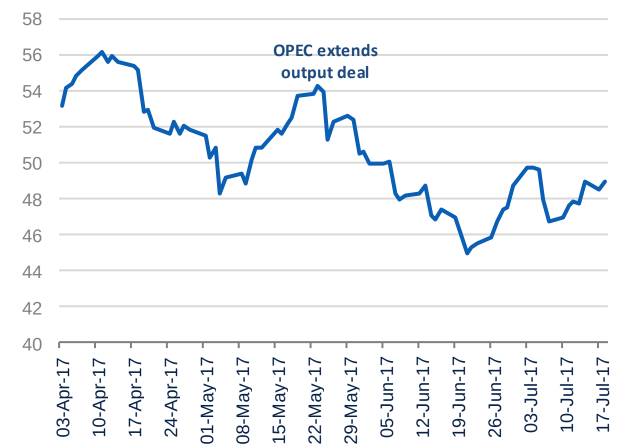
3. Oil prices outlook

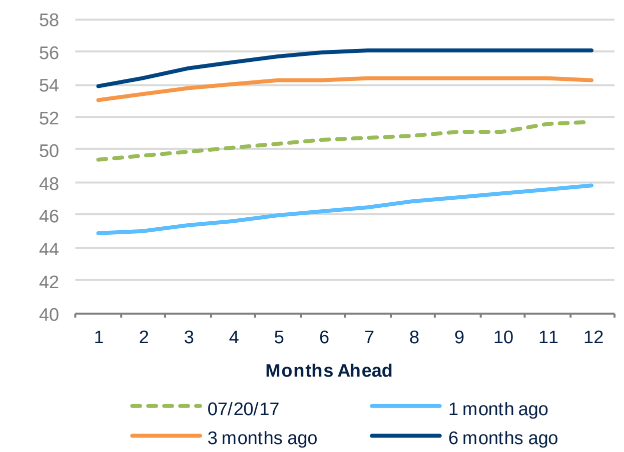
The second quarter of 2017 was marked by growing scepticism on the effectiveness of OPEC strategy to stabilize the market. The extension of the deal to cut output for nine more months did little to boost confidence and prices went down further. As a result, we expect Brent crude oil prices to average $51.7/b in 2017, $6 less than our forecast at the beginning of the year. For 2H17 and beyond, our baseline scenario continues to discount a gradual adjustment of current imbalances and convergence to $60/b, although this would be reached later than previously expected.

Figure 3.1 Brent crude oil spot prices April-July ($/b)



Source: BBVA Research with data from Haver Analytics

Figure 3.2 Brent crude oil futures ($/b)

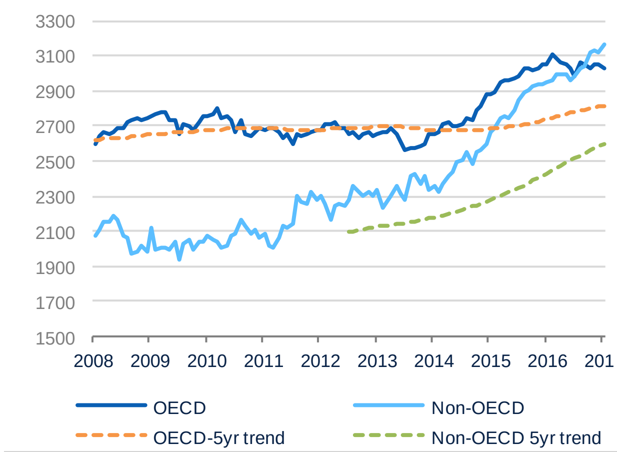


BBVA Research with data from Bloomberg

OPEC extension of production cuts is expected to have an impact on inventory accumulation, which in turn would exert upward pressures on prices. Inventories have already shown some signs of correction. In the U.S., stocks of crude oil excluding the Strategic Petroleum Reserves have declined for twelve out of the last fourteen weeks. Meanwhile, OECD oil inventories continue to expand, but at a lower pace. Although encouraging, these changes are still not enough to balance the market and trigger a sustained increase in prices mainly because inventories remain at historically high levels.

