A more balanced oil market: just a matter of time

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OPEC shocked the market at the end of November 2014 when it maintained its production quota, indicating that it would not cut production to support the price of oil. Just over one year later, the market is again reacting negatively to the latest OPEC meeting (December 4, 2015), in which its production quota was maintained.

In both cases, oil prices fell as the market digested the decisions and contemplated whether OPEC had given up its perceived role as the global balancing agent in the oil market. Collectively, OPEC has decided to allow the forces of supply and demand to balance the markets. We view this as a rational response to the new structural supply source found in North American shale oil. The key question now — are the economic forces of supply and demand working?

LOWER OIL PRICES = REDUCED SUPPLY

Until November 2014, North American shale-based oil production was growing by one million barrels a day year-over-year, and had been since 2012. This was a function of high oil prices and producers' easy access to funds through the credit and equity markets. Post OPEC's original decision, credit markets are largely closed to new issuance of debt from U.S.-based Exploration and Production (E&P) companies, and the equity markets are becoming much more selective in funding new production growth. Due to the lack of financing options, U.S. E&Ps have aggressively cut capital budgets. The growth in U.S.-based production has started to slow and is now expected to turn negative in 2016.

In addition, large international oil companies are also starting to reduce and constrain the development of future projects. Due to the curtailment of capital to new projects, it is now estimated that, by 2020, four million barrels of production will not come to market. Non-OPEC supply is responding.

OPEC members are also starting to see the impact of reduced spending. Iraq, which the International Energy Agency (IEA) had projected to be the OPEC member with the best growth profile in their 2014 long-range forecast, has recently indicated that its production growth will not meet expectations. It is now looking to produce approximately five million barrels a day by 2020 (four million barrels a day less than its original nine million barrels a day projection).

The reduction in the price of oil will constrain supply, both in the near term and in the years to come.

….AND INCREASED DEMAND

On the demand front, the decline in oil prices has led to a reduction in the cost of refined product globally, incentivizing increased demand. Recent data from both North America and China has shown an increase in the pace of demand for refined products, particularly gasoline. The IEA now estimates that oil demand will increase by 1.9 million barrels a day, up by 700,000 barrels a day from its forecast at the beginning of the year. OPEC itself indicated that demand is likely to grow by an additional 1.3 million barrels a day in 2016.

With supply decreasing and demand increasing, it is only a matter of time before the market will balance itself. Furthermore, we believe the market is overly optimistic in its assessment of the pace at which U.S. production could be brought back, should prices increase. The oilfield service industry has been deeply burdened by the decline in oil prices and the resultant decline in oil-directed capital expenditures. Its ability to react to an increase in demand for its services has been impaired.

Overall, OPEC's decision to maintain production will likely lead to a much stronger market in the future, one in which the forces of supply and demand are better aligned. As a result, the market will be more structurally sound and should support higher prices.