

Nigeria Strategy Report

H1 2019

Global Economy and Markets

Crude Oil: Not Great, but not all gloom either

Executive Summary

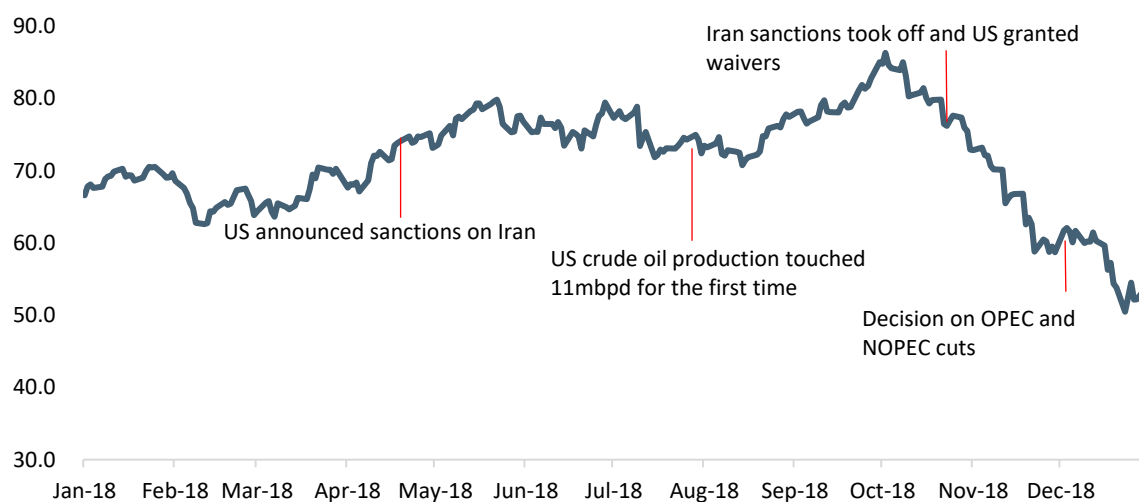
At the start of the second half of 2018, we had projected a steady rebalancing in the oil market, reflecting resilience in oil demand, lower supply from Iran and falling global crude oil inventory, with our interpolation between changes in balance and Brent crude resulting in a base case forecast of \$72.5/bbl. over H2 18. In sync with the view, average crude oil price over the period printed at \$72.22/bbl. hinged on market reaction to sanctions on Iran by the US which was announced in May. That said, the crude oil market was well greased over the period with average supply expanding by 2.14mbpd to 101.48mbpd in H2 18 relative to 99.33mbpd in H1 18. Production over the period grew at a faster pace in Q3 (+1.44mbpd) than Q4 (+970kbpd), with the US boosting the supply growth in both quarters. On the demand side, consumers' appetite for crude remained robust over H2 18 (+390kbpd), albeit weaker than in H1 18 (+1.62mbpd), due to the slowdown in industrial and manufacturing activities which has impended global economic growth. On balance, the faster pace of growth in supply than demand led to a reversion of the oil market to a net surplus position of 940kbpd in H2 2018, compared to a deficit of 20kbpd recorded in H1 18.

Going into 2019, we forecast growth in supply by 1.19mbpd to 101.6mbpd, on average, with a bulk of the production still to stem from the US and other non-OPEC producers. On the demand side, we estimate a weaker pace of growth in 2019 by 510kbpd to 100.45mbpd, compared to 1.39mbpd growth in 2018. Weak global economic growth is expected to impede oil demand growth. Similar to 2018, we estimate weaker demand from the OECD countries, following declines in Japan, as well as weaker growth in US demand. Among the non-OECD, we estimate demand growth of 460kbpd, compared to 1.03mbpd posted in 2018. Appetite for crude in India and other non-OECD regions is expected to outweigh decline in China. On balance, the market is likely to extend the net surplus position in 2019. Based on our interpolation between changes in net supply and Brent crude, we update our crude oil forecast to \$50/bbl.-\$60 bbl with a base case of \$55.95.