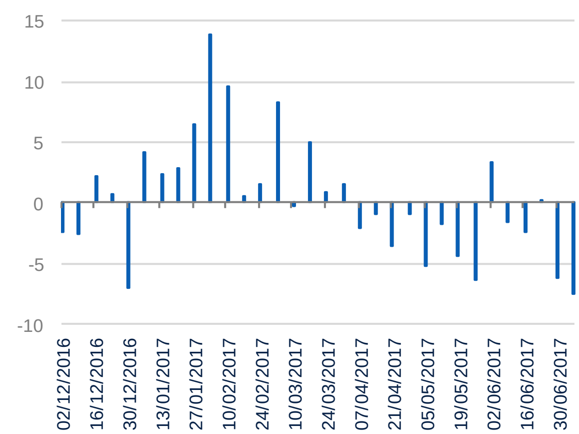
In our baseline, the expected increase in prices is contained by the rebound in U.S. production. After reaching a bottom in July 2016, U.S. production surged by 1 million b/d to 9.4 million b/d as of July 14, 2017. At this pace, production could surpass its previous peak of 9.6 million b/d later in the year. The U.S. Energy Information Administration expects production to reach 10 million barrels per day in 2018, which would be the highest level since 1970. U.S. shale oil producers continue to beat expectations due to their manufacturing-style processes and ongoing technological innovations (for a detailed analysis of the drivers of U.S. crude oil production see The Permian basin and the rebound in U.S. crude oil production).

Figure 3.3 Crude oil inventories (eop, million barrels)



Source: BBVA Research with data from Haver Analytics

Figure 3.4 U.S. stocks of crude oil excluding SPR (eop, 1-week difference, million barrels)

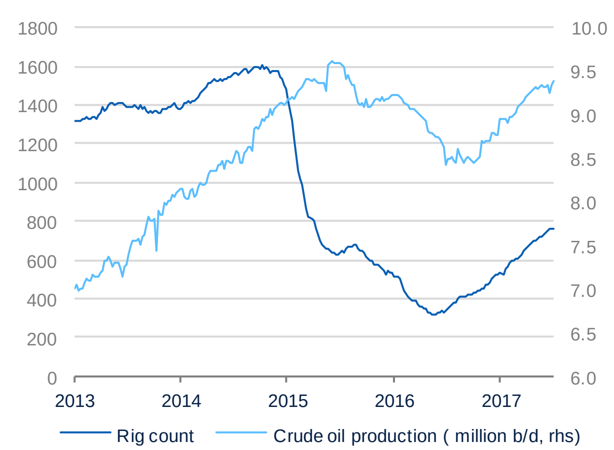


Source: BBVA Research with data from Haver Analytics

Meanwhile, production is still trending up in non-OPEC countries like Brazil and Canada, while Libya and Nigeria, currently exempted from the output deal, will most likely increase production through the remaining of the year, offsetting a portion of the OPEC's quota. Libya, for example, has plans to boost production beyond the 1 million b/d by the end of the year.

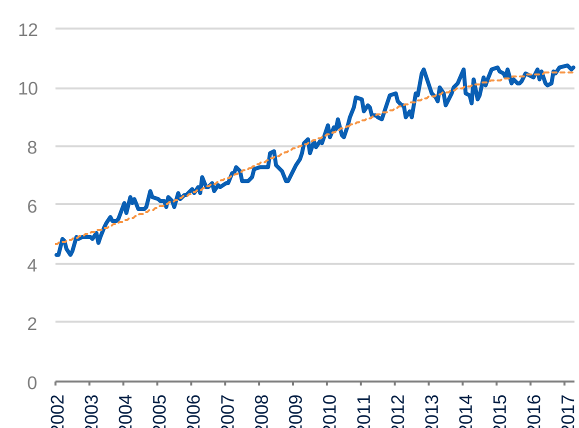
Demand remains supportive of prices, but with no apparent upside in the near future. Global demand of petroleum products expands at 1.3 million b/d per year. Meanwhile, China's apparent demand seems to be stabilizing in line with the ongoing rebalancing. Economic growth in OECD continues to be favorable too, but its impact is constrained by a declining relative importance driven by improving energy efficiency.

Figure 3.5 U.S. crude oil production and active rig count



Source: BBVA Research with data from EIA

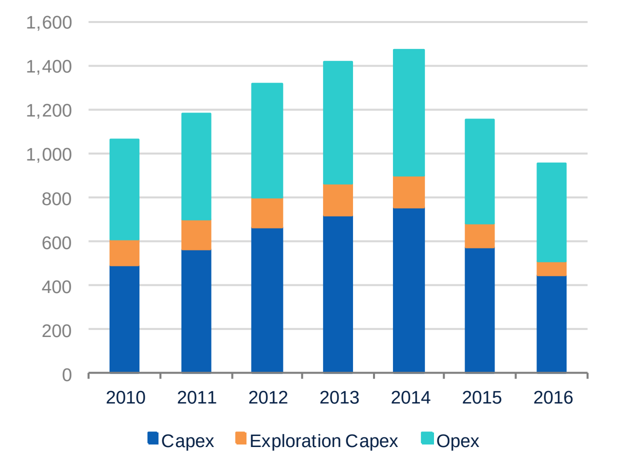
Figure 3.6 China apparent oil demand (million b/d)



