WEST TEXAS INTERMEDIATE OIL PRICES MAY BE DOWN

BUT CERTAINLY NOT OUT...

By Alan Lammey

Since October 2018, the West Texas Intermediate (WTI) crude oil price suffered one of its worst downturns in years. In just under six weeks, after topping-out near $76.90/MMBtu (one million British thermal units) as the high point for 2018, the price of oil plunged nearly 30 percent before finding a floor near $55.00 a barrel (bbl) in mid-November. While supply-demand dynamic has shifted substantially in recent months and oil prices have taken a sizeable dive, for the most part, a healthy U.S. economy historically keeps oil prices underpinned. Not only that, but demand for U.S. oil and natural gas exports continues to increase as other countries around the globe clamor for new American supply. So, while the WTI price may be seeing a setback, it is only a matter of time before the market bulls will return in earnest.

THE IMPACT OF SUPPLY AND DEMAND ON TEXAS OIL PRICES

Perhaps nothing directly influences oil prices more than the supply-demand dynamic. Most people use oil every day, even if they don't drive a car or fly on an airplane. Oil is used in many thousands of everyday products ranging from packaging to chemicals and much more. Therefore, the price of oil is extremely sensitive to the supply-demand dynamic in the marketplace and right now supply is starting to greatly outweigh demand. While the well-being of the overall domestic economy in the U.S. does exhibit periods of fluctuation and volatility over the course of time, this dynamic of an overage of supply and a reduction of demand does appear likely to persist and could conceivably accelerate into 2019, putting more downside pressure on oil prices in the process.

In looking back at prior months and quarters on the demand side of the equation, during the second quarter of 2018 ”world oil demand” came in at roughly 98.45 million barrels per day. Although this is slightly higher than the previous quarter, it is lower than the world demand figure of 98.61 million barrels per day during the fourth quarter of 2017. In a nutshell, from a year-over-year perspective, demand increased by just 0.43 percent, from 98.03 million barrels per day in the second quarter of 2017. This is substantially lower than the full year projected demand growth of 1.4 percent for 2018.

While oil ”demand” rose by just 0.43 percent year-over-year, world oil ”supply” surged by over 2 percent. In fact, last year's demand outstripped supply by an average of more than one million barrels per day during the second quarter. As of the end of 2018, the opposite was happening as supply outweighed demand by nearly half a million barrels per day.

This is quite a shift in market dynamics and the overall scenario implies that supply may continue to outweigh demand going forward. Furthermore, with so much supply coming online in the West Texas Permian Basin, which appears to be a pattern development of slower than anticipated demand, it is highly unlikely to see elevated oil prices for a prolonged period in the near to intermediate future.

THE IMPLICATIONS OF RECORD PRODUCTION IN AND OUTSIDE OF THE U.S.

In recent months, the U.S. and global oil industry has seen the most oil ever flood the markets and there are no signs of it slowing down. Despite some OPEC/Russia-imposed constrictions on supply, which essentially created a floor under oil prices in the last oil bear market, Russia continues to inundate the world with more oil than it ever has before.

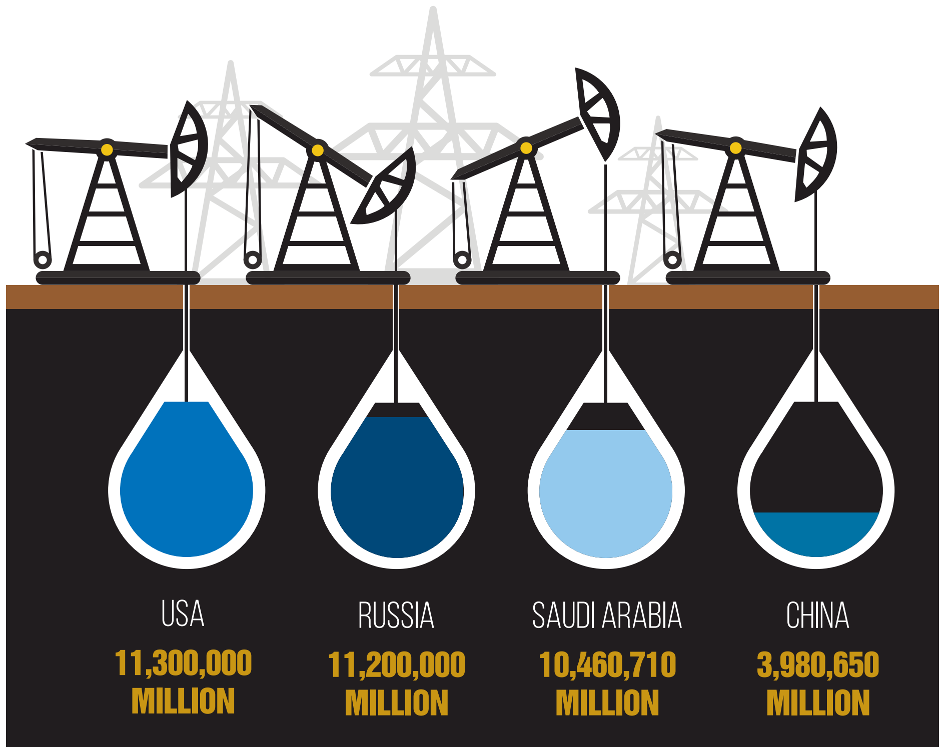
For example, Russia's production is approaching 11 million barrels per day, about 5 percent higher than where it was at the height of 2014, before the previous collapse in oil prices began. At the same time, the U.S. now produces more than 11 million barrels per day, which is about 15 percent above its 2015 peak of 9.8 million barrels per day. Growth in American oil production (much of it coming from Texas) has been nothing sort of incredible, essentially doubling over the past decade and resulting in a world awash in oil.

