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STRATEGY NOTE

THE OIL MARKET:

Awaiting Demand

NBK CAPITAL
INVESTMENT STRATEGY & ADVISORY

HIGHLIGHTS

- After the start of the oil price decline in late 2014, **traditional oil producers led by OPEC opted to continue their pump-at-will policy in an effort to maintain market share,** increase revenue, and drive out high cost producers and ultimately benefit from a price rebound once global demand recovers

- Fast forward a year and a half later, oil prices continued their decline dipping below USD 30 per barrel by January 2016 with inventory reaching record levels amid sluggish global demand

- **OPEC and non-OPEC countries unable to sustain the status quo came to an agreement in November 2016** to cut production starting in January 2017 by 1.8 million b/d for a period of six months which the market interpreted as a positive step forward and prices quickly rallied to over USD 50pb

- **Despite a record compliance level with the agreement**, a large part of the cut was offset by accelerated production by US shale companies. The rig count continued to push upwards and with it the market skepticism that the supply glut would be absorbed resulting in renewed weakness in prices levels

- As supply numbers showed no sign of the oil market rebalancing, **Kuwait led the call for an extension of the November 2016 agreement into the second half of 2017** eventually finding support from KSA and Russia with **possible talks of an extension that goes beyond year-end and into Q1 2018**

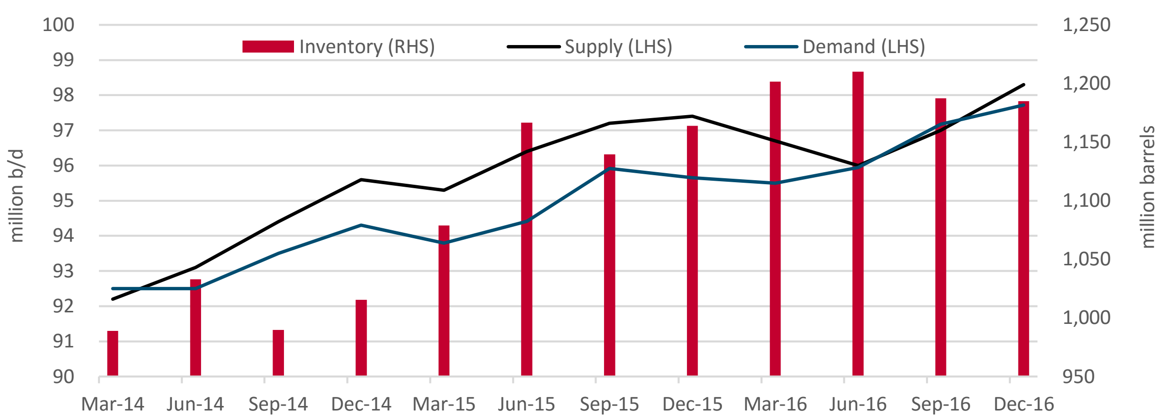
- Shale producers across the US, many of whom have used the rally earlier in the year to lock-in their sales prices in the derivatives market well into 2018, **have adapted to low prices, cutting their production costs through technological advancement and increased operational efficiency becoming less sensitive to low oil prices**

- Market dynamics over the past couple of years is proving that the major part of the problem is on the demand side, and that even though controls on the supply side would help in stabilizing prices in the short term, they are far from effective in the long term. **Traditional producers no longer have the upper hand in controlling the market**, **and until we see a sustained improvement in global energy demand, oil prices will remain weak and vulnerable to short-term market data**

BACKGROUND

As oil prices began dropping in mid-July 2014, oil-producing countries began to feel a pressure they had last felt in 2008 when oil dropped from a high of USD 146.08pb to a low of USD 40pb in a matter of 6 months. As 2016 ushered in new lows of USD 27.88pb, oil producers' budgets quickly turned from surpluses to deficits. Yet they continued their pump-at-will policy in an effort to gain market share and increase revenue. Coupled with demand lagging behind supply over the past few years, this resulted in a large increase in inventory levels, applying further downward pressure on prices. By early Q3 2016 OPEC and non-OPEC countries realized that this continued state of low oil prices was taking a toll on their economies, diminishing reserves, and creating social problems. In Q4 2016, OPEC rushed to formalize an agreement to cut production with major oil producers outside of the block, mainly Russia, in an effort to reduce global inventory and increase prices. In November, an agreement was struck; this resulted in an immediate spike in prices followed by a rally through the end of the year. With prices relatively higher and stable during the first two months of 2017, it seemed OPEC had accomplished its goals. In March 2017, data confirming increased production from the US and little changed global inventory levels caused prices to falter, casting doubt over OPEC's ability to maintain cuts within the block and with other non-OPEC countries. As Q2 began, prices again fluctuated and talks of extending the November agreement began to emerge as production, inventory and prices were far from balanced.