In this report, we look at the major themes that dominated the Crude Oil market in H2 2018 as well as our outlook for the market and crude oil prices for the rest of the year

A fickle market as political rattles dictate the tune

At the start of the second half of 2018, we had projected a steady rebalancing in the oil market, reflecting resilience in oil demand, lower supply from Iran and falling global crude oil inventory. Consequently, we envisaged the rebalancing process will leave H2 18 crude oil price stable, with our interpolation between changes in balance and Brent crude resulting in a base case forecast of \$72.5/bbl. over H2 18. In sync with the view, average crude oil price over the period printed at \$72.22/bbl. hinged on market reaction to sanctions on Iran by the US which was announced in May. Stripping into quarters shows average crude oil prices over Q3 18 stood at \$73.79/bbl. while average prices slowed to \$69.31/bbl. in Q4 18, as higher supply by the US and OPEC (particularly Saudi Arabia) outweighed demand with Brent crude oil price closing the year at \$53.80/bbl. (2017: \$66.87/bbl.) Irrespective, average crude oil prices over 2018 was at \$71.69/bbl. compared to 2017 average of \$54.73/bbl.

Figure 1: Crude oil activity trend (\$/bbl)

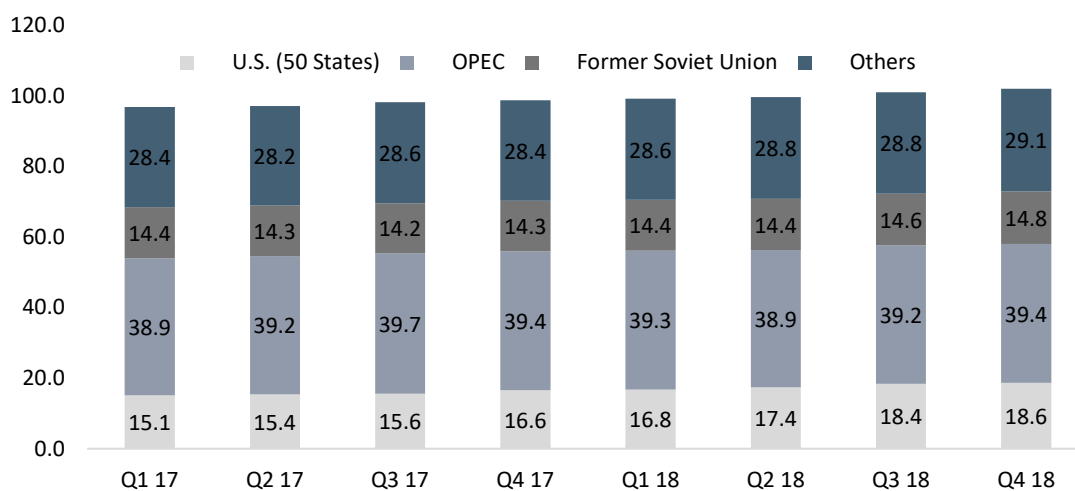
Source: EIA, ARM Research

Global producers ramp up supply in 2018

The crude oil market was well greased over the period with average supply expanding by 2.14mbpd to 101.48mbpd in H2 18 relative to 99.33mbpd in H1 18. Production over the period grew at a faster pace in Q3 (+1.44mbpd) than Q4 (+970kbpd), with the US boosting the supply growth in both quarters. US drillers ramped up supply to record highs, with average production touching 11mbpd for the first time in August, a fruition of the 436 additional rigs invested in 2017. Also, in a twist of events, OPEC (particularly Saudi Arabia) and its key ally (Russia) increased supply over H2 18 in a bid to take up expected shortfalls in the supply of Iranian oil, following U.S. re-imposition

of sanctions. Basically, following the announcement in May, Iran's supply declined by only 730kbpd, while Saudi Arabia and Russia ramped up supply by 1.38mbpd. By the end of the year, OPEC's surplus crude oil production capacity (which is concentrated in the Middle East) had depleted by 730kbpd over the half year to 850kbpd. Meanwhile, unplanned outages in Venezuela continued to place brakes on supply over H2 18, declining by 180kbpd, albeit slower than the decline in H1 18 (280kbpd). Overall, average crude oil supply in 2018 was higher by 2.63mbpd at 100.31mbpd, compared to 97.68mbpd in FY 17.

