Crude oil: geopolitical risks are intensifying

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June, 18th 2019

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Executive summary

- Our **positive outlook** on crude oil prices is explained by geopolitical risks and tight markets during summer. However, **downside risks** intensified due to strong U.S. output growth.
- **Fundamentals:**
  - The market is now expected to record a small **deficit this year** and to be in small **surplus in 2020**.
  - The most bullish factors are again **geopolitical risks** in the Middle East and in Venezuela.
  - Longer term, prices should increase to boost investments in conventional capacity.
- **Macro and financial drivers:**
  - **Market sentiment and risk on/risk off swings** are the main drivers.
  - Deterioration of the economic cycle due to **trade limitations** and **weak macroeconomic data**. Several agencies are revising downwards their forecasts about global economic growth.
  - However, the macroeconomic environment remains supportive and characterized by adequate global growth and by fiscal and monetary policies ranging from expansionary to neutral in all areas. In China, Authorities are taking steps to support growth.

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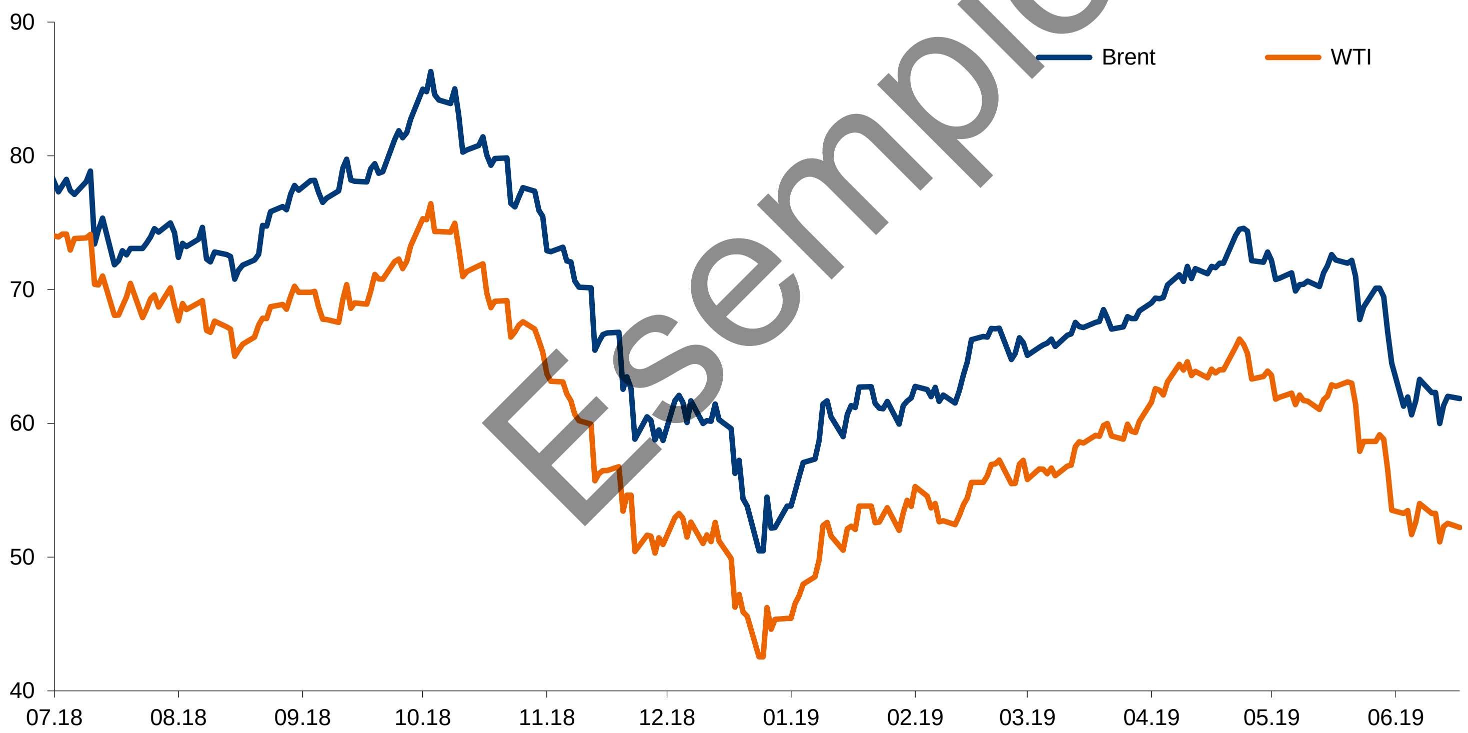
A negative market sentiment

Despite **heightened geopolitical risks**, downward pressures prevail, driven by **growing macroeconomic concerns**, a serious **deterioration in U.S.-China trade relationship**.

Brent and WTI crude prices in USD/barrel



Source: Intesa Sanpaolo on Bloomberg data

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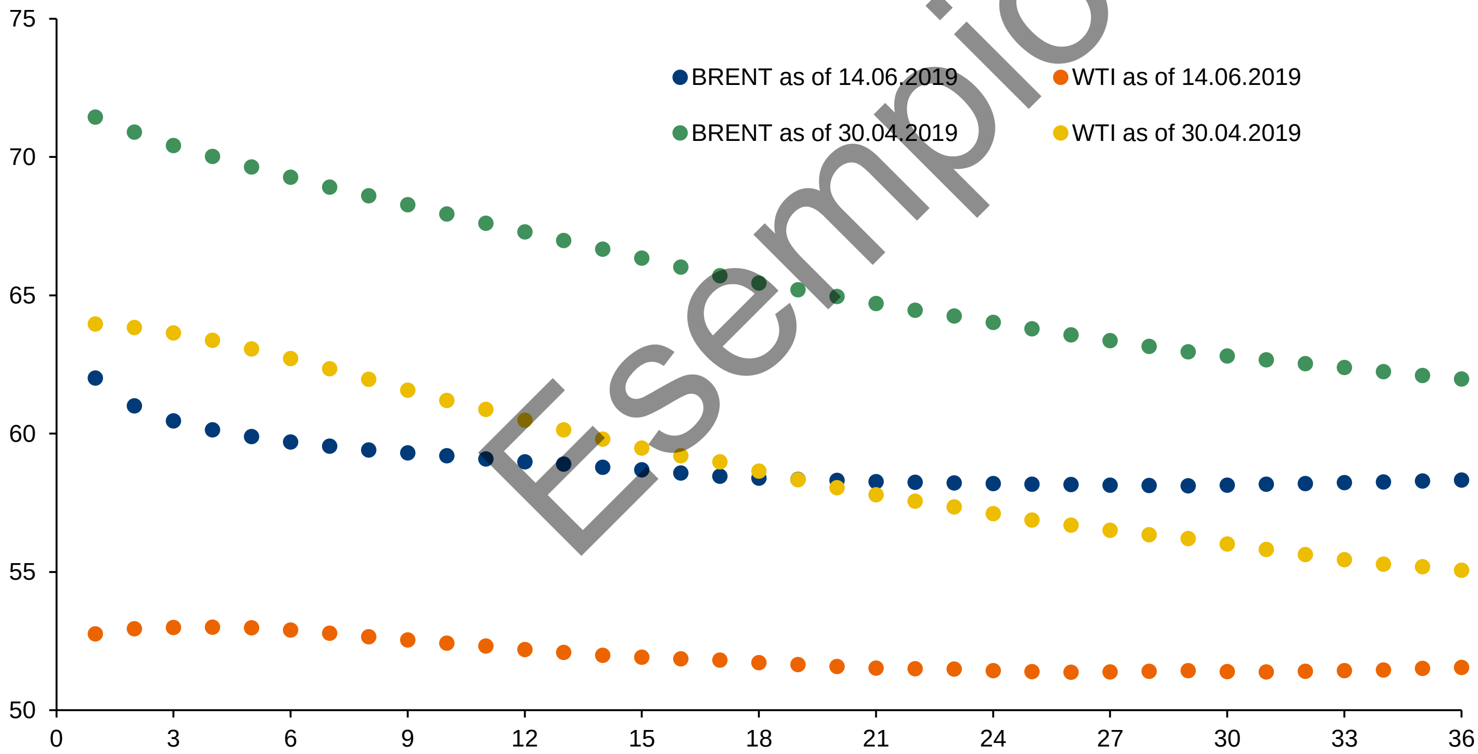
Forward curves again sending mixed signals

Again, crude forward curves are telling two different stories. The **Brent** structure remains in **backwardation**, supported by supply disruptions and the threat of escalation in geopolitical tensions. The **WTI** structure remains in **contango** amid high U.S. crude and products' stocks.