Chart 1: Global Inventory Levels vs Supply & Demand



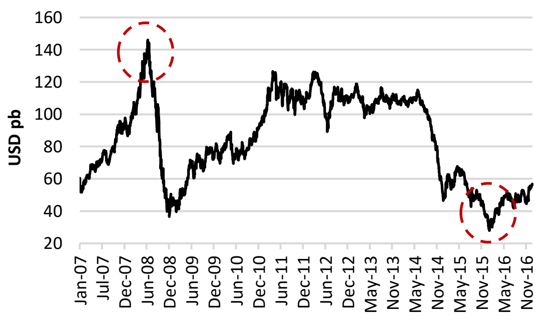
Source: US Energy Information Agency (EIA)

THE PRICE OF OIL

Oil prices fluctuated drastically between December 2006 and December 2016. At the start of this period, Brent was priced at USD 60.44pb while in December 2016 it stood at USD 56.82pb. Oil prices reached a high of USD 146.08pb in July 2008 and a low of USD 27.88pb in January 2016. From January 2007 through December 2016 the average volatility for oil prices was 32.4% compared to 18.3% for the S&P 500. While oil prices tend to be more volatile than the

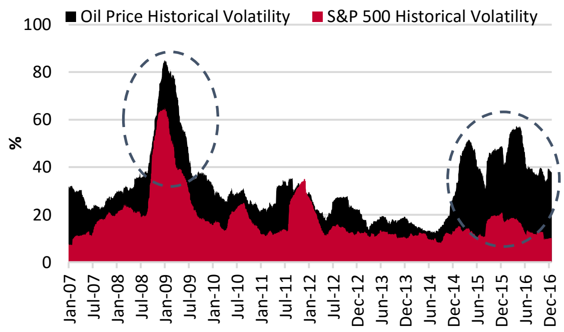
S&P 500, the spread widened significantly during the global financial crisis and later in 2015 and 2016. During the financial crisis, both oil prices and the S&P 500 experienced heightened volatility spiking at 84.9% and 65.0%, respectively. The next period of significant volatility was more recent during 2015 and 2016. While neither oil nor the S&P 500 experienced volatility levels similar to those in early 2009, the spread did widen to 29% compared to the 10-year average of 14.0%, directly attributable to oil price volatility.