Source: BBVA Research with data from Bloomberg

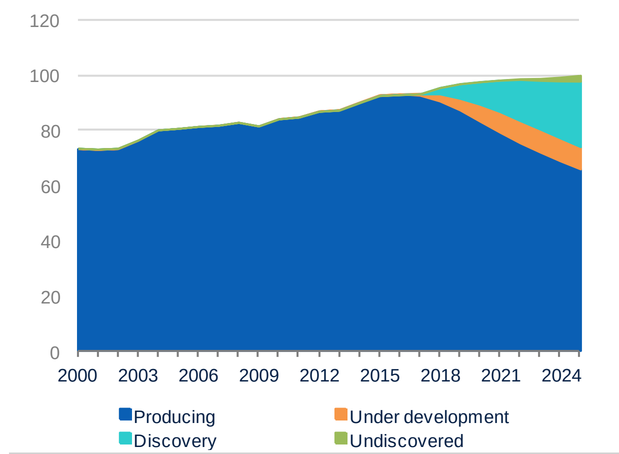
In the long-term portion of the forecasting period, global economic growth and the lagged effects of capital spending cuts in 2015 and 2016 are expected to bring prices up and close to $60/b. Further investments are needed to replace a declining legacy production; however, exploration CAPEX in 2016 was 53% below the levels observed in 2014. At $60/b several projects onshore and offshore would become profitable; however, the costlier ones would still be out of the market. Meanwhile, $60/b would not damage demand growth.

Figure 3.7 Oil & Gas capital expenditures ($ million)



BBVA Research with data from Rystad Energy

Figure 3.8 Crude oil and other liquids production by life cycle category (million b/d)



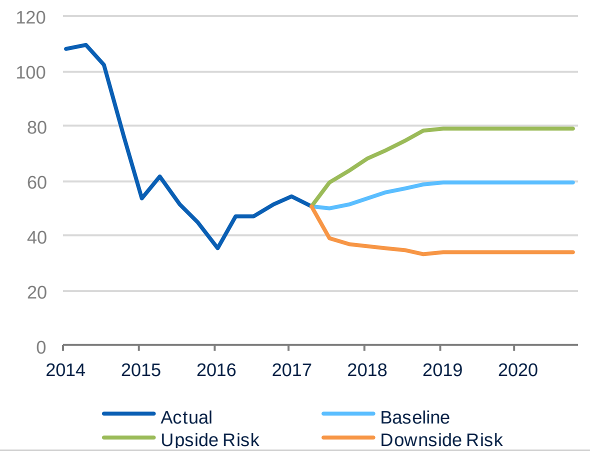
Source: BBVA Research with data and projections from Rystad Energy

The risks to our baseline are tilted to the downside. Although OPEC and its partners have shown considerable restrain, production in Libya and Nigeria could increase faster than expected, offsetting a big portion of the cuts. In addition, the probability of cheating or breaking the agreement has increased as countries will find it increasingly difficult to keep their quotas for a longer period of time, particularly if lower oil revenues have a larger-than-expected negative impact on public finances. In the U.S., higher oil prices could revive production in areas with greater breakevens, boosting total output and stocks even further, thereby limiting or even reversing potential increases in oil prices. On the demand side, a faster-than-expected deceleration in China, stricter import and re-exporting restrictions as well as tighter tax scrutiny on Chinese independent refineries “teapots” could affect the country’s demand of oil in the short-term (teapots account for 18% of the country’s total crude imports).

Some factors could cause prices to move above our baseline. For instance, OPEC could decide to increase the size of its current quota. Faster-than-expected economic growth in the U.S. due to expansionary fiscal policy (infrastructure spending and tax cuts to individuals and corporations) could have positive spillovers to the rest of the world that could result in a stronger-than-expected demand. Likewise, growth in other emerging markets could also gain speed, which would lift oil demand and accelerate the rebalancing process. Further volatility could come from current and potential geopolitical conflicts as well as exchange rate volatility.

In any case, the expected evolution of prices will occur in a different type of market than the one prevailing until a few years ago. A new market in which OPEC oligopolistic power has diminished due to the ingenuity of multiple companies operating in the U.S. shale regions.

Figure 3.9 Brent crude oil prices forecast ($/b)



Source: BBVA Research

Table 3.1 Brent crude oil prices forecast ($/b)

	New Baseline	Previous Baseline (March)	Upside	Downside
2015	52.8	52.8	52.8	52.8
2016	45.2	45.2	45.2	45.2
2017	51.7	56.6	57.9	44.1
2018	56.3	58.7	72.8	35.1
2019	59.6	59.6	79.3	34.1
2020	59.6	59.6	79.3	34.1

Source: BBVA Research

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