Figure 2: World supply and components (mbpd)



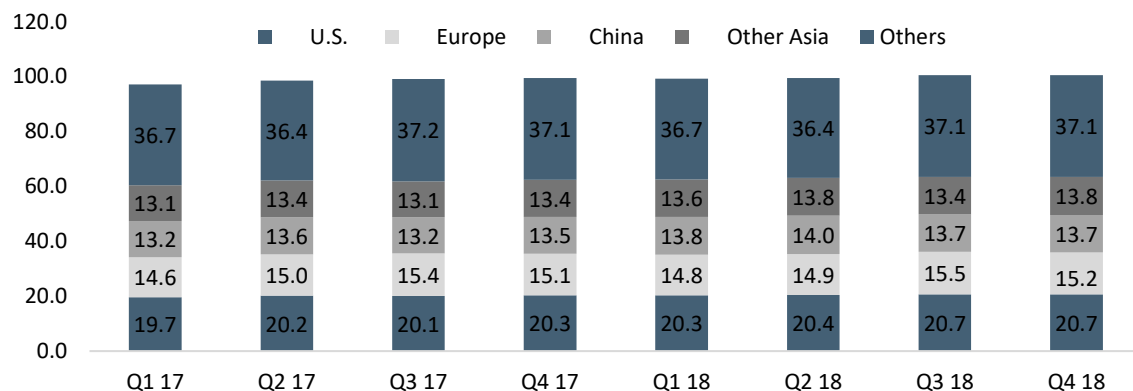
Source: EIA, ARM Research

Global demand under siege?

Consumers' appetite for crude remained robust over H2 18 (+390kbpd), albeit weaker than in H1 18 (+1.62mbpd). This was largely attributable to the slowdown in industrial and manufacturing activities which has impeded global economic growth. With many thanks to the trade spat between China and US, as well as lingering Brexit concerns, curtains were drawn on the highly regarded synchronized global growth which bolstered crude oil demands. The pent-up trade tensions weighed on demand from U.S. and China – the world's top producers. In China, crude oil demand expanded by 270kbpd, slower than the 810kbpd growth recorded in H1 18. India's story came in similar as demand growth also slowed significantly to 60kbpd in H2, compared to 420kbpd in the first half, amid slowdown in economic growth as well as decline in car sales. Growth in US crude oil demand also slowed to 60kbpd over H2 18 relative to growth of 410kbpd in the first half. For context, in September alone, US crude oil demand contracted sharply by 1.35mbpd relative to prior

month as gasoline consumption declined sharply from previous trend reflecting slower automobile sales, a feed-through from trade tensions. Meanwhile, demand relapsed in Europe (140mbpd) over H2 18 as the crackdown on regulation of diesel cars led to decline in car sales even as slower growth in the region further amplified the contraction. Overall, demand in FY 18 grew by 1.34mbpd to 99.89mbpd, with consumption in both OECD and non-OECD regions remaining at relatively strong levels, although waning towards the end of the year.

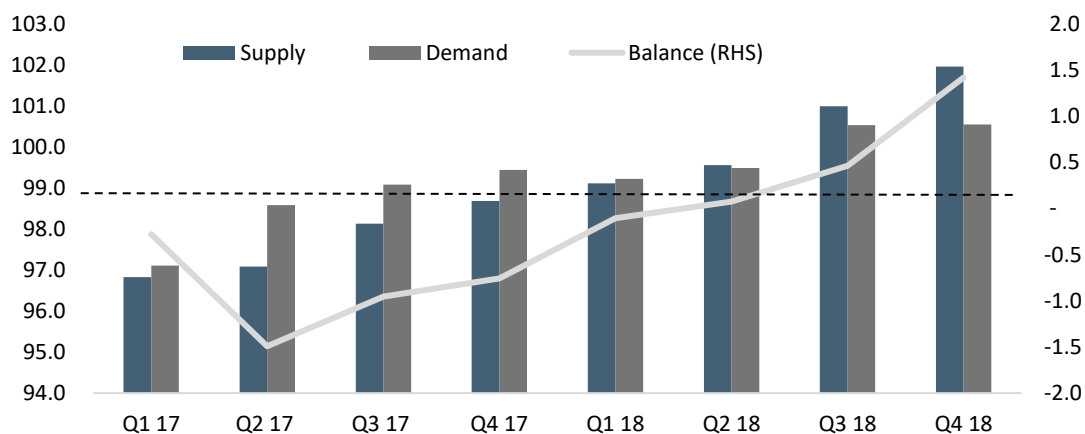
Figure 3: World demand and components (mbpd)



Source: EIA, ARM Research

On balance, the faster pace of growth in supply than demand led to a reversion of the oil market to a net surplus position of 940kbpd in H2 2018, compared to a deficit of 20kbpd recorded in H1 18. Both quarters in Q3 18 and Q4 18 closed with surpluses of 460kbpd and 1.42mbpd, respectively – an extension from Q2 18's net surplus of 70mbpd. Overall, FY 2018 market balance printed at a net surplus of 420kbpd from net deficit of 870mbpd in FY 2017.