Brent and WTI forward curves in USD/barrel



Source: Intesa Sanpaolo on Bloomberg data

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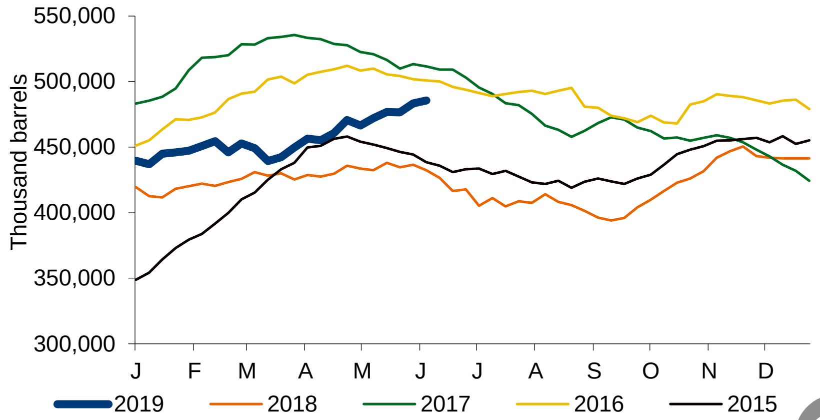
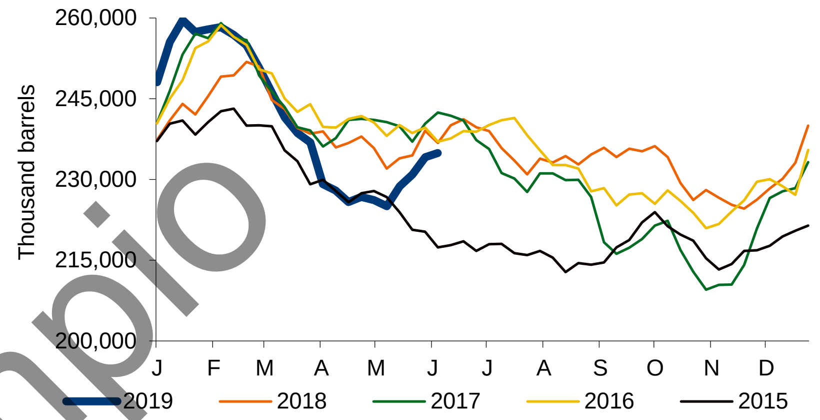
U.S. commercial inventories

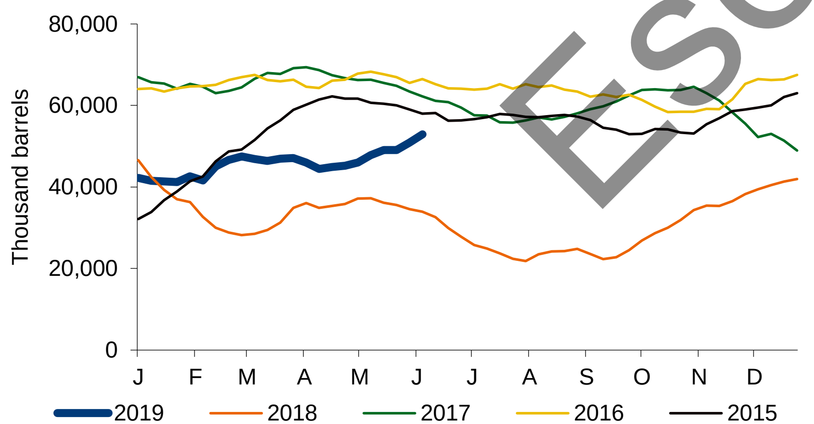
Total crude oil stocks



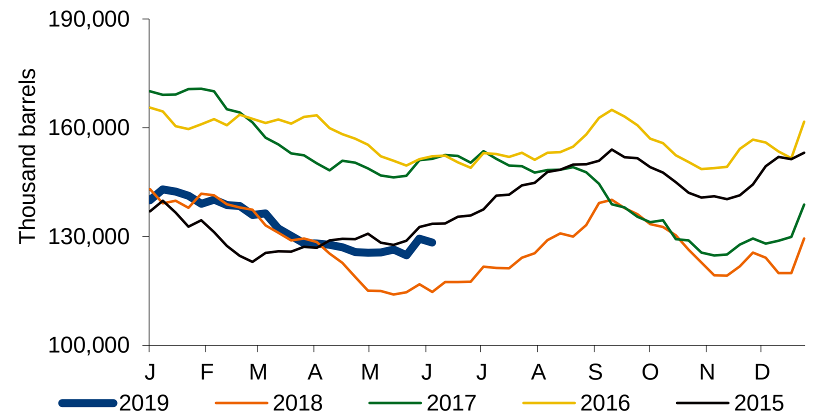
Gasoline stocks



Crude oil stocks at Cushing



Distillate stocks



Source: Intesa Sanpaolo on U.S. Department of Energy (DoE) data

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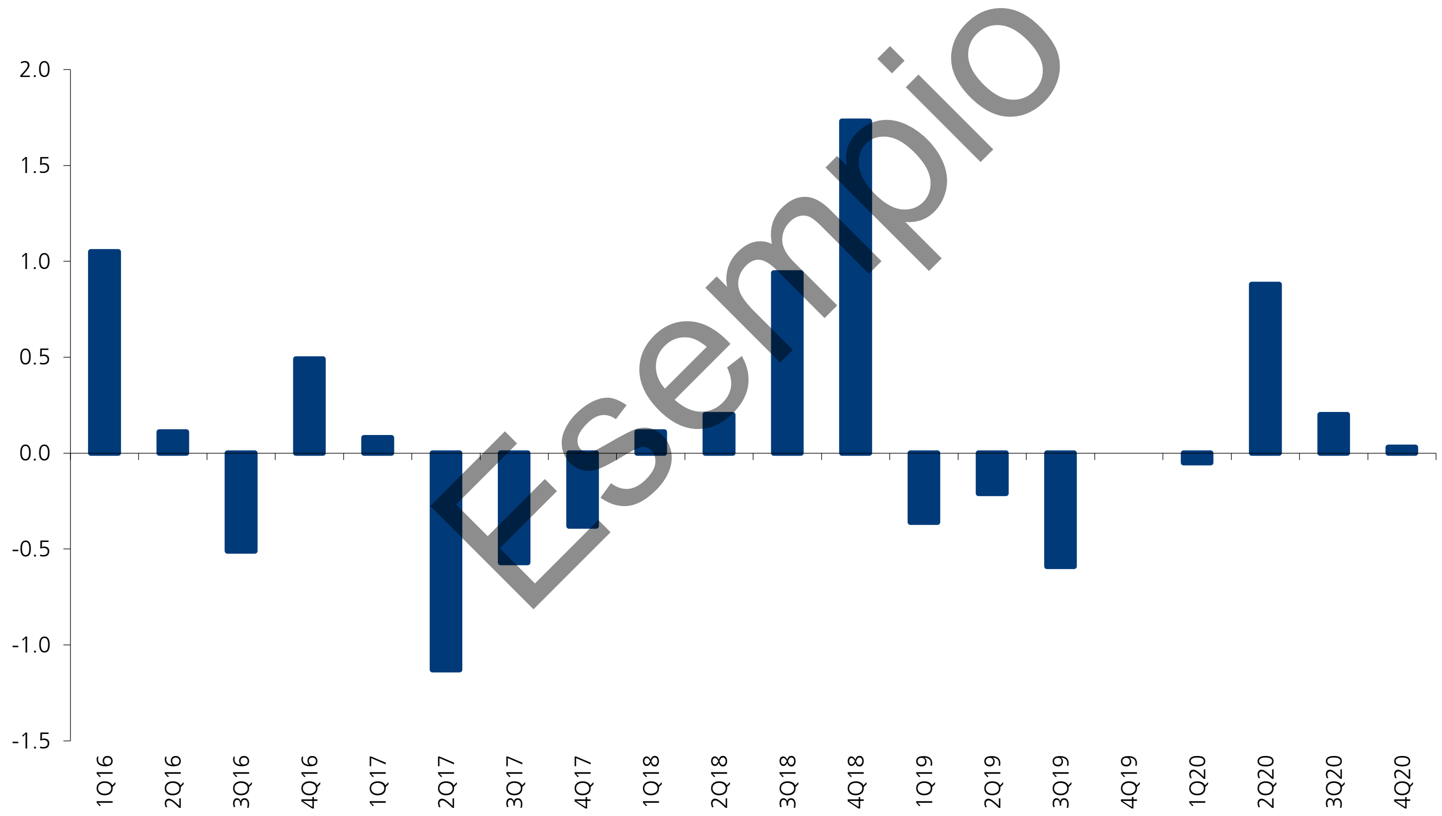
Stronger fundamentals thanks to exogenous events

Supply and demand fundamentals tightened over the past months thanks to OPEC+ cuts and exogenous events fueling supply disruptions.