Chart 2: Oil Production: OPEC vs Global



Source: Bloomberg

Chart 3: 90 Day Annualized Historical Volatility

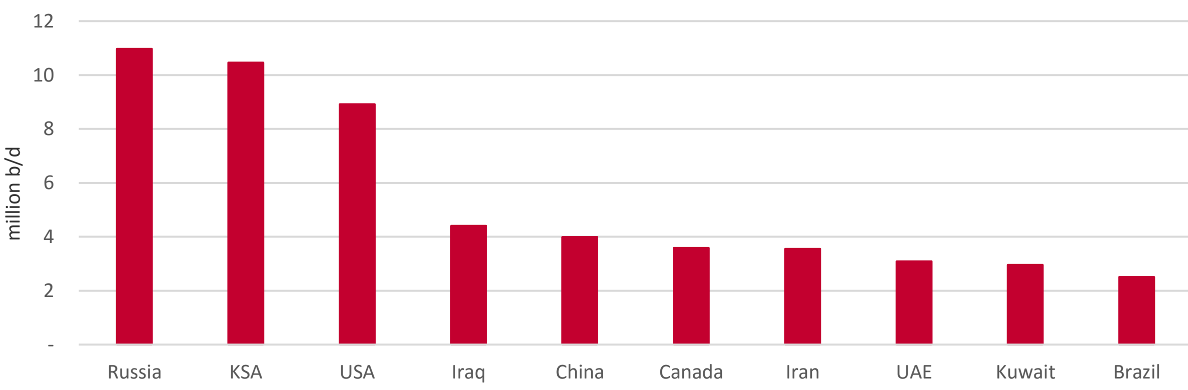


Source: Bloomberg

LEADING UP TO THE AGREEMENT

Over the last 10 years, global production has increased by an average of 1.6% per annum, increasing from 83.2mb/d in 2007 to 95.1mb/d in 2016. The top ten global producers accounted for 56.9% of global production in 2016. Of these, Russia, Saudi Arabia (KSA) and the US are by far the largest with outputs of 10.97mb/d, 10.46mb/d and 8.92mb/d respectively.

Chart 4: Top Ten Global Producers in 2016

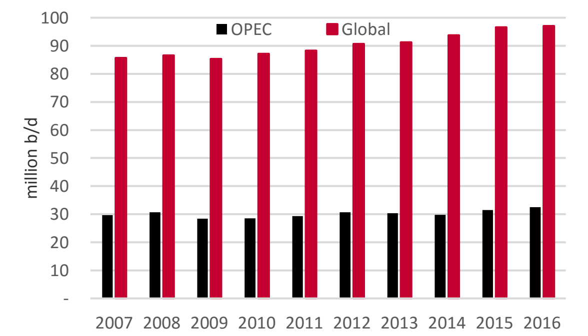


Source: Energy Intelligence Group (EIG)

OPEC

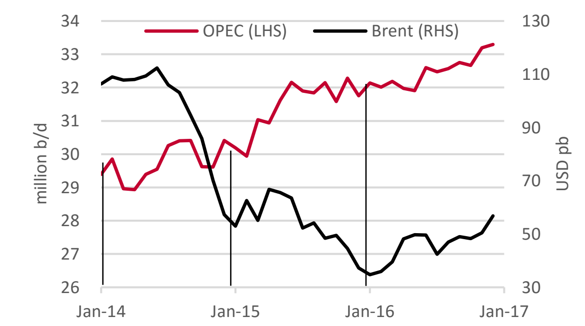
The Organization of the Petroleum Exporting Countries, otherwise known as OPEC is a group of 13 countries together forming the largest block of oil producers. Five of the top 10 global producers are members of OPEC and account for just over 70% of OPEC's total production. In turn, OPEC as a whole accounts for over 30% of global production. From the initial drop in oil prices in July 2014 until November 2016, OPEC continued to produce oil under their pump-at-will policy in an effort to increase market share and increase revenue. The low price of oil forced certain countries to tap into their sovereign wealth funds, trim subsidies to citizens, and even revert to international debt markets to meet budgetary requirements. During the first six months of 2016, OPEC's rhetoric revolved around formalizing an agreement to cut production, which somewhat helped prices to rally from the low of January 2016.

Chart 5: Oil Production: OPEC vs Global



Source: EIG and International Energy Agency (IEA)

Chart 6: OPEC's Oil Production vs Brent Price



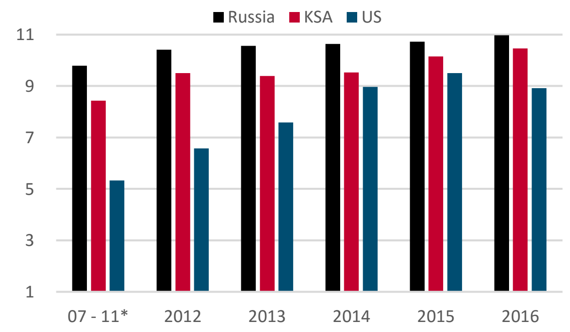
Source: EIG and Bloomberg

Rest of the World

The largest oil producers outside of OPEC are Russia, US, China, Canada, and Brazil. Russia on a standalone basis produces oil at an average rate greater than that of KSA. In the past, Russia tried to work with OPEC to stabilize prices, such as in 1998, 2001, 2008, and more recently in 2016. Unfortunately, the agreements have rarely held, with Russia reneging on their commitment more often than not. Similar to OPEC, Russia increased output as prices dropped. In 2014, it was producing an average of 10.6mb/d, which increased to 10.7mb/d in 2015 and further increased to 11.0mb/d in 2016.