Interestingly enough, Saudi Arabia is now the world's third largest oil producer and is also pumping out more than 10 million barrels per day (about 10.5 million), which is just slightly lower than the country's peak production of about 10.7 million barrels per day in 2016.

These three countries combined now account for about 36 percent of all the world's oil output, but they are not the only ones firing on all cylinders. Many other major oil producing nations are at peak or near-peak in terms of production and have no incentive for slowing output. The result of this immense crude oil production will likely lead to much more oil than the world's economy can utilize (at least for the time being) and prices could go lower in 2019.

BY THE NUMBERS

Oil Production, Barrels Per Day



U.S. Energy Information Administration database for calendar year 2016.

THE INFLUENCE OF SLOWER ECONOMIC GROWTH ON OIL PRICES

At this juncture, there is simply not enough oil demand to keep up with robust oil domestic and global production. As healthy as the U.S. has been in terms of job growth and stock market growth in the past couple of years, not all markets will go up forever and periods of cyclical regressions will occur. Looking ahead, it does appear that the U.S. may be entering a period of slower and lower economic growth. If this situation does come to fruition in 2019, it implies that oil demand can continue to come in lower than expected.

The International Energy Agency (IEA) is forecasting that at the end of 2018 overall global oil demand will increase by just 1.4 percent, which is down from last year's 1.6 percent. Moreover, demand is expected to decrease to slightly above 1.2 percent in 2019 and should then hover around 1-1.2 percent over the next few years.

THE TUG OF WAR FOR OIL PRODUCTION DOMINANCE

While the U.S. may be poised to see a temporary pullback in the overall economy in the months ahead; by and large, the U.S. historically has shown the resiliency to rebound much faster in cyclical economic downturns than many other major nations of the world. However, the problem for Russia and for Saudi Arabia is that their economies are not designed to withstand low oil prices for prolonged periods of time. As such, when oil prices stay down for too long, they'll typically institute a cap on production in order to prop-up oil prices. But when this happens, oil producers in the U.S. spring into action in order to capture gains from rising prices, which helps to bolster local economies across America and, particularly, in Texas where oil and natural gas production is undoubtedly very prolific.

The U.S. now produces the most oil in the world and its production output is about 15 percent above prior highs, whereas Russia's oil output is about 5 percent above prior highs and Saudi Arabia is yet to eclipse its recent output capacity.

WHERE DO OIL PRICES GO FROM HERE?

If oil prices continue to remain at lower levels, it's not out of the question that there will be yet another battle for the world's oil market dominance between the U.S., Russia and Saudi Arabia. Because an economic slowdown in the U.S. and in other countries may occur very soon, oil prices appear poised to sink lower. However, because it doesn't appear any of these major oil-producing countries are voluntarily stepping up to cut production by a substantial amount, this is a set-up for even more supply to flood the markets for the foreseeable future. So, the likeliest outcome is that the price of the WTI will correct further from current price levels before "over-sold conditions" kick-in and send prices rebounding for at least a period of time. We're estimating that prices are likely to remain range-bound from a mid-$40s/bbl to a mid-$60s/bbl level throughout 2019. It should be noted that any notable hiccups in supply or demand events or unforeseen geopolitical upheavals will very likely exacerbate the overall volatility of the price of the WTI.

While the overall oil market tone sounds rather pessimistic in the near-term, the bigger picture is that the global population of the earth grows at roughly 1 percent per year. With an estimated 7.7 billion humans inhabiting the planet, annual increases in population around the world are sure to keep demand for oil on the rise without ceasing for multiple decades to come. So, while a pullback in oil prices may be felt in the Texas and U.S. oil patch in the months ahead, it should only be a temporary period of regression before more supply is needed and prices respond by advancing higher again. **N**

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