U.S. Energy Information Administration (EIA), estimated global market balance in mb/d



Source: Intesa Sanpaolo on EIA data

A small surplus in 2020

Now, the market is expected to record a **deficit in 2019 (-0.3 mb/d**, unchanged from May, vs. a forecast of a 0.4 mb/d surplus formulated four months ago), but to revert into **a small surplus in 2020 (+0.3 mb/d**, up from +0.1 mb/d in May, but lower than the 0.6 mb/d surplus expected in February).

U.S. Energy Information Administration forecasts, in mb/d

US EIA, STEO JUNE 2019	World Demand	Non-OPEC Supply	US Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market balance**
2018	99.9	63.4	11.0	5.3	32.0	31.2	0.7
2019	101.1	65.5	12.3	5.2	30.2	30.4	-0.3
y/y change	*1.2*	*2.2*	*1.4*	*-0.2*	*-1.8*	*-0.8*	
2020	102.6	68.1	13.3	5.0	29.7	29.5	0.3
y/y change	*1.4*	*2.6*	*0.9*	*-0.2*	*-0.4*	*-1.0*	

Source: Intesa SanPaolo on data from the US Energy Information Administration (EIA), Short-Term Energy Outlook June 2019.
** "Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply"*
*** "Market balance = OPEC crude supply - Call on OPEC crude"*

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Still, non-OPEC supply grows more than demand

Estimates from OPEC, IEA e EIA for the year 2019				
Estimates in June 2019, in milion barrels per day	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC Crude"
OPEC	99.9	64.5	4.8	30.5
vs. 2018	1.1	2.1	0.1	-1.1
IEA	100.3	64.6	5.6	30.2
vs. 2018	1.2	1.9	0.1	-0.7
EIA	101.1	65.5	5.2	30.4
vs. 2018	1.2	2.2	-0.2	-0.8

Estimates from OPEC, IEA e EIA for the year 2020				
Estimates in June 2019, in milion barrels per day	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC Crude"
OPEC				
vs. 2018				
IEA	101.7	66.8	5.6	29.3
vs. 2018	1.4	1.9	0.0	-0.9
EIA	102.6	68.1	5.0	29.5
vs. 2018	1.4	2.6	-0.2	-1.0

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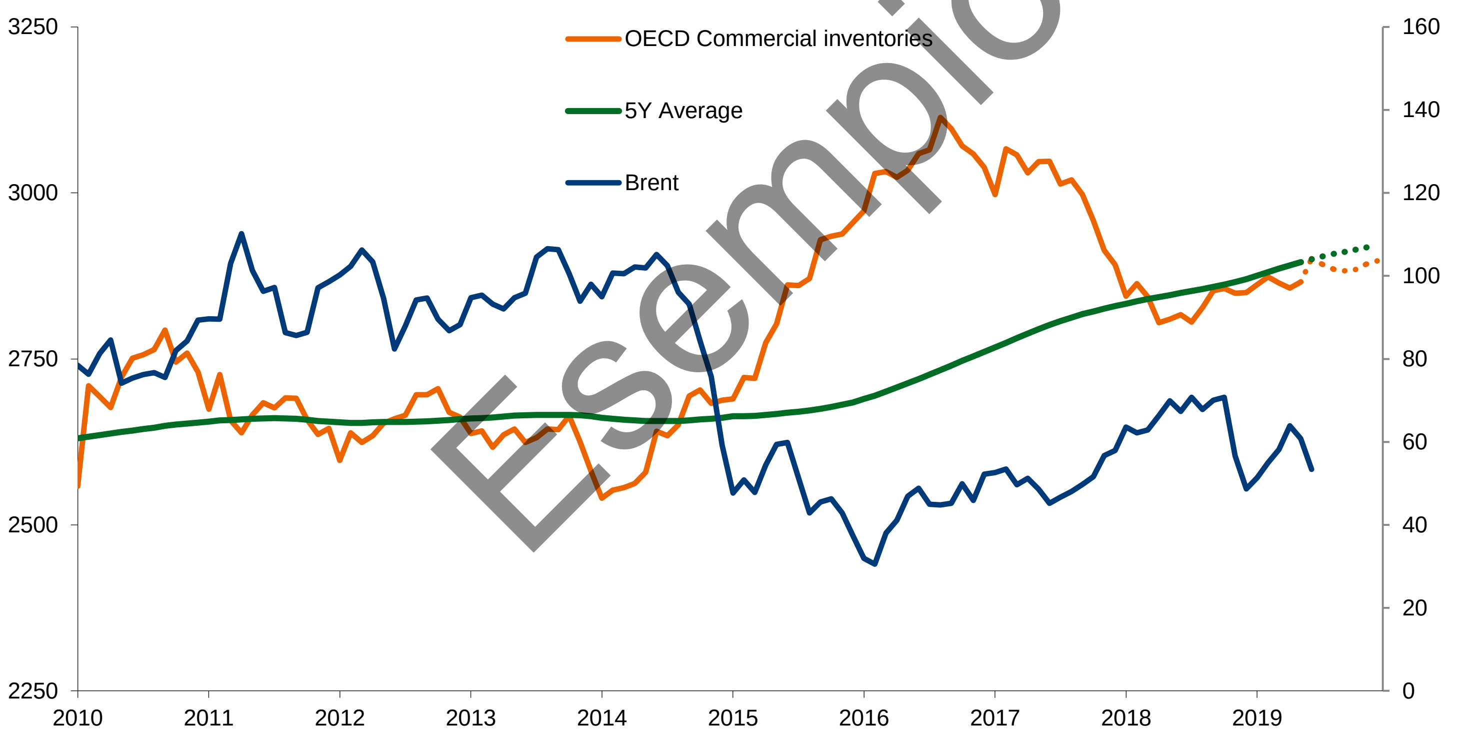
Source: Intesa Sanpaolo on OPEC, U.S. Energy Information Administration (EIA), International Energy Agency (IEA) data. June 2019 dataset

OECD stocks below their 5y average

OECD crude and oil products' stocks are expected to grow, but remain **below their 5-years average** over the next quarters.