Figure 4: Crude oil demand and supply (mbpd)



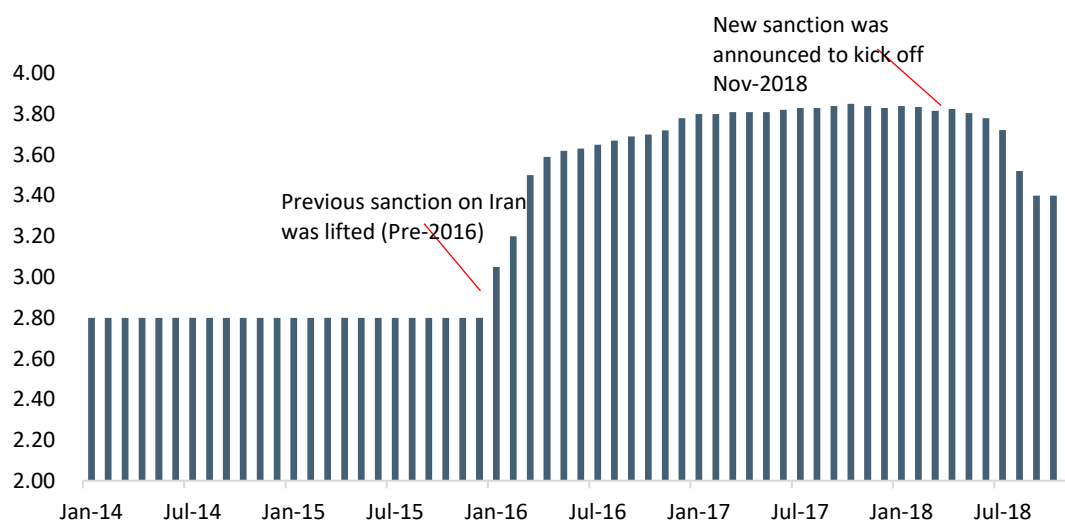
Source: EIA, ARM Research

Iranian oil fizzles as US imposes sanctions

Earlier in May 2018, the U.S announced plans to withdraw from the Joint Comprehensive Plan of Action (JCPOA) multilateral deal and re-instate sanctions on Iran from November 2018. This was like the sanctions which were lifted in 2016. Pre-2016, an embargo on Iran exports caused a drop in Iran's crude oil supply to record-lows of 2.8mbpd, which later surged to 3.8mbpd following the lifting of sanctions in 2016. Similarly, post-announcement of fresh sanctions in 2018, Iran's crude oil production fell by 730kbpd to average 3.10mbpd² by the end of the year, almost back to pre-2016 levels. The announcement bolstered bullish sentiments and resulted in higher oil prices (peaking at \$86.39 in October), which in turn translated to higher gasoline prices, quite to Trump's displeasure.

As a result, in November, the Trump-administration granted waivers to eight countries (including India, China, Japan etc.) who accounted for 70% of Iran's oil exports, salvaging the oil market from further shortfalls in supply. With the waivers set to expire in May 2019, a lot of uncertainties on what is to be expected from Trump lie ahead. More so as he remains stern on re-imposing the Iran sanctions, whilst still calling for lower oil prices. However, it is worth stating that there are chances the Iran government bends to satisfy the Trump-administration (although quite thin) and avoids any sanctions exists, as the Iranian economy has been dealt a severe blow, despite the waivers.

