ENERGY: OPEC RESETS THE BAR

"The steep drop in oil prices over the last few years can be partly traced back to the `price war' inside the OPEC cartel. It looks to us like the war is over."

– Francisco Blanch, Commodity and Derivative Strategist

Our view

OPEC cuts back
The big news is that, for the first time in eight years, OPEC agreed on November 30 to cut its production. Key non-OPEC nations (led by top-producer Russia) are also parties to the agreement, a first since 1998. OPEC member nations will curb their output by 1.2 million barrels per day, others by 600,000 barrels per day. Country allocations and an independent production monitoring committee are also part of the deal, so we expect firmer compliance than for prior agreements.

Holding firm
Based on the OPEC announcement, the global oil market should enter into a deficit as soon as Q1 2017. As such, we are keeping our 2017 forecasts for Brent and WTI crude oil unchanged at $61 and $59 per barrel, respectively.

Potential downsides
While we expect annual global oil demand to grow (by an average of 1.2 million barrels a day), we still see downside risks to our forecast. Demand could decline if U.S. interest rates move higher and if the Chinese yuan depreciates in a disorderly fashion. Also, some OPEC nations or Russia could break free of the agreement, or production could rise faster than expected in nations outside of this unlikely alliance.

Rising U.S. output
Our price expectation embeds a sequential 500,000 barrels per day increase in U.S. crude production, raising output to 9.2 million barrels a day by the end of 2017.

Natural gas forecast
We see U.S. natural gas balances tightening between now and mid-2018 on falling production and strong structural demand growth. Our 2017 price forecast is $3.50 per million British Thermal Units (BTUs), about 15 cents above the current forward curve. In the longer term, the Trump presidency presents some downside risks prices as it could speed up pipeline infrastructure, allowing for a faster supply expansion.

LNG outlook

Spot LNG prices have decoupled from Brent and may push lower even if oil prices continue to recover, as a wave of supply from U.S. and Australia is underway. Asian buyers have bought too much LNG on long-term contracts and will be selling in the face of this largest supply wave ever. EU and Asian spot LNG prices may eventually find support on coal-to-gas switching levels.

Coal bear

Coal has been one of the best performing commodities in 2016 as China coal production has fallen steeply on mandated reduction in mining days from the government. The thermal coal price rally was exacerbated by a number of other factors, including tightness in the met coal market. Producers are now restarting production in response to prices, setting the stage for another leg down in prices next year.