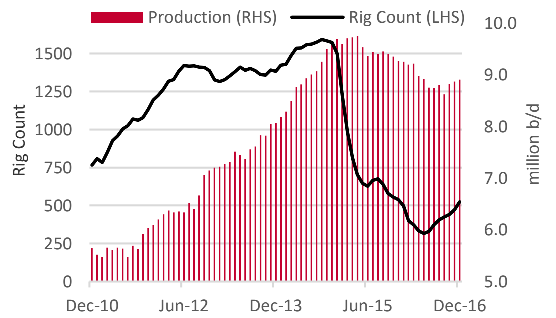
The US is also a large producer but unlike Russia, production is fragmented between thousands of producers. In recent years, as technologies and efficiencies have made shale production more feasible, the US's overall production has increased to levels comparable to both Russia and KSA at 9mb/d. In 2014, US crude and shale production averaged 8.9mb/d while US rig count peaked at 1,592 in September 2014. As oil prices began falling in mid-2014, the rig count followed and dropped precipitously to a low of 316 in May 2016. From this perspective OPEC and Russia's pump-at-will policy pushed out high cost US producers; although US production did not decline in line with the drop in rigs. It was not until 2016 that US production dropped slightly, reverting to its 2014 average.

Chart 7: Annual Average Monthly Production: Russia, KSA, & US



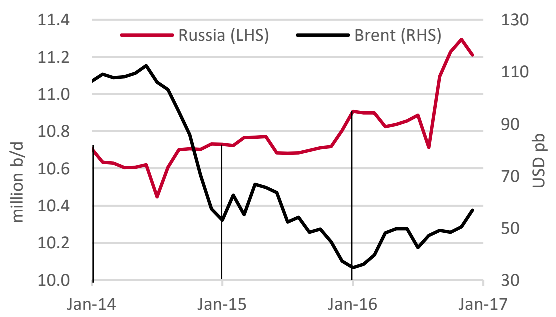
*Source: EIG   *Note: represents the average between 2007 - 2011*

Chart 8: US Rig Count vs US Crude/Shale Production



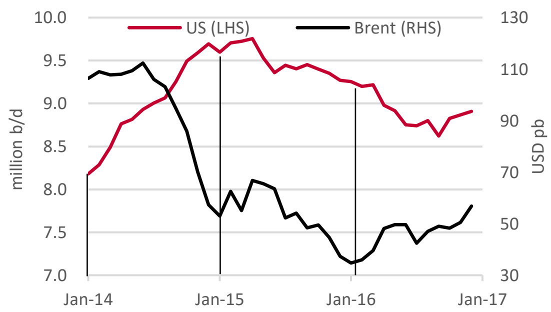
Source: EIG and Bloomberg

Chart 9: Russia Oil Production vs Brent Price



Source: EIG and Bloomberg

Chart 10: US Oil Production vs Brent Price



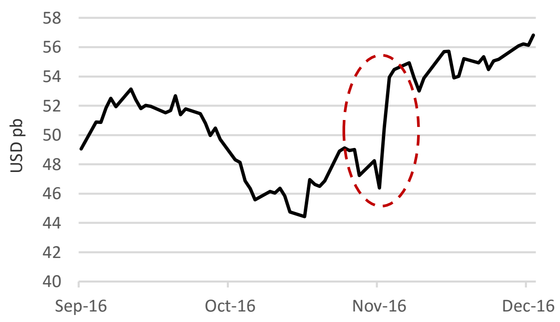
Source: EIG and Bloomberg

THE AGREEMENT

By the end of Q3 2016, OPEC and non-OPEC countries realized that the current market environment was not sustainable. Production reached new highs, inventories were accumulating, and the price of oil was not adjusting upwards to an acceptable level. In late November, OPEC and non-OPEC countries reached an agreement on cutting production in 2017. The agreement called for a cut of 1.8mb/d beginning in January 2017 for a period of six months with the option to renew for an additional six months in June of 2017. OPEC would reduce production by 1.2mb/d while Russia and other non-OPEC countries would cut production by 0.6mb/d.