Figure 5: Iran crude oil production (mbpd)

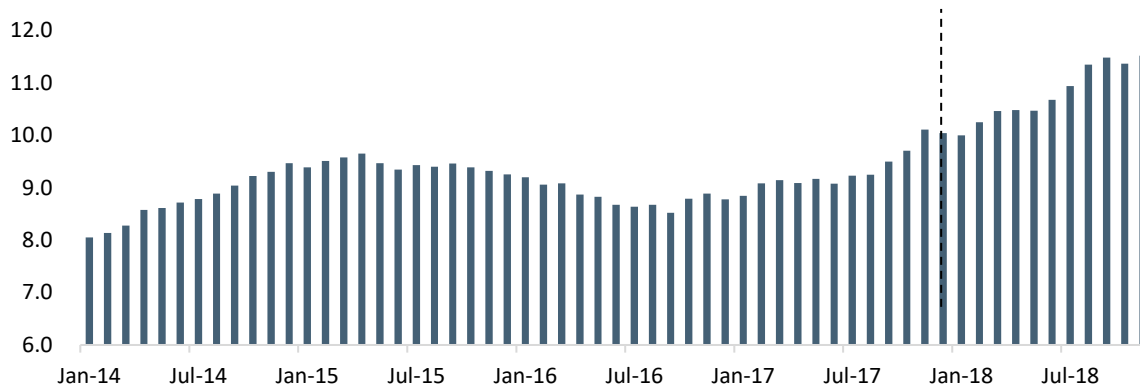


Source: EIA, ARM Research

US Oil production: how far can it go?

In 2018, US crude production rose to a record high of 11.95mbpd in November, a payoff of the 436 rigs added in 2017 – the highest since 480 rigs were added in 2011. Over 2018, crude production averaged 10.81mbpd which was higher by 1.46mbpd compared to 2017. The surge in production led to US becoming the world's top oil producer – surpassing Saudi Arabia or Russia for the first time in over two decades. This was a major driver of the nosedive in prices from the peak reached in October. With wellhead breakeven of \$40 (according to Rystad Energy estimates) US shale players were incentivized to build wells and pump more oil. Although briefly, US became a net oil exporter for the first time in 75 years during the year. The US commercial inventory, similar to the overall OECD stockpile, added 15 million barrels to rise to 1.25 billion barrels – above the 5-year average of 1.24 billion barrels. This further attested to the extent of excessive ramp up in US oil production during the period.

In 2018, 148 rigs were added in the US, bringing total rig count to 1,032 rigs. The lower addition to US rigs suggests crude production in 2019 is unlikely to come at the pace recorded in 2018. Hence, we estimate increase in the average production of US crude and other liquids by 710kbpd to 11.53mbpd in 2019.

Figure 6: Historic rise in US crude production (mbpd)

Source: EIA, ARM Research

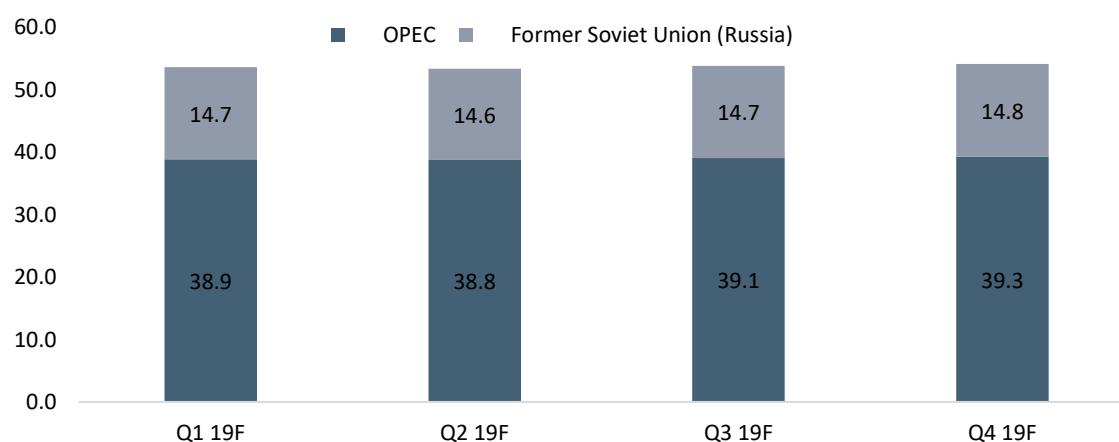
OPEC Outlook, price stability or market share?

