Oil Market Report: May 2018

It would be inaccurate to describe fuel prices in May as volatile, because volatility tends to describe price movements that go up, as well as down. Fuel prices in May on the other hand, just went up…and up…and up a bit more! For most of this year we have experienced an ever-tightening oil market, with OPEC production cuts, a shale oil industry still struggling to shake off its 2014 price-crash hangover and of course, incessant increases in global demand. But what really sent the price rocketing in May, was Donald Trump's announcement that the USA was pulling out of the Iranian Nuclear Agreement and would thus be seeking to reinstate sanctions on Iranian oil.

Iran is a big hitter when it comes to oil production. Not only does it sit on huge reserves (approximately 150bn barrels), but current production sits at 4m barrels per day (bpd), which means that the Shia Republic is responsible for about 4% of the world's oil. Under the previous sanctions (between 2012 – 2015), Iranian oil production was constrained to 2m bpd