OECD commercial stocks in mb vs. their 5-years average, Brent price (right hand scale)



Source: Intesa Sanpaolo on Bloomberg data, U.S. EIA forecasts

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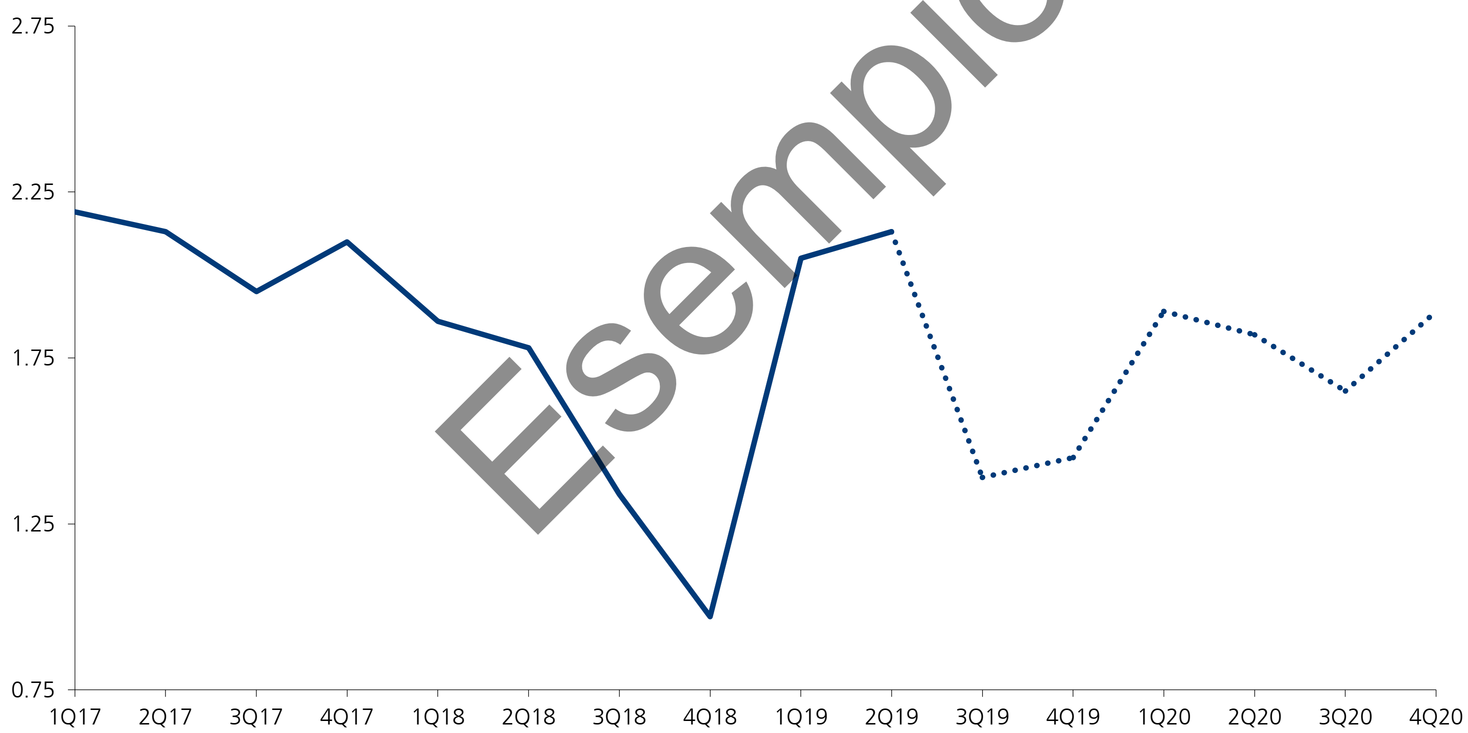
Global spare capacity set to decline

The EIA estimates that global spare capacity reached **a local peak in 2Q19** due to several sources of supply disruption.

EIA estimates of global surplus capacity in mb/d



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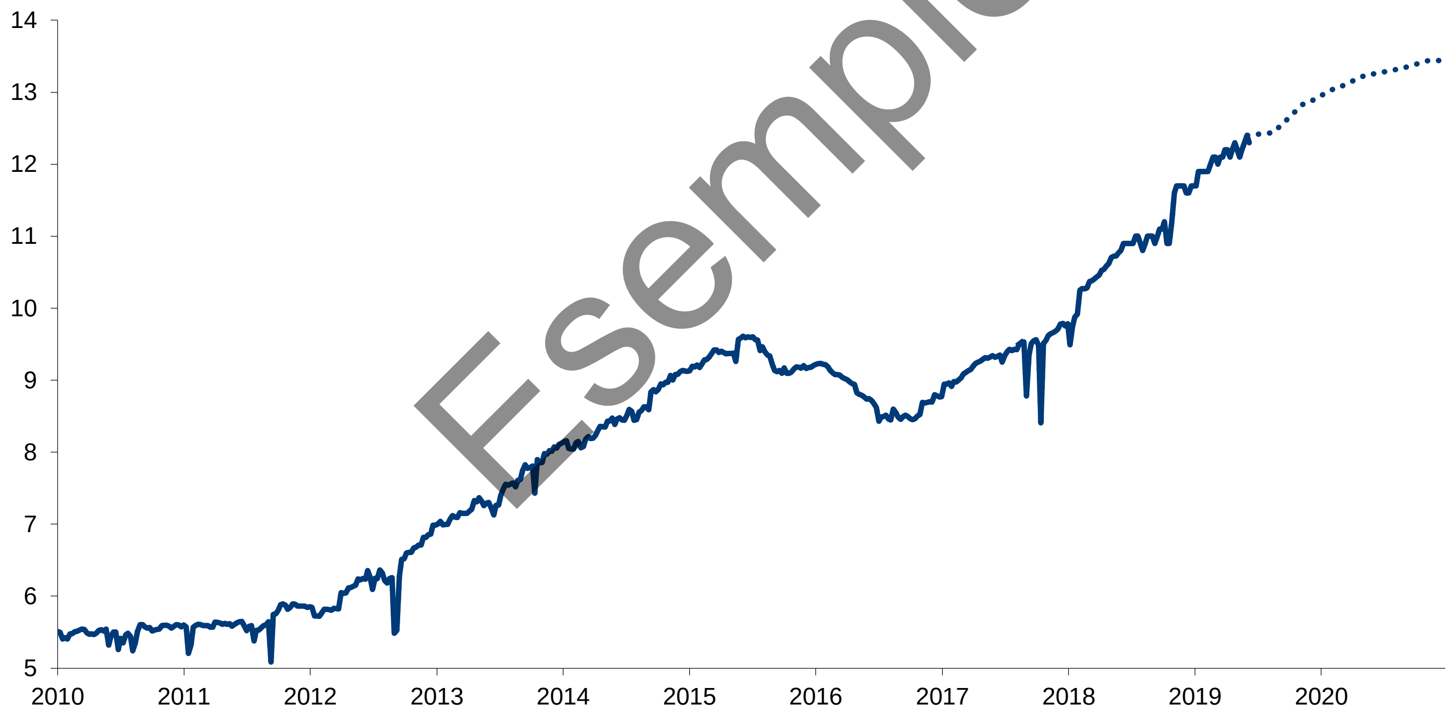
Source: Intesa Sanpaolo on U.S. EIA data

U.S. supply: stellar growth

Over the next 18 months, the U.S. output is expected to grow by 1 mb/d. It is on track to surpass the 13 mb/d threshold in 1Q20.

U.S. domestic crude production, in mb/d



Source: Intesa Sanpaolo on Bloomberg data, U.S. EIA forecasts

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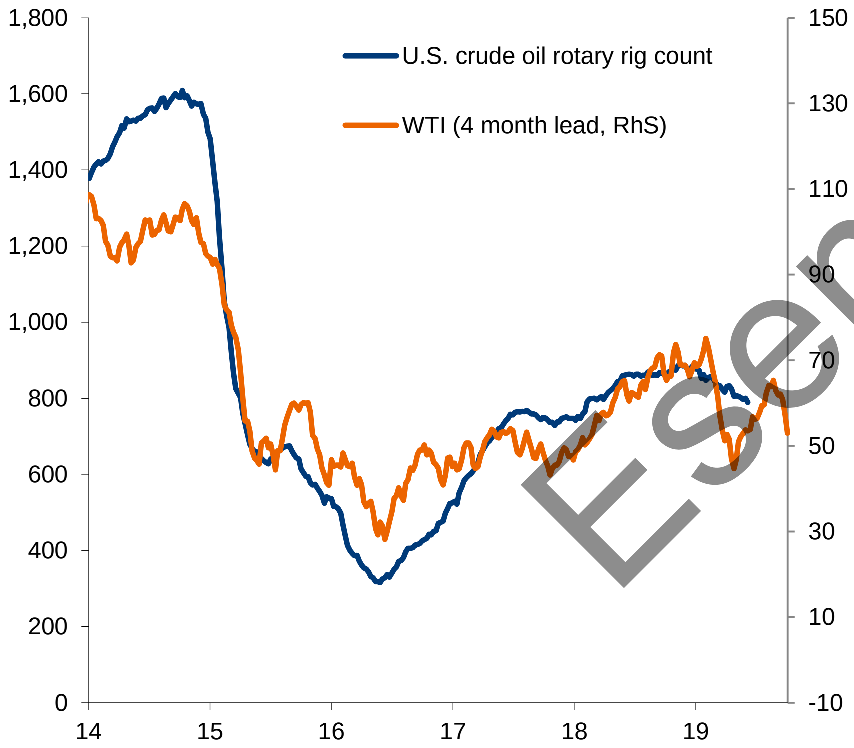
Oil rig count probably close to the bottom