During the 5th OPEC and non-OPEC Ministerial Meeting which held on 7th December 2018, a joint decision to adjust oil production by members of OPEC cartel and allies in OPEC+ was reached – reaffirming commitment of the producing countries to the ‘Declaration of Cooperation’ to stabilize the market. The producing countries’ outflows are to be adjusted by 1.2mbpd – 800kbpd to members of OPEC (except Iran, Libya, and Venezuela) and 400kbpd to the non-OPEC participating countries. The oil cuts are to take effect from January 2019 for an initial period of six months. While statement on the specific allocation per country is yet to be released at the time of

writing, the cuts are to be taken from their October production levels. Also, of the allocations to participating countries in NOPEC, Russia is to bear a cut of 230kbpd. Russia – the leader of the NOPEC group – has shown commitment to a gradual observation of the cut though the six-month period and holding the output level until the end of the year. However, Alexander Novak, the Russian Energy minister dashed hopes of a permanent agreement institutionalizing the arrangement between the OPEC and NOPEC producers.

While Saudi Arabia appears eager for a rise in oil prices to support the increased spending in their budget (even more so following setbacks after the Kashoggi case), Russia has expressed satisfaction for prices at \$60. Hence while the Arab producer may stick to the oil cuts agreement going into 2019, we think Russia and other producers in the cartel may shift the needle in compliance levels. It is worth stating that we think involuntary shortages are likely to persist in Venezuela. It is pertinent to note that Qatar, after 57 years of OPEC membership, announced exit from OPEC in December. The rationale for the exit, according to the energy minister, is to focus on its LPG exports, which as at 2017 makes up 28% of world exports, according to Bloomberg data. Other sources linked the decision to the need for a smooth sail to the state-owned oil firm's (Qatar Petroleum - QP) ambition in the US, where it holds one of the world's biggest LNG terminals and intended to increase investments for major investments. However, Qatar's exit left little-to-no effect on the OPEC cartel, considering the nation contributes a meagre 600kbpd, has a spare capacity of 300kbpd, and proven oil reserves making up only 2.1% of the cartel's total.

Figure 7: OPEC and Russia production forecast for 2019F (mbpd)



Source: EIA, ARM Research

Market to remain in net surplus in 2019

Going into 2019, we forecast growth in supply by 1.19mbpd to 101.60mbpd, on average, with a bulk of the production still to stem from the US and other non-OPEC producers, who

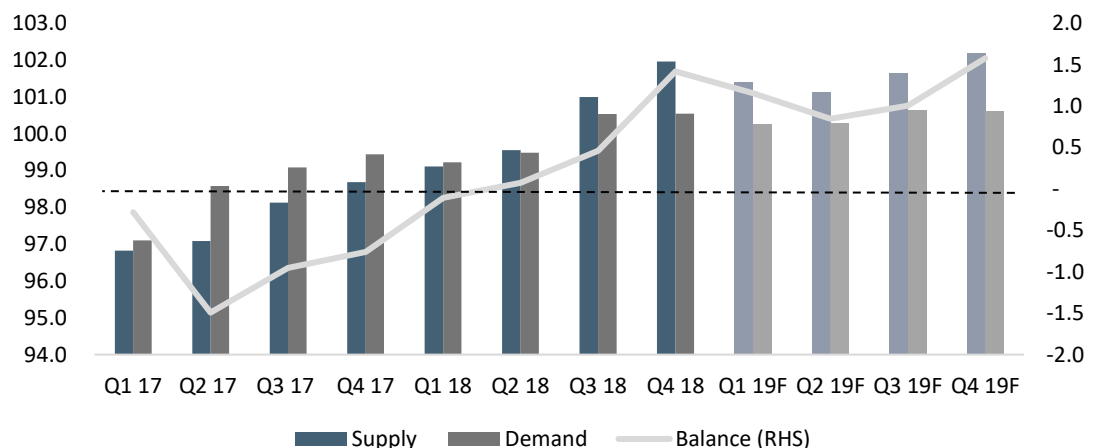
by our estimate will add 1.10mbpd over the year. Similar to 2018, we expect growth in US production to drive the supply, offsetting declines in Canada and Mexico.

Elsewhere, oil production among the OPEC and its allies is expected to grow by 90kbpd in 2019 to 70.65mbpd. Following the OPEC cuts which kick off in January, we estimate a decline by 210kbpd to 39.01mbpd in 2019. We envisage compliance to the cuts may dwindle by H2 19 leading to a ramp up in production by the member countries. On the other hand, we estimate Russia will add 170kbpd to production by FY 19, as we posit likelihood of non-compliance to the joint cut agreement, considering their comfort with prices at \$60.

