

Energy Monitor

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Strong deal but uncertainties remain

- ▶ **The OPEC+ production cut agreement is historic**
- ▶ **In particular, the length of the deal was a positive surprise**
- ▶ **There are many uncertainties left, though, which kept oil prices trading sideways**
- ▶ **ABN AMRO oil price forecast unchanged: flat in the short term, some recovery during H2 2020**

Unprecedented OPEC+ production cut agreement

After an extensive meeting last Thursday, OPEC and its partners led by Russia agreed upon a new production cut agreement. It is a historic agreement, in size, length, as well as in the number of participants. However, it took until Sunday before the deal was finalized. In order to balance future supply and demand, the oil producers have agreed to lower their crude production by 9.7 million barrels per day (mb/d) in May and June. This will be followed by a smaller production cut of 7.7 mb/d until the end of the year, and a 5.8 mb/d cut up to April 2022. This agreement will be revised during the next virtual meeting on 10 June. Although Mexico initially threatened to reject the deal, the US in the end agreed to take over a large part of the Mexican production cut quota. As a result, Mexico will cut production by 100kb/d, the US by an extra 300kb/d. This should bring the total of the OPEC+ production cut to 10 mb/d.

Brent and WTI oil price developments

USD/bbl



Source: Bloomberg

Besides the OPEC+ production cut agreement, the G20 Energy Ministers also met on Friday. They announced a production cut of a minimum 3.4 mb/d (mainly by the US and Canada). However, this production cut will be the result of market dynamics. In other words, due to the low oil prices, these oil producers will be forced to lower their production.

The market dynamics are a combination of (too) high production, transportation and storage costs, as well as a lack of capacity in transportation and storage.

The pros and cons of this deal

The most positive part of the deal is clearly the length. The agreement intentionally lasts until April 2022. This should be long enough to balance supply and demand during the coming months, and to lower the abundant inventories in the months thereafter. This length was necessary to prevent high inventories from continuing to cap the upside potential for oil prices for years to come. In line with OPEC's mission to create an environment which is good for both producers and consumers, prices should recover somewhat to prevent even more serious hits to the sector in the coming years.

There are however also several issues which make investors somewhat hesitant to become too enthusiastic about this deal. These are mainly to do with the size, compliance, G20 cuts based on market dynamics, and the Strategic Petroleum Reserves (SPR) buying. To summarize: the production cut agreement does provide a floor under oil prices, especially for oil prices which reflect the market situation in the Middle East and Asia (like Brent oil). But at the same time, higher SPR stocks and the fact that G20 production cuts will only materialize if oil prices remain relatively low would (later) cap prices .

Size: The 9.7 mb/d production cut is unprecedented. However, it may not be as big as the headline suggest. This is because of the baseline used. For almost all participating OPEC+ oil producing countries, the production levels of October 2018 will be the baseline for the announced production cuts. For both Russia and Saudi-Arabia the baseline will be 11 mb/d as they will both cut production to 8.5 mb/d in May and June. In March, Russia reported a production of 11.5 mb/d. However, this was including 0.9 mb/d of Natural Gas Liquids. So, the actual crude production was 10.6 mb/d. Furthermore, in May and June, Russian crude production always drops somewhat due to annual maintenance. In Saudi Arabia the baseline is even more questionable. March production was 9.8 mb/d, but Saudi Arabia announced after the failed OPEC+ meeting in early March that they would ramp up production to 12.5 mb/d in April, suggesting an even bigger theoretical production cut.

Compliance: There are several countries which have a reputation for not always fully complying to production cut agreements. There is no reason to believe that this time will be different. Weak economic conditions in many of these countries may give them in their belief an exceptional reason to bypass the rules.

The G20 cuts: The market dynamics-driven production cuts will be seen in the course of the coming months. As a result of low oil prices, oil production – especially in the US and Canada – will continue to drop. Expectations are that this will sum up to the 3.4 mb/d as mentioned. One condition to see this drop in crude production is that oil prices will remain relatively low. Besides the fact that this part of the deal thus caps the upside potential of oil prices, it is a very rough estimate. In the end it will remain a commercial decision to cut production or keep production running, depending on the need for cashflow versus the cost of production. This can vary per producer/production well and is something which cannot be imposed by the local authorities.

Buying strategic reserves: The IEA indicated that oil consumers can help balancing supply and demand by filling up their Strategic Petroleum Reserves (SPR). In our view, this will help to facilitate the current oil glut and find some storage capacity. It does provide a cushion to balance somewhat of the demand shock. However, this also automatically caps the further upside potential of oil prices in the medium term.

