Crude Oil Outlook: OPEC+ Flexes Its Muscles

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

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The battle for control over the oil market has ramped up further following OPEC+'s unexpected decision to lower its overall production target by a hefty 2.0 mb/d (from August production levels) beginning in November. In reality, however, the cut amounts to roughly 1.0 mb/d in actual output (or 1.0% of current global supply), as many members have been unable to meet their quotas for many months. Nonetheless, the move has reaffirmed that the **longer-term risks to prices and our current forecasts** (WTI: US$85.00/bbl in 2022Q4 and $90.00 in 2023) **are tilted to the upside** despite increasing concerns about a global recession and the associated impact on oil demand.

Although OPEC+ unsurprisingly did not disclose the true intention behind its decision, it's clear they want to reverse the sharp slide in prices in previous weeks. This was shown by the decision to introduce a seemingly insignificant 100 kb/d cut at the early September Ministerial Meeting after WTI slid below $90 (and Brent below $95) in August. Thus, it seems that OPEC+ is looking to maintain a floor at around $90 for WTI. WTI between $90-to-$100 over an extended period would (arguably) fulfill a few key objectives: (1) Help maintain comfortable budget surpluses for key members. Notably, the IMF last estimated Saudi Arabia's fiscal breakeven oil price at $80 for 2022, though it is projected to fall to around $70 for 2023. (2) Prevent a surge in non-OPEC+ production, as recent trends show that the recovery in U.S. crude output has slowed as prices fell sharply. (3) Avoid significantly worsening global inflationary pressures and forcing central banks to tighten to a point that results in a deep global recession.

Global supply could come under further pressure once the EU's embargo on imports of Russian crude and refined products comes into full effect in February 2023. This means that roughly 2.5 mb/d of Russian oil will have to be absorbed elsewhere, according to the IEA. Whether these barrels are shut in or not will have significant bearing on overall global oil supply. However, the West's price cap on Russian oil, which is designed to be slightly above Russia's break-even price, should help mitigate the risk of oil becoming shut in. For the record, Russia's total oil exports stood at 7.5 mb/d in September, down only 560 kb/d from pre-war levels.

However, it does not appear that the West, particularly the U.S., would be able to offset a further roll back in OPEC+ production. As noted earlier, the recovery in U.S. crude output appears to have stalled at around 12.0 mb/d since May (vs. a pre-pandemic level of 13.1 mb/d). Pressure on U.S. shale producers to maintain capital discipline remains intense and is expected to endure given the increased volatility in prices. Meanwhile, the Biden Administration's 1.0 mb/d withdrawals from the Strategic Petroleum Reserve (SPR) are set to end this year. Though the U.S. could extend and/or increase withdrawals, there are limits to the SPR and releases will not be able to outlast a more aggressive OPEC+ cutting strategy.

On the demand front, both the IEA and OPEC have stuck to their baseline assumption that global oil consumption will grow next year despite the slowing economy. The IEA is forecasting world oil demand to rise by an average of 1.7 mb/d in 2023, compared to an estimate of 1.9 mb/d in 2022. Declining demand from road transportation is expected to be offset by greater demand for jet fuel and gas-to-oil switching in the power generation sector in Europe and the Middle East, driven by elevated natural gas prices. OPEC is even more optimistic and is projecting global oil demand to rise by 2.3 mb/d in 2023. However, neither organization is factoring in a major global economic downturn, which if it were to occur, could result in global oil demand falling by perhaps 1-3 mb/d in 2023, based on past experience (excluding the steep pandemic-driven drop in 2020).

Though we do not share either the IEA or OPEC's optimism, we nevertheless think that global oil demand will remain relatively resilient next year. Based on BMO Economics' baseline view that Europe and the U.S. will only experience modest recessions, global oil demand should not witness a large contraction of 2-3 mb/d (or 2-3% of total demand). China's economy, which has been the biggest driver of incremental global oil demand in recent years, remains a wild card due to uncertainty over its strict zero-COVID strategy. If it is eased next year, which we expect to eventually occur, a revival in China's economy would likely help boost global oil demand.

Separately, the discount of Western Canada Select (WCS)—a blend of heavy oil produced in Alberta—to WTI has blown out to US$30/bbl in recent days (previously $20) following some unplanned refinery maintenance in the Midwest and Midwest refiners also cutting runs as they struggle to ship products due to the low level of the Mississippi river. Thus, the WTI-WCS differential, which was already suffering from the release of barrels from the SPR, with the vast majority of those being of the heavy-sour variety, is only likely to narrow back to its long-term average (roughly $15) once the Biden Administration decides to abandon the SPR strategy.

Key Takeaway: As we often suggest, forecasting the price of crude oil has never been trickier as the trajectory of both global oil supply and demand remains far from certain. Thus, we expect prices to experience more big swings in the months ahead.

General Disclosures