely known for its cheap cost of production led the increase.

As the excess supply in market increased, prices crashed further to the record-lows and it became even more unprofitable for producers, including the US. So much so that many US shale companies began to file for bankruptcies⁴; the biggest of them being Chesapeake – the 'pioneer of America's drilling renaissance'. Thus, the US government, in an arguably hypocritical move⁵, called on a resolution of the OPEC+ conflict and that an agreement for voluntary production cuts be made by the cartel. Thus, in April, an agreement was reached by OPEC+ oil producers to take a 9.7mbpd production cut from 2018 referenced production

² After the vote to increase production cuts at the time failed to pass

³ The highest on our available record dating back to Dec-2016

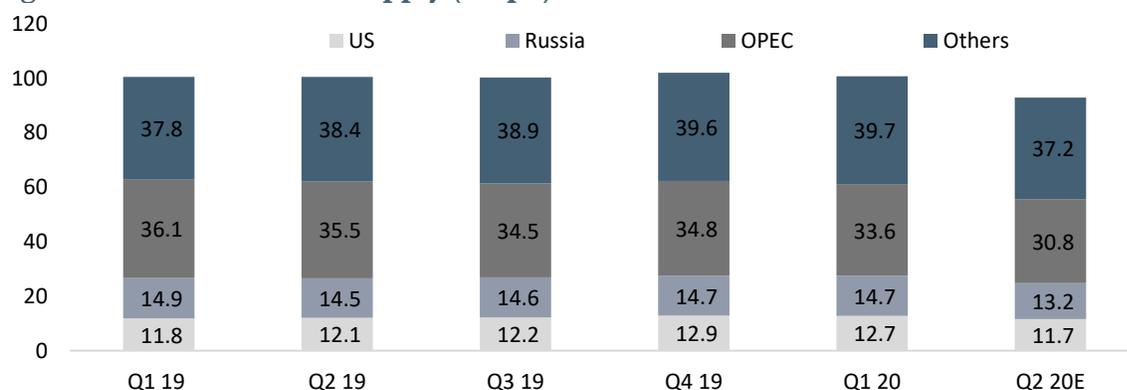
⁴ A report by a Texas based law firm, corporate law firm Haynes and Boone, puts the number of bankruptcies by US oil companies at 18 as at May

⁵ Given the US' major stance for free markets

level, effective from May to July⁶. Subsequently, the agreed cut will ease to 7.7mbpd from August till December 20 and then 5.8mbpd till Dec-22. These, together with forced shut-ins in the US, drove global supply down by 11mbpd MoM to 89mbpd in May – US (-1mbpd MoM), OPEC+ (-8mbpd).

Meanwhile, involuntary cuts remained in Iran, Libya and Venezuela, with supply printing at an average of 2mbpd, 0.24mbpd and 0.69mbpd over H1 20, vs 2019 average of 2.3mbpd, 1.1mbpd and 0.8mbpd, respectively. Iran and Venezuela’s oil production remain suppressed due to the US sanctions placed on the respective government, while the ongoing civil war in Libya have kept production shut in the region. It is worth stating that these forced shut-ins are exempted from the OPEC production cuts.

Figure 6: Global crude oil supply (mbpd)



Source: EIA, ARM Research

OPEC compliance necessary to balance markets

Going forward, compliance with the agreed cuts by members of OPEC will be necessary to ensure balance in the oil market is reinstated. The leader of the cartel, Saudi Arabia, has horned on the need for compliance by members. The latest compliance rate of 81% by the OPEC+ (based on EIA’s production data) in May, largely mirrored defaults by Iraq (38%), and Nigeria (62%). This was called out by the cartel’s leader and members were made to commit to improved compliance to the stipulated cuts going forward.

In our projections, while we expect improved compliance in Q3 at 89%, we think defaults could ramp up in the final quarter, with compliance rate estimated at 52% as we expect demand to improve. Nonetheless, we still think supply by the cartel will be lower in H2 at 23mbpd (ex-condensates), compared to 24mbpd in H1.

⁶ The agreed cut was extended to July at the OPEC June meeting.