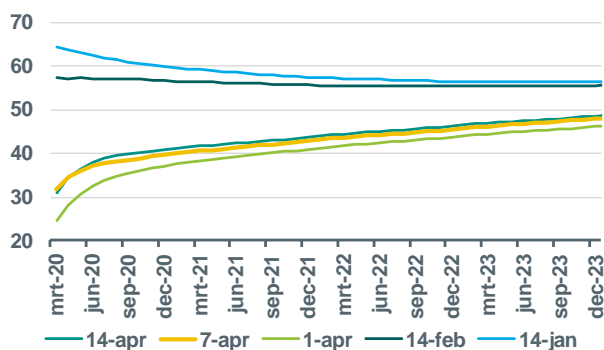
Oil prices have hardly reacted

Some might have expected that, as a result of this unprecedented production cut agreement, oil prices would jump higher. That did not happen. In fact, Brent even traded lower on Monday. Most of the expectations were already priced in

after the pre-announcement of US President Trump on 2 April, after which prices jumped almost 40% higher, before easing to a gain for the day of 'only' 22%. The main effects of the OPEC+ production cut agreement were seen in the forward curve. Although the front end of the curve hardly reacted as mentioned above, the future prices for the longer term did trade somewhat higher. This means that the market expects this deal to have a positive effect in the medium term, as it should bring back balance between supply and demand going forward. It should also help to reduce inventories. This is further confirmation that the length of the deal has been well-received by the market.

Forward curve Brent

x USD/bbl



Source: Bloomberg

Brent/WTI spread

As a result of the production cut agreement, Brent has traded sideways as most of the positive news was already priced in some time ago. WTI on the other hand, traded lower as the effects on US crude production will take longer to materialize. As a result, the Brent/WTI spread widened to almost USD 10/bbl from almost zero during mid March. We do believe that the spread will narrow in the course of the year. Still, it may remain somewhat wider during the coming weeks as the effects of low oil prices will only be translated into lower US crude production data at a relatively moderate pace compared to the active production cuts in other regions.

Brent / WTI spread

x USD/bbl



Source: Bloomberg

Oil price forecasts

Although the OPEC+ production cut agreement will put a floor under prices, this does not mean that all the downside risks are gone. After all, this deal is aimed at balancing the demand shock we are currently facing. However, we are not

yet sure how long the coronavirus measures will last before the economies start to recover, and oil demand will start to pick up again. Therefore, we are still comfortable with our forecasts for USD 25/bbl at the end of Q2. Our macro economists expect a recovery in the second half of the year. This coincides with a recovery in oil prices. However, we also still expect that the upside potential will be capped due to high inventories and the delayed effects on US shale production. Therefore we slightly adjusted the recovery path in WTI which also reflects a wider Brent/WTI-spread. All in all, we feel even more confident that our current oil price forecasts are a good reflection of current market expectations.

Forecasts oil and gas prices

| End of period | | 14-apr | jun-20 | sep-20 | dec-20 | mrt-21 | jun-21 | sep-21 | dec-21 | mrt-22 | jun-22 | sep-22 | dec-22 |
|------------------|-----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Brent | USD/bbl | 31,02 | 25 | 35 | 45 | 50 | 45 | 45 | 50 | 55 | 55 | 55 | 55 |
| WTI | USD/bbl | 21,46 | 25 | 32 | 40 | 45 | 42 | 41 | 45 | 50 | 50 | 50 | 50 |
| Natural Gas (HH) | USD/mmBtu | 1,68 | 2,00 | 2,00 | 2,25 | 2,25 | 2,25 | 2,50 | 2,75 | 2,50 | 2,50 | 2,50 | 2,50 |
| TTF | EUR/MWh | 7,00 | 13 | 14 | 15 | 15 | 14 | 15 | 17 | 18 | 17 | 18 | 18 |

| Average | | 2019 | Q2 20 | Q3 20 | Q4 20 | 2020 | Q1 21 | Q2 21 | Q3 21 | Q4 21 | 2021 | 2022 |
|------------------|-----------|-------|-------|-------|-------|------|-------|-------|-------|-------|------|------|
| Brent | USD/bbl | 64,17 | 28 | 30 | 40 | 36 | 48 | 48 | 45 | 48 | 48 | 55 |
| WTI | USD/bbl | 57,00 | 26 | 29 | 36 | 34 | 43 | 44 | 42 | 43 | 43 | 50 |
| Natural Gas (HH) | USD/mmBtu | 2,53 | 1,80 | 2,00 | 2,10 | 2,00 | 2,30 | 2,30 | 2,40 | 2,60 | 2,40 | 2,50 |
| TTF | EUR/MWh | 14,55 | 13 | 14 | 15 | 14 | 15 | 15 | 15 | 16 | 15 | 18 |

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