On the demand side, we estimate a weaker pace of growth in 2019 by 510kbpd to 100.45mbpd, compared to 1.39mbpd growth in 2018. Weak global economic growth is expected to impede oil demand growth. Similar to 2018, we estimate weaker demand from the OECD countries, following declines in Japan, as well as weaker growth in US demand. Demand from Europe is expected to remain weak thanks to Brexit uncertainties as well as slowed car sales. Among the non-OECD, we estimate demand growth of 460kbpd, compared to 1.03mbpd posted in 2018. Appetite for crude in India and other non-OECD regions is expected to outweigh decline in China. Added to concerns of slowdown in China's economic activities is the reported reduction in allocation of import quotas in the first batch for Chinese independent refiners (aka the teapots) to 89.84 million tonnes (~658.53 million bls) from 121.32 million tonnes (~889.28 million bls) issued in the first batch for 2018.

On balance, the market is likely to extend the net surplus position in 2019. We estimate excess supply of 1.15mbpd, a 690kbpd increase from 2018, reflecting continued oil pumps from US (particularly in H1), as well as weak demand from China, Japan and Europe.

Figure 8: Crude oil demand and supply (including forecast)

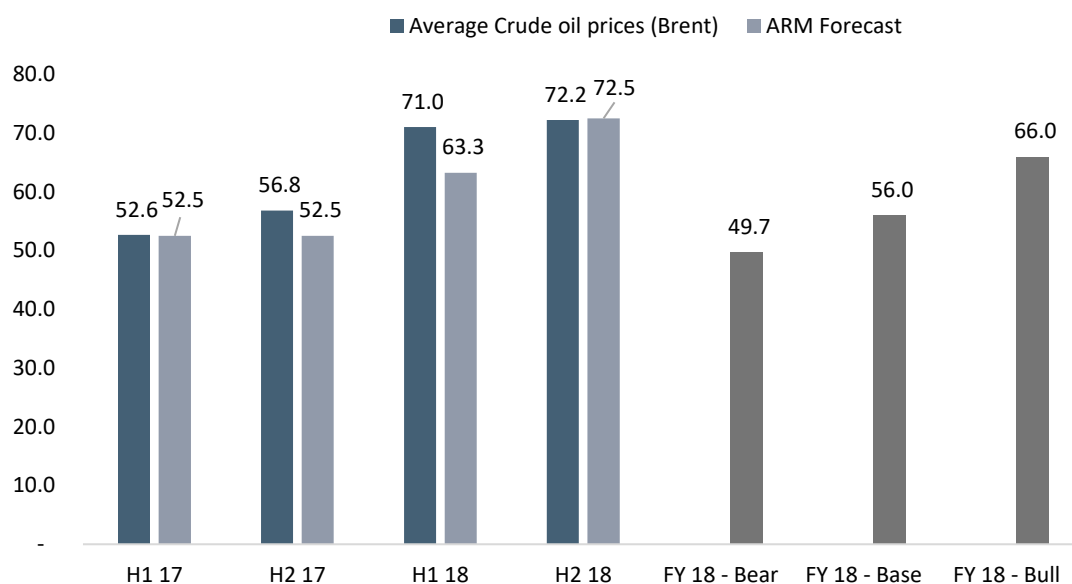


Source: EIA, ARM Research

Based on our interpolation between changes in net supply and Brent crude, we update our crude oil forecast to \$50/bbl.-\$60 bbl with a base case of \$55.95.

However, we note that upside risks of (1) full compliance of the oil cuts by OPEC and allies, (2) worsened geopolitical tensions in Venezuela and Libya, and (3) strong global growth stemming from the resolution of the Sino-US trade conflicts and positives in Brexit, could drive oil prices higher to the \$60-\$70/bbl. range. Our more pessimistic view of oil prices sits at \$45-\$55/bbl, taking into consideration the down side risks of excessive oil glut owing to ramp up in US oil production and non-compliance to the oil cuts agreement by OPEC and OPEC+.

Figure 9: Crude oil forecasts (\$/bbl.)



Source: Bloomberg, ARM Research

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