A long-term shut-in of US production

Over in the US, production is expected to remain suppressed for the rest of 2020. EIA forecasts production could drop further to as low as 10.7mbpd by Dec-20, from current lows of 11.4mbpd. This will bring the US' average oil production to 11.6mbpd in FY 20, as against 12.3mbpd in FY 19. In fact, the US production is also expected to decline further in 2021, to an average production of 10.8mbpd, according to the EIA.

You will recall that at the start of the year (Pre-COVID) the US' production growth was already expected to slow in 2020. This was because many US oil producers are expected to shift focus to ensuring improved return to shareholders via dividend payments and share buybacks, while cutting back on capex. However, the recent crash in oil prices has resulted in faster decline in investments in the sector.

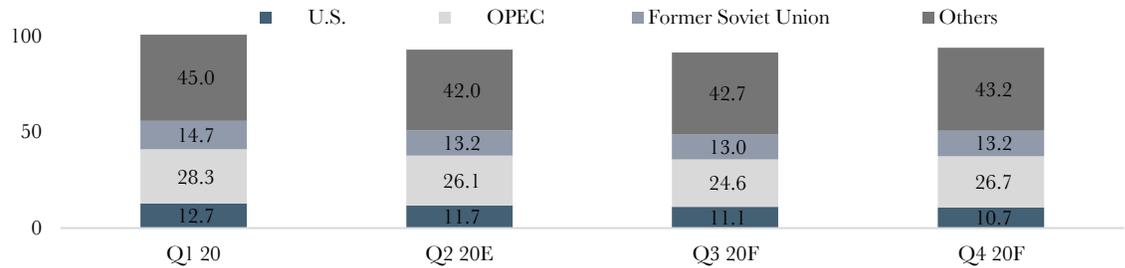
This plunge in investment in the sector is evident in the sharp drop in US oil rigs, which plunged even faster as production became uneconomical following the nosedive in oil prices. More so, considering the high cost of production in the US, which is estimated at an average of \$4/bbl, according to a recent Dallas Fed Energy Survey. US rigs have dropped by 530 rigs over H1 20 to 274 bringing total rig count to the lowest on Baker Hughes' available record dating back to 1975. The decline so far this year, already exceeds the total of 261 rig drop recorded across US producing regions last year.

Figure 7: US rig count

Source: Baker Hughes, ARM Research

Overall, we forecast global oil supply in the second half of the year will print 4.16 mbpd lower to 92.7mbpd in H2 from 96.8mbpd in H1. Bulk of the decline is expected to stem from lower supply in the US (-1.4mbpd to 10.9mbpd), OPEC (-1.5mbpd to 25.7mbpd) as well as Russia (-0.8mbpd to 13.1mbpd). Global oil supply over FY 20 is expected to print at 94.7mbpd, 6mbpd lower than FY 19 average of 100.7mbpd.

Figure 8: Global oil supply forecast (mbpd)



Source: EIA, ARM Research

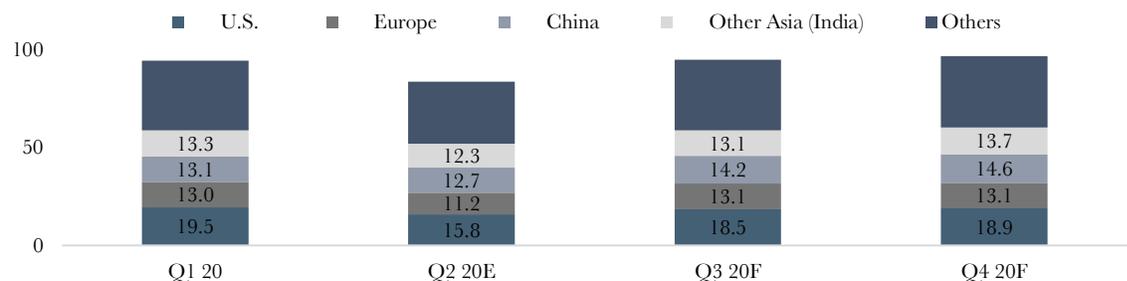
A tight-lipped optimism for demand in H2

In our latest oil market update, we highlighted our optimism for strong recovery in global demand in the second half of the year. However, our optimism is now partly tamed by the threat of a second wave of the COVID 19 outbreak. In fact, US and China have recently started to record increase in new cases, with the latter even imposing new soft sanctions in parts of Beijing. That said, we still think it is unlikely global economies ground to a halt like they did in most of H1, thus we retain a cautious optimism of a recovery in H2.