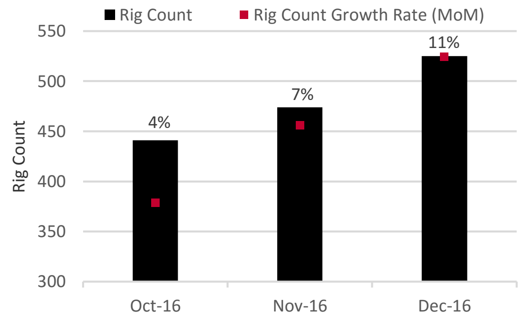
As a result, oil prices began to rally and within two trading days Brent increased 16.3% from USD 46.38pb to USD 53.94pb. By the end of 2016, oil was trading at USD 56.82pb, up 104% from the low of USD 27.88pb in January 2016. In the US, and during the months leading to the agreement, the rig count started to grow steadily reaching 525 by year end 2016.

Chart 11: Brent Price in Q4 2016



Source: Bloomberg

Chart 12: US Rig Count and Growth Rate



Source: Bloomberg

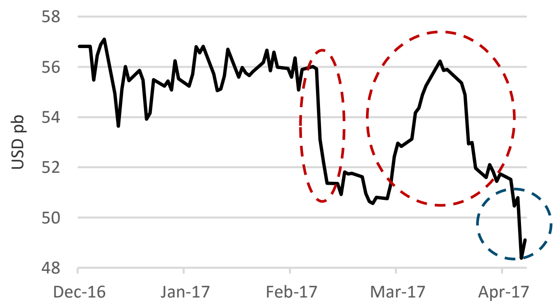
POST AGREEMENT AND 2017

At first, markets were unsure of whether countries would commit to the cuts. As time progressed, data from secondary sources showed OPEC and Russia were holding to the agreement. As a result, oil prices remained stable at around USD 54pb. In March, oil prices began to falter, dropping 8% in a matter of three days. The drop in prices was a direct result of increased US production and unchanged or increasing inventory levels. Markets began to doubt OPEC's ability to maintain cuts and support prices in the face of US production.

By mid-April, oil prices had rebounded up to USD 56pb due to several factors including disruption in oil production in Libya because of a blocked pipeline and the increase in geopolitical tensions after the US airstrikes in Syria. Further supporting the rally was the call, led by Kuwait, to extend production cuts for an additional six months. This did not gain traction or public support from either KSA or Russia until early April.

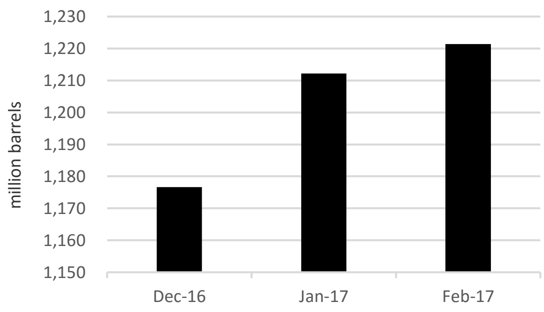
By the end of April and early May, prices retreated to the USD 50pb, breaking the 50 price level for the first time on May 4th. This drop comes on the back of the market's perception that OPEC will not be able to bring global crude inventory levels down to its target level.

Chart 13: Brent Price in 2017



Source: EIA and Bloomberg

Chart 14: Global Crude Inventory Levels



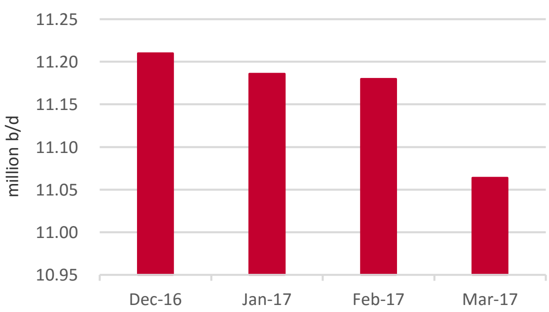
Source: IEA

With the exception of Nigeria, every member of OPEC actually cut production over a period of three months, from January 2017 through March 2017. The largest three to cut production were KSA, Iraq, and UAE. Overall, KSA bore the weight of OPEC's cut, trimming its own production by 0.6mb/d thus exceeding their commitment towards the overall cut of 1.8mb/d. KSA production in December was at 10.5mb/d and decreased to 9.9mb/d by the end of March. Although Iraq and the UAE cut production, they were unable to reduce their daily average to the agreed limits. Overall, OPEC's compliance with the cut is over 100%, although the exact figure is dependent on the source of production data.

