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COLUMBIA THREADNEEDLE INVESTMENTS

Tight oil markets are driving prices higher

COLUMBIA THREADNEEDLE ENERGY ANALYST TEAM

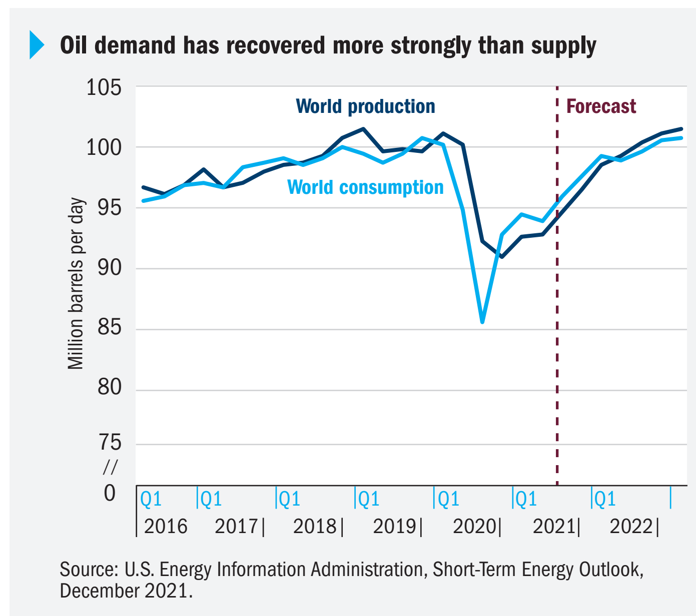
As energy prices continue to rise, we have increased our forecast for WTI oil prices to $73/barrel in 2022. We expect global demand to rebound to pre-COVID 2019 levels by mid-2022. At the same time, we believe supply will increase steadily but remain constrained, resulting in a market that is broadly balanced. We present our updated views on supply, demand and inventory, and our resulting expectation for prices.

Demand is strong

We have increased confidence of a return to normal in demand.

After declining by nearly 9% in 2020, global demand recovered — increasing 6% y/y (or 5.5 million barrels per day) in 2021 — and is expected to return to prepandemic levels by mid-2022. In the U.S., the EIA estimates crude demand will grow 4% in 2022 — which is consistent with our view. Meanwhile, emerging markets, which drove all 2019 global demand growth and currently make up more than half of global oil demand, will continue to drive longer term future demand growth. Specifically, demand from China this year, which currently makes up 15% of global demand, is expected to track well above 2019 levels.

Oil demand has recovered more strongly than supply



Source: U.S. Energy Information Administration, Short-Term Energy Outlook, December 2021.

Supply remains constrained

Since OPEC+'s production low in June 2020, supply continues to steadily rise. Notably, from April 2021 to February 2022, OPEC+ will have increased production to 48% of the original OPEC+ cuts during the peak of the COVID shutdown. Recently, OPEC+ debated the decision to add back the expected monthly production increases for January and February 2022 given concern about the negative demand impact from omicron. The group ultimately decided to continue with the unwinding of its production curtailment agreement — returning ~400 thousand barrels per day, per month through September of 2022 — as the oil price continues to rise.

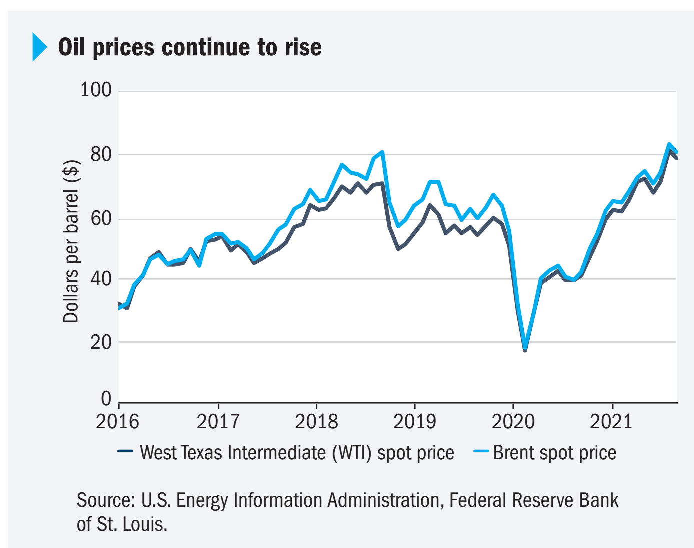
But global supply is not likely to normalize in the short term. Production has been falling short of OPEC+ quotas in recent months, as some countries have struggled to add back supply quickly enough due to underinvestment during the 2020 downturn. Some estimates are calling for OPEC+ spare capacity to fall to 25-year lows in the coming quarters.

Additional upward price pressure is emerging as producers are passing through higher costs for oilfield service and labor inflation, increasing the marginal cost of supply.

Pricing continues to be driven by tight inventories

Global oil inventories (i.e., crude oil in storage tanks) have declined materially from the mid-summer 2020 peak and are now well below historical averages. U.S. crude inventories are 8% below the 5-year average and OECD crude inventories are 12% below (as of September 2021), which is the widest deficit in recent history. Moreover, with demand increases from fuel switching and constrained supply, despite additional supply from OPEC+, inventories are not likely to build to normalized levels in the near future.

Oil prices continue to rise



Source: U.S. Energy Information Administration, Federal Reserve Bank of St. Louis.

A notable change to our price outlook involves the addition of geopolitical risk premium. When the oil market is loose and oversupplied, there is a negligible impact of geopolitical risk on price. But because supply is tight and inventories are low, risk of supply disruptions due to geopolitical events has a meaningful impact on oil price. The risk premium has increased because of escalating tensions in Kazakhstan and between Russia and Ukraine. Going forward, we expect the geopolitical risk premium to fluctuate depending on the nature of a resolution of the Russia/Ukraine conflict. Should a diplomatic solution be reached, we would expect a risk premium of low single digits. Should a ground war ensue, a significant risk premium with the possibility of price spikes will be incorporated in the price of oil.

Additional price volatility could come from uncertainty relating to: the potential for additional supply from Iran depending on the outcomes of negotiations; U.S. production could grow faster than anticipated; there could be a slowdown in demand due to the potential for an economic slowdown (if interest rates rise); reduction in OPEC space capacity; and unintended consequences of policy marker decisions in energy transition efforts.

Given the constraints on supply, surging demand and tight inventory, our energy team is increasing its West Texas Intermediate oil price forecast for 2022 to $73/barrel on average (below the current 2022 forward curve), suggesting we are less constructive than the commodity market about prices holding up to increased supply.

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