

Crude Oil Outlook: Risks Still Skewed to the Upside

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

It's been a wild couple weeks in the oil market with more twists and turns on both the supply and demand fronts. Notably, the EU partially banned imports of crude oil from Russia (positive for prices), OPEC+ fast forwarded increases in their production target (negative for prices), Shanghai's economy reopened (positive for prices) and both the OECD and World Bank sounded the recession alarm (negative for prices). Taking it all into account, we remain of the view that **the oil market will remain tight in the foreseeable future** and, in turn, crude oil prices will remain elevated.

The EU's latest sanctions, which include completely phasing out all imports of Russian seaborne crude oil and petroleum products and pledges by Germany and Poland to cut supply via pipelines by year-end, is expected to eliminate 90% (or roughly 3.0 out of 3.3 mb/d) of the bloc's oil imports from Russia. Though not the perfect deal when viewed from the perspective of the West wanting to quickly undermine Russia's energy industry and war efforts, it's clearly a step in the right direction.

The bigger question is **how all of this will impact the actual global supply of crude oil** as some of these barrels will simply be redirected. However, given self-sanctioning by buyers and logistical challenges (for example, redirecting shipments that typically head to Germany via the Baltic Sea to say China or India), a significant proportion of these barrels could become shut in, leading to lower Russian production and exports. The U.S. Energy Information Administration (EIA) recently projected Russia's total production of crude oil and refined petroleum products to decline from 11.3 mb/d in 2022Q1 to 9.3 mb/d in 2023Q4. This appears to be a fairly reasonable estimate as we suspect that Russia will be more than willing to continue deeply discounting its oil to entice buyers and keep hard currency flowing back to its economy—its benchmark Urals crude is currently priced 30% below Brent crude.

The loss of 2.0 or even 3.0 mb/d of Russian oil output, equivalent to roughly 2.0%-to-3.0% of global supply, is significant but may not lead to massive misalignment from a market balance perspective. **The world has the capacity to fill this void, but whether it will is highly uncertain.** Much will depend on whether OPEC+ (ex-Russia) or the U.S. shale sector will ramp up production. However, it doesn't appear that either will be coming to the rescue anytime soon. As was well publicized, many members have not been able to meet their production quotas in recent months, thus reducing the impact of the decision to increase the cartel's production target by 648 kb/d in July and August (vs. +432 kb/d for June). The two members with significant spare capacity are Saudi Arabia (~1.8 mb/d) and the UAE (~1.0 mb/d). However, it doesn't appear that they will be allowed to make up for shortfalls by other members until the current agreement concludes at the end of this year. Much of the same can be said for the U.S. as domestic production has flatlined at 11.9 mb/d in recent weeks. However, the EIA is forecasting output to rise to 13.4 mb/d by end-2023, surpassing the pre-pandemic peak of 13.1 mb/d. Although we agree that U.S. production will eventually/slowly rise given

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prices are well above break-even levels, oil companies face an uphill battle given ongoing investor pressure to maintain capital discipline and labour shortages. Canada will also chip in but the expected increase in output is very modest at around 200 kb/d in 2023.

Arguably, the bigger, new unknown in the oil market is **the global demand picture**. With COVID-driven lockdowns largely easing in China and the summer driving season in the Northern Hemisphere beginning, it appears that global demand for oil could accelerate in the coming months. However, concerns that the global economy could be heading for a recession have risen sharply, which we believe is helping to temper prices. Admittedly, assessing the impact that a recession could have on global oil demand is rather tricky as much will depend on the severity of the downturn (i.e., soft or hard landing). For now, we remain in the soft landing camp as many Western economies appear capable of absorbing the blow of higher central bank policy rates due to the strength of the job market.

Key Takeaway: To reflect the balance of these risks, we have revised up our annual forecasts for benchmark West Texas Intermediate (WTI) crude to US\$105/bbl in 2022 and \$95 in 2023 (from \$100 and \$85). Nonetheless, with global supply appearing to be under greater threat than demand at the moment, we think that pricing risks may be still skewed towards the upside.

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