In line with the EIA’s forecast, demand is expected to grow 8% (6.7mbpd) over H2 20 to 95.9mbpd, from H1 20 of 89mbpd. Typically, H2 is known to have stronger demand for crude than H1, owing to summer driving season in the US which increases demand for gasoline, while global demand for heating fuels rise owing to the winter seasons in Q4. That said, while improving from the first half of this year, demand is still expected to remain 5% lower compared to H2 19 where global demand printed at 101.5mbpd.

Looking at the breakdown, non-OECD countries are expected to record the faster growth by 4.1mbpd over H2 20, particularly in the China (+1.5mbps), India (+0.66mbpd) and other non-OECD regions (+1.97mbpd). Meanwhile, recovery in the US (+1.06mbpd) and Europe (+1.02mbpd) are expected to be the major drivers of demand in the OECD region (+2.6mbpd). Overall, global demand in FY 20 is expected to print at 92mbpd from 100.9mbpd in FY 19, before growing to 99.7mbpd in 2021.

Figure 9: Global oil demand forecast (mbpd)



Source: EIA, ARM Research

A switch to net deficit, but still frail prices

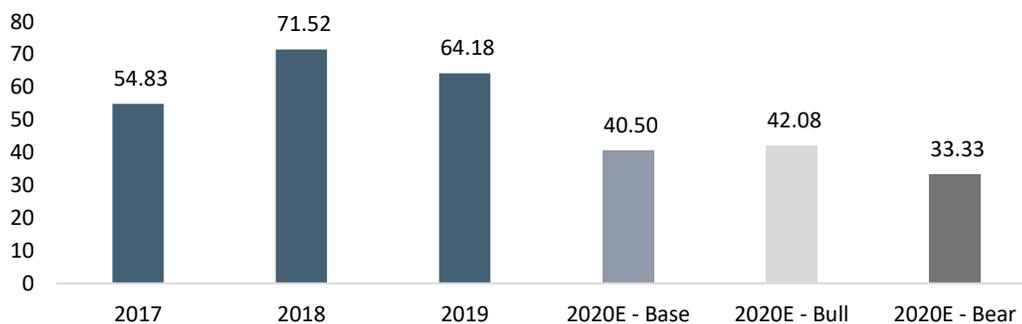
A culmination of our forecast points to likelihood of a net deficit in market balance over the second half of the year. With demand expected to print at an average of 95.9mbpd and supply at 92.7mbpd, the oil market could be in a net deficit position of 3.2mbpd over H2 20 from a net surplus of 7.6mbpd in H1. That said, we think it is unlikely prices return to the highs of \$60-70 levels as it did at the start of the year. Thus, we project oil prices could print at an average of \$40 over H2 20. Thus, we leave our FY 20 oil price forecast unchanged from our last update of \$40.5.

A key upside risk to our forecast could stem from a robust recovery in economic activities which could propel a stronger growth in demand over H2 than we expect. On the supply side, risks of middle east tensions which could further pressure outflows from Iran and/or put the key route such as the Strait of Hormuz at risk (jeopardizing supply from Saudi Arabia and other middle eastern producers) could put pressure on supply. Also, a better than expected compliance to the stipulated cuts by OPEC could also propel a lower market supply. The aforementioned factors could place market in a higher net deficit of 4.5mbpd while prices could print higher at \$45/bbl over H2 20 and at \$42/bbl. over FY 20.

On the downside, should a second wave of the Coronavirus pandemic resurface, and economic activities are, again, disrupted by another set of lockdowns (particularly in the flu winter season in Q4), we think demand could be pushed even lower than we forecasted. However, as stated earlier we do not expect this will be as chronic as in Q2. On the other hand, a non-compliant OPEC and recovery in Middle East shut-ins, particularly in Libya, could push supply higher over the period. We project these could push market to net deficit of 0.1mbpd (assuming a net surplus in Q4) while prices could print lower at \$29.4/bbl over H2 and \$33.33 over FY 20.

Overall, we project oil prices could print within a range of \$33-\$42 for FY 20, with our base case printing at \$40.5; based on our foregoing assumptions.

Figure 10: Oil price forecast in \$/bbl. (Base, Bull and Bear)



Source: Bloomberg, ARM Research

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