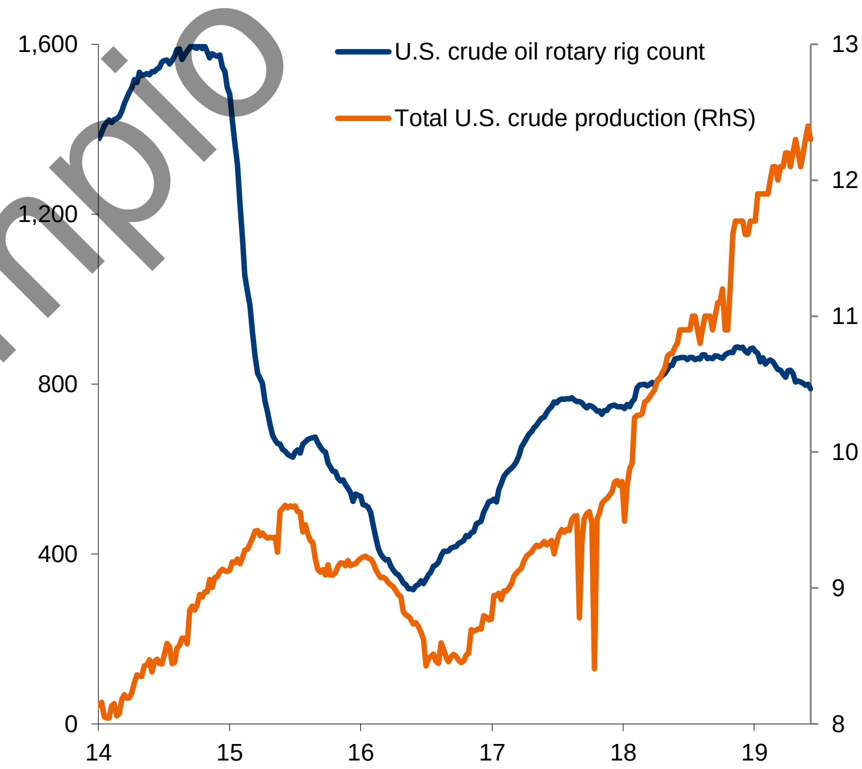
Oil rig count declined over the past quarters. We think it is close to the bottom and should remain stable over the next months.

U.S. crude oil rig count and WTI crude price



Source: Intesa Sanpaolo on Bloomberg, Baker Hughes data

U.S. crude oil rig count and U.S. crude output



Source: Intesa Sanpaolo on Bloomberg, U.S. EIA data

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Several geopolitical risks: Venezuela

- **Venezuela: a regime change?** Things have to get worse before they can get better. A pacific regime shift needs the **support of the army** and also needs the international acceptance from historical allies. Our hypotheses:

  - **A regime change will not likely take place this year** and we deem unlikely it could happen in 2020.

  - We think **China will continue to support the Maduro administration as long as the relationships with the U.S. do not improve**. In our opinion, only if China obtains big and significant concessions from the U.S. and credible pledges to repay its loans, it could abandon its strategic partnership with Venezuela.

  - Russia gains from its support to the Maduro administration, at least through an higher risk premium incorporated in oil prices and a tighter global market. Over the next months, **Russian foreign policy could become even more confrontational** to shield its economy from U.S. sanctions or tariffs and support Iran.

  - Venezuelan crude output is therefore expected to remain below its historical average over the next years.

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Several geopolitical risks: U.S.-China tensions

- **U.S.-China tensions escalated**: more trade limitations were implemented and talks suspended.

  - **U.S.-China antagonism is set to remain a structural feature** in the new global equilibria despite all the possible (but, in our opinion, unlikely) pledges to cooperate.

  - Now, **no developments are on the table** up to the G20 meeting at the end of June. Moreover, the several retaliation measures now in place will not be removed easily. Therefore, we think that **it will take a very long time** before restoring the positive mood that drove the 1Q19 commodity rally.

  - **Other issues** (political developments in North Korea and Venezuela) are **set to remain frozen** as long as trade talks do not progress in a meaningful way.

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Several geopolitical risks: Iran and the OPEC future

- **Heightened tensions in the Middle East**: several sabotage attacks were reported near the Strait of Hormuz and Yemen's Houthi rebels are more actively targeting Saudi infrastructures.

  - In our opinion, the strength of the U.S.-Saudi relationship and the recent escalation of tensions with Iran are extremely dangerous. Such unusual level of **political tensions could force actors to deviate from the preferred paths and lead to undesired consequences**.

  - We see a serious **risk of Iran abandoning the nuclear deal** and irremediably compromising its relationships with western countries.

  - If tensions between Saudi Arabia and Iran do not ease, **OPEC unity will break**, and OPEC would become largely irrelevant.

  - Apparently, **the first cracks in OPEC+ are also emerging** as Russia do not profit from the current cuts and is pushing to abandon the deal. On the contrary, Saudi wish to roll over the output limitations at least up the end of the year.

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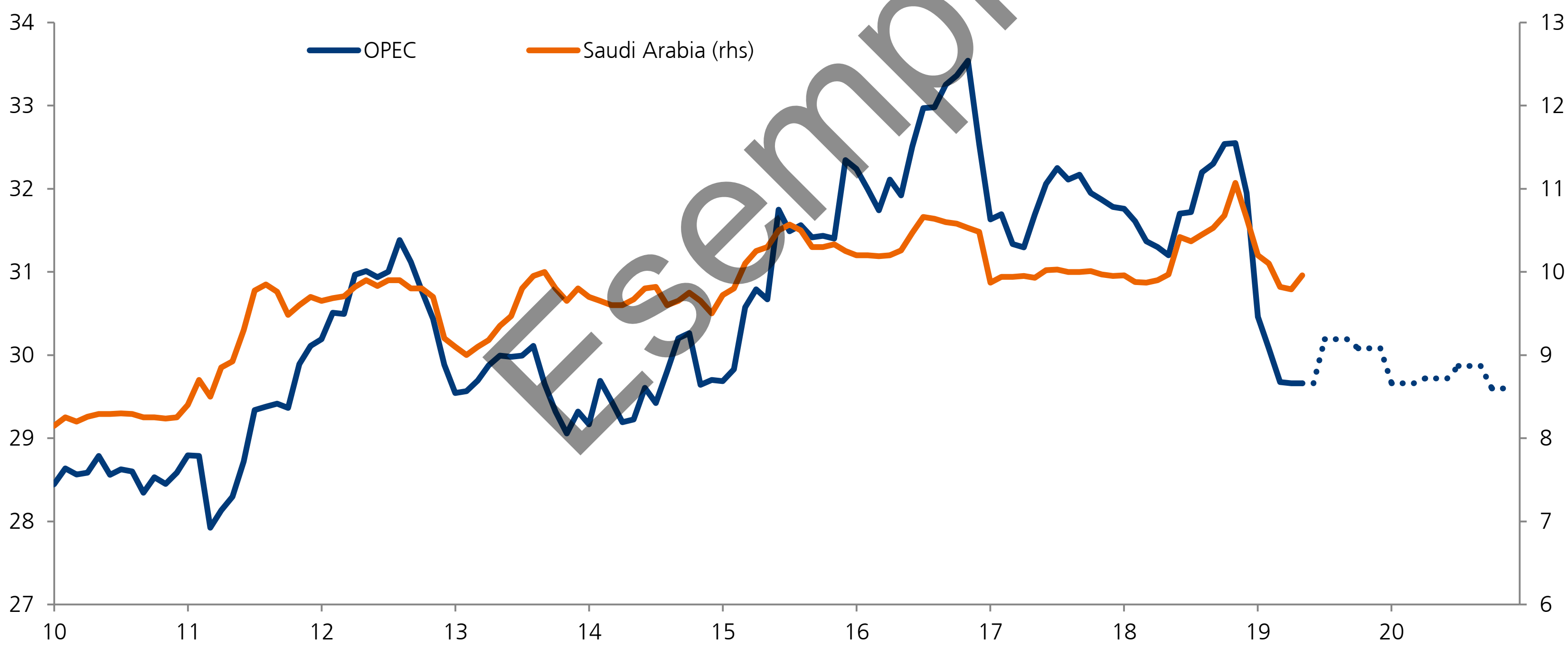
Saudi Arabia favoured by exogenous events

Few months ago, **Saudi Arabia was ready to accept a bigger burden** to maintain satisfactory levels of compliance, **but it is no longer necessary** thanks to other countries' lower output.

Cumulative OPEC output and Saudi output (right hand scale) in mb/d



Source: Intesa Sanpaolo on Bloomberg data, U.S. EIA forecasts

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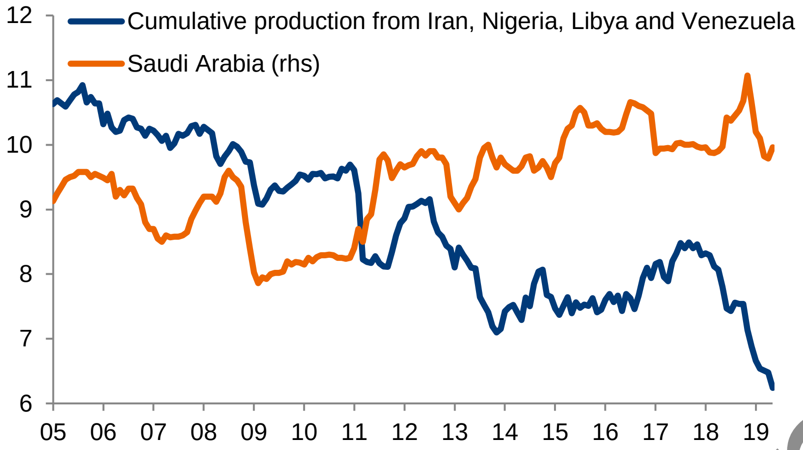
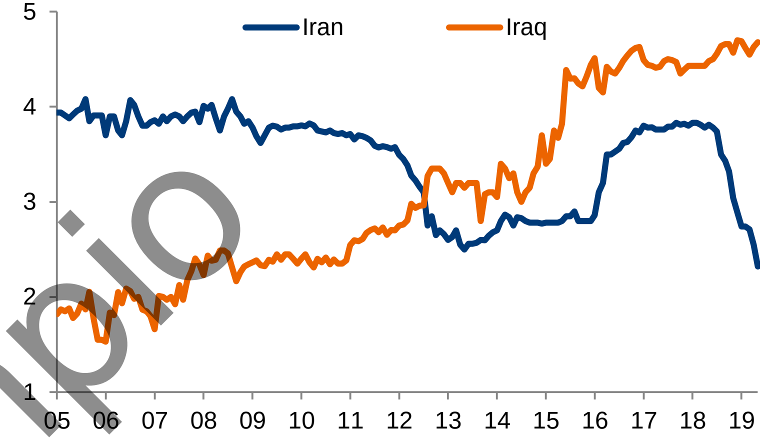
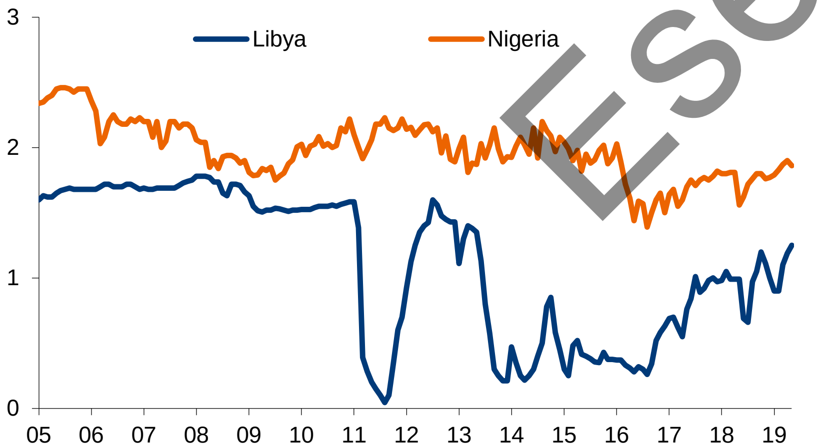
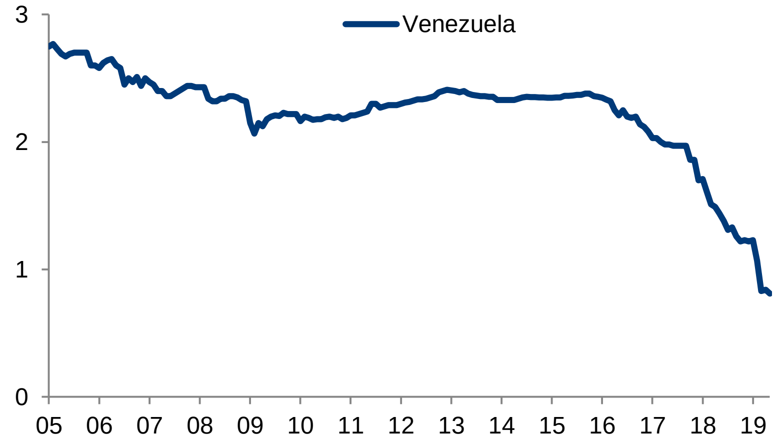
Lower output in Iran and Venezuela

Output in selected OPEC countries in mb/d









Source: Intesa Sanpaolo on Bloomberg data

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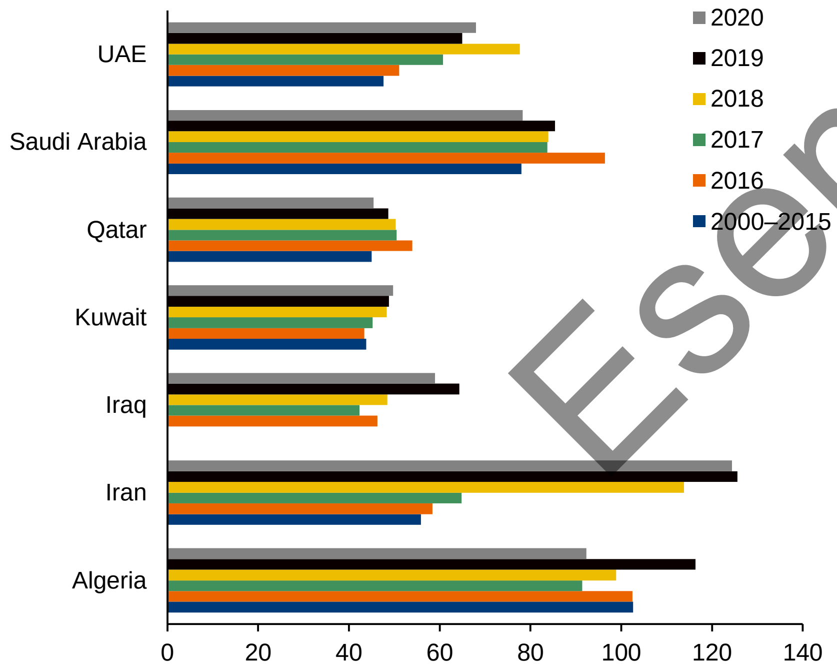
Still, Saudi Arabia needs a tight market

A stable and relatively high crude price is necessary to finance spending and attract capitals. Saudi Arabia needs both foreign investments to diversify its economy and finance its 2030 goals and U.S. support to strengthen its regional hegemony against Iran. **The fiscal breakeven oil price for Saudi Arabia has been revised upwards to 85 USD in 2019 and 78 USD in 2020**.

Fiscal Breakeven Oil Prices in USD/barrel for selected OPEC countries…



…and for MENA producers

	Average				Projections	
	2000–2015	2016	2017	2018	2019	2020
Algeria	102.6	102.5	91.4	98.9	116.4	92.3
Bahrain	74.1	105.7	112.6	118.4	94.9	93.0
Iran	55.9	58.4	64.8	113.8	125.6	124.4
Iraq	…	46.3	42.3	48.5	64.3	59.0
Kuwait	43.8	43.4	45.2	48.3	48.8	49.7
Libya	70.4	244.5	102.8	77.9	71.3	79.0
Oman	62.4	101.1	91.1	101.1	97.0	85.9
Qatar	45.0	54.0	50.5	50.3	48.7	45.4
Saudi Arabia	78.0	96.4	83.7	83.9	85.4	78.3
United Arab Emirates	47.6	51.1	60.7	77.7	65.0	68.0
Yemen	197.1	364.0	125.0	…	...	...

Source: Intesa Sanpaolo on IMF Regional Economic Outlook Middle East and Central Asia, April 2019

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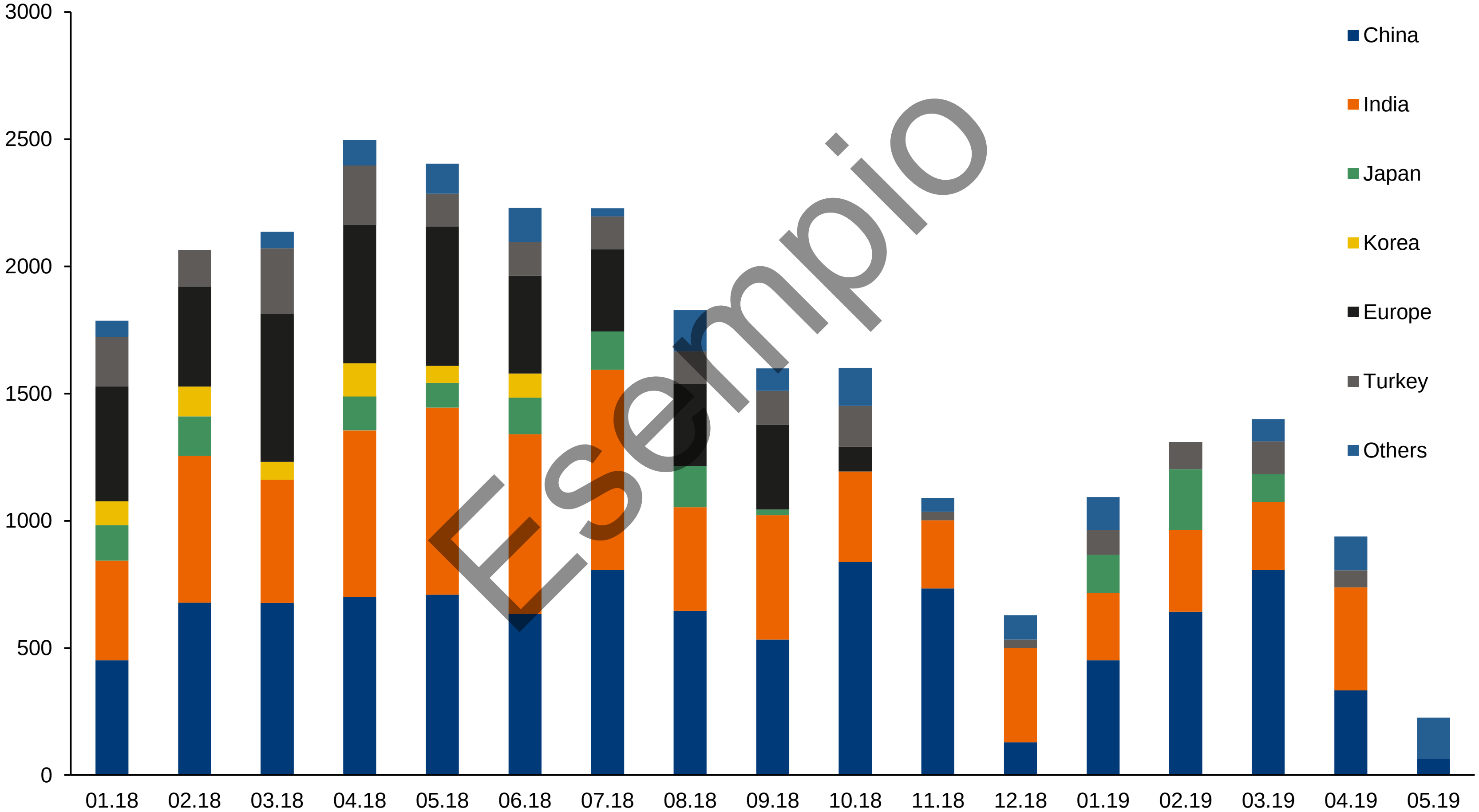
Iran: U.S. waivers came to an end

Iranian crude exports to selected countries



Source: Intesa Sanpaolo on Bloomberg data, thousand barrels per day

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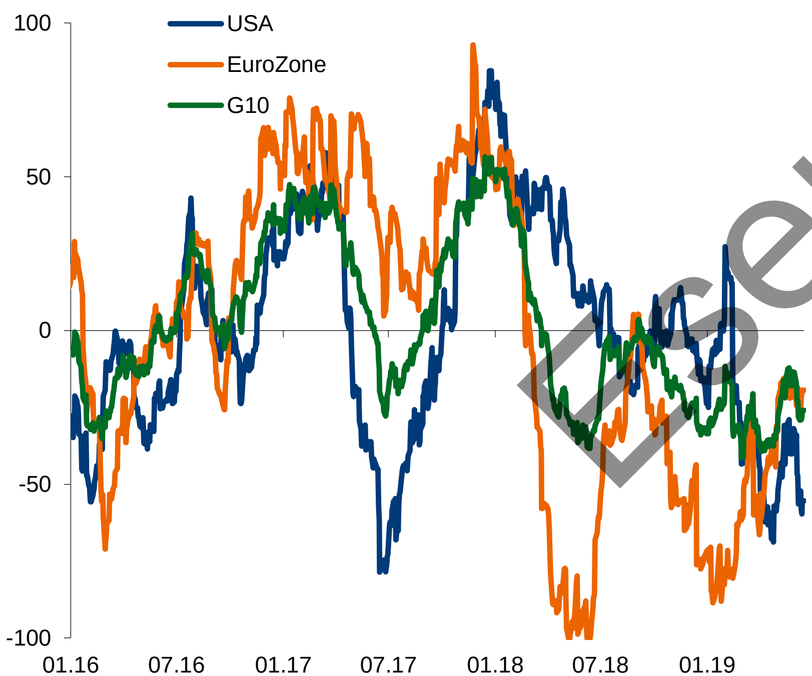
Optimism is fading away

In most areas, macroeconomic surprises remain negative. In China, some data surpassed expectations but still indicated a slowdown.