Non-OPEC countries also cut production, but by less than their commitment. In December 2016, Russian production stood at approximately 11.2mb/d and slowly dropped to 11.1mb/d. In absolute terms, production was reduced by 0.16mb/d by end of March, not nearly as much as was committed to in November 2016.

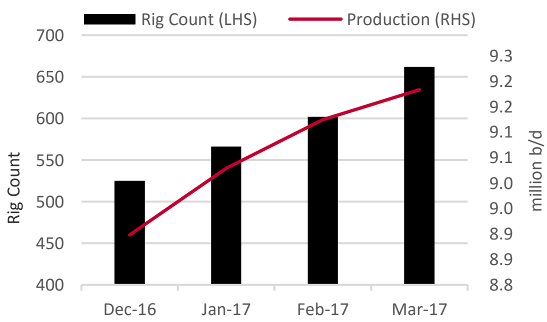
US producers on the other hand, took full advantage of increasing oil prices. Rig count increased by 33% from 525 to 697 by the end of April while production increased by 3.2% as of the end of March, increasing from 8.9mb/d to 9.2mb/d.

Chart 15: Russia Oil Production in 2017



Source: EIG

Chart 16: US Rig Count & Oil Production in 2017



Source: EIG and Bloomberg

WHATS NEXT; THE REST OF 2017

The next OPEC meeting is set for May 25. Until then, the question remains whether or not OPEC along with non-OPEC countries will continue with the agreed upon production cuts for an additional six months or even more. With prices retreating to the USD 50pb or lower, OPEC will most likely agree to an extension in conjunction with non-OPEC countries.

According to data from the IEA, inventory levels should shrink by year-end, assuming the market remains undersupplied. For Q1 2017, market demand exceeded supply with figures reported at 96.58mb/d vs 96.34mb/d, respectively. Moving forward, several factors must either improve or at least remain unchanged in order to drop crude stock to an acceptable level and support an increase in prices. First, production cuts from OPEC should not drop below the current 100% commitment and Russia along with other non-OPEC countries should improve their compliance levels with the promised cuts to reach the ceilings agreed on in November 2016. Secondly, US production should not outpace the cuts undertaken by OPEC and Russia.

Further impeding OPEC's efforts is US production and the challenges it poses. US producers number in the thousands and as prices increase, more rigs are likely to come online in turn increasing production. OPEC members own and control their state production, as does Russia through multiple state-owned companies. Producers across the US are privately held and will continue to pump so long as market prices allow a profit to be generated or at least most of the costs to be covered. Further supporting an increase in US production is efficiency, with producers becoming less susceptible to market downturns. According to several Bloomberg articles, "the well-head break-even costs for US shale plays declined 46% between 2014 and 2016" and the slump in prices has over the past two years forced producers to become more efficient. Moreover, US producers are using derivatives to lock in prices today for delivery of un-pumped oil several years out.

CONCLUSION

OPEC, Russia, and the US are at odds. OPEC and Russia need the price of oil to rise and eventually stabilize, as it has a major effect on government budgets. As for the US, production and rig count is trending upwards and so long as prices remain in the range of USD 50pb, a reversal of such is highly unlikely.

Since the agreement to cut oil production came into effect at the beginning of the year, OPEC and Russia together have reduced production by approximately 4.2% whereas the US increased production by approximately 3.20%. Production ceilings will not hold indefinitely and US production will increase with time, whether due to oil price appreciation or efficiency. Assuming no increase in production levels and an extension of the agreement for an additional six months or longer, global crude inventories will decline. This will push prices upwards and prompt an increase in US production in turn increasing global inventories and applying downward pressure on prices; essentially pitting prices against supply in a never-ending cycle. In the end, long term market stability will only materialize when global growth picks up and drives demand growth in line with the growth in supply levels.

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