Citi economic surprise indexes for developed…



Source: Intesa Sanpaolo on Citi data

…and emerging markets

Source: Intesa Sanpaolo on Citi data

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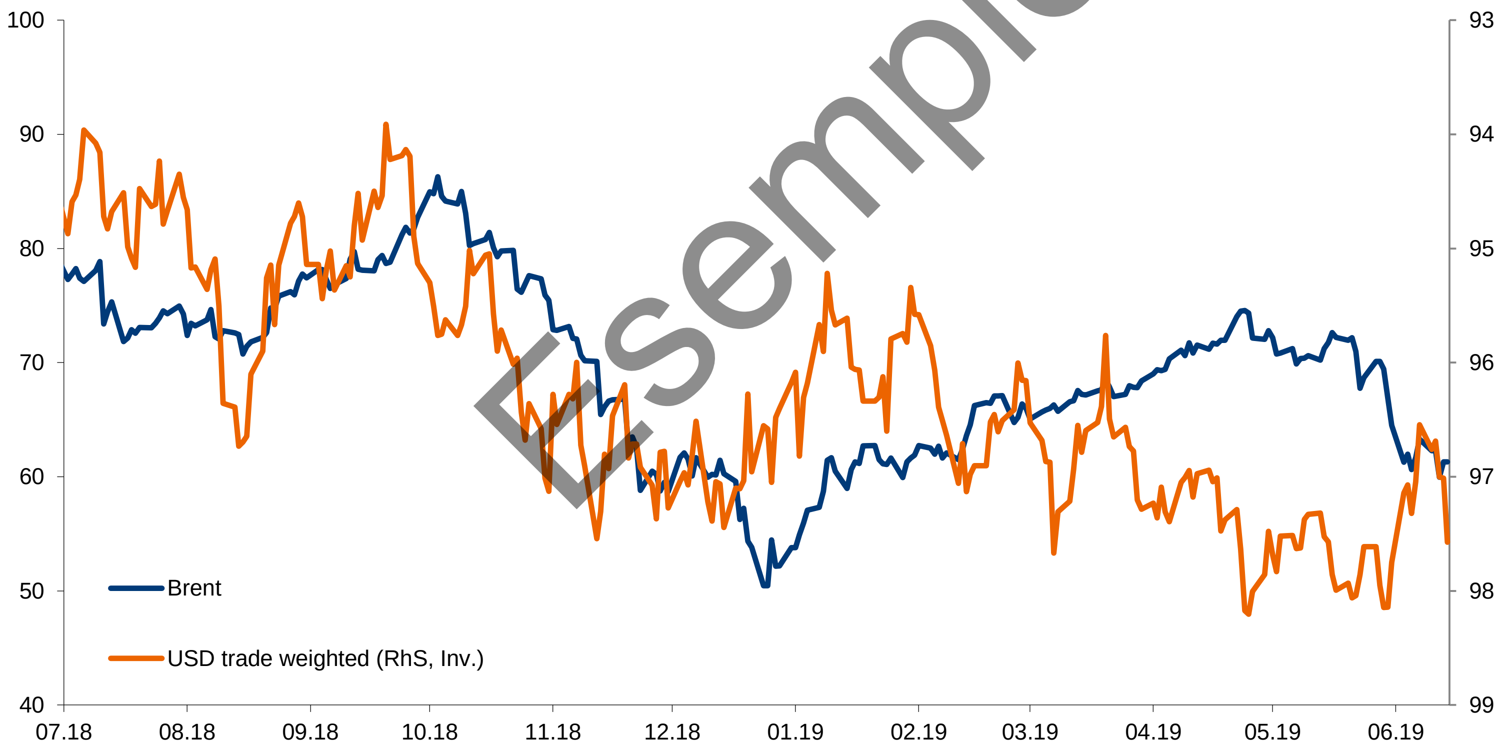
Correlation with the U.S. dollar

The negative correlation between crude oil and the U.S. dollar could resume strength. Between late January and late April, the geopolitical risk premium shielded crude prices from negative pressures related to a stronger than expected U.S. dollar and a fragile macroeconomic environment.

Brent and trade weighted U.S. dollar



Source: Intesa Sanpaolo on Bloomberg data

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Our baseline scenario

In our baseline scenario, crude prices are expected to trade in a relatively wide range over the next months: we expect **more volatility** and **frequent price swings** driven by market sentiment.

- Overall, **appetite for risk is deeply influenced by expectations about future developments on the U.S.-China tensions**.

- If market participants focus on stubbornly **high level of global stocks** and concerns that the **ongoing U.S.-China trade war** will negatively affect global commodity demand, downward pressures will prevail.

- If market participants focus on **current supply disruptions** and **geopolitical risks**, upward pressures will prevail. However, the upside potential on crude prices is limited by high global stocks and by the fact that non-OPEC output growth is overperforming global demand growth.

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Our price forecasts

ICE BRENT		3Q19	4Q19	2019	2020	2021	2022
17/06/2019	**ISP forecasts**	67.0	70.0	67.2	70.0	70.0	68.0
17/06/2019	BBG Median	70.0	70.0	67.8	68.0	67.0	68.0
18/06/2019	Forward	59.6	58.9	62.4	58.3	57.8	58.1

NYMEX WTI		3Q19	4Q19	2019	2020	2021	2022
17/06/2019	**ISP forecasts**	58.0	62.0	58.4	64.0	66.0	64.0
17/06/2019	BBG Median	62.0	62.3	61.0	61.6	62.9	63.8
18/06/2019	Forward	58.9	52.2	55.3	51.7	51.1	51.4

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Source: Intesa Sanpaolo forecasts and Bloomberg data

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Valuation Methodology

This document has been prepared in accordance with the following method.

Macroeconomic Data

Comments on macroeconomic data are prepared based on macroeconomic and market news and data available via information providers such as Bloomberg and Thomson Reuters-Datastream. Macroeconomic and interest rate forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated econometric models. Forecasts are obtained using analyses of historical-statistical data series made available by the leading data providers and also on the basis of consensus data, taking account of appropriate connections between them.

Forecasts in the Energy Sector

Comments on the Energy Sector are prepared based on macroeconomic and market news and data available via information providers such as Bloomberg and Thomson Reuters-Datastream. Unless otherwise stated, consensus estimates come from the leading international energy Agencies, primarily the IEA (International Energy Agency – which deals with this sector on a global scale), the EIA (Energy Information Administration – an institute that deals specifically with the US energy sector) and OPEC. Forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated models.

Forecasts in the Metals Sector

Comments on the Metals Sector are prepared based on macroeconomic and market news and data available via information providers such as Bloomberg and Thomson Reuters-Datastream.

Unless otherwise specified consensus estimates on precious metals come mainly from GFMS, the long-established forecasting agency based in London. The forecasts cover gold, silver, platinum and palladium. Forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated models.

Unless otherwise stated, consensus estimates for industrial metals come mainly from Brook Hunt, an independent forecasting agency which has prepared statistics and predictions on metals and minerals since 1975, and from the World Bureau of Metal Statistics (WBMS), an independent research body on the global market of industrial metals which publishes a series of monthly, quarterly and annual statistical analyses. Forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated models.

Forecasts in the Agricultural Sector

Comments on the Agricultural Sector are prepared based on macroeconomic and market news and data available via information providers such as Bloomberg and Thomson Reuters-Datastream.

There are several consensus estimates on agricultural products. Each individual country has its own internal statistics agency that estimates and forecasts crops, production capacity, the product supply quantities and, above all, the amount of land available for cultivating a particular product, in both absolute and percentage terms.

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At an international level, the main agencies are: the USDA (United States Department of Agriculture) which, in addition to providing data on the US territory, also deals in general with the grain industry worldwide through the FAS (Foreign Agricultural Service); the Economist Intelligence Unit of the Economist Group which deals with all agricultural products on a global scale; and CONAB (Companhia Nacional de Abastecimento), the Brazilian Government agency that deals with agriculture (with a particular focus on coffee) and which also provides some insight into the entire South America.

Forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated models.

Technical levels

Comments on technical levels are based on market news and data available via information providers such as Bloomberg and Thomson Reuters-Datastream. Interest rate technical level forecasts are prepared by the Intesa Sanpaolo Research Department, using dedicated technical models. Forecasts are obtained using analyses of historical-statistical data series made available by the leading data providers and also on the basis of consensus data, taking account of appropriate connections between them. There is also a further in-depth study linked to the choice of appropriate derivatives that best represent the sector or the specific commodities on which one intends to invest.

Recommendations

Negative Outlook: a Negative Outlook recommendation for a sector is a wide-ranging indication. It not only indicates deteriorating price conditions of the indices or futures that best represent the commodity in question (thus the reduction of a price performance), but it also implies the deterioration in the forecasts on production, weather and input supplies (like water or energy) that characterize these sectors more than other financial instruments.

Neutral Outlook: a Neutral Outlook recommendation for a sector is an indication that includes a multitude of aspects. It indicates that the combination of price forecasts of indices and futures and all the conditions of production, weather and input supplies (like water or energy) will lead to a sideways movement in prices or inventories or production capacity, recording, therefore, void or minimum performances for the sector under examination.

Positive Outlook: a Positive Outlook recommendation for a sector is an indication covering a wide range of areas. It not only indicates net improvements in price conditions of the indices or futures that best represent the commodity in question (thus a positive price performance), but it also implies the improvement in the forecasts on production, weather and input supplies (like water or energy) that characterize these sectors more than other financial instruments.

Frequency and validity of forecasts

Market indications refer to a short period of time (the same day or the following days, unless stated otherwise in the text). Forecasts are developed over a time span of between one week and 5 years (unless specified otherwise in the text) and have a maximum validity of three months.

Disclosure of potential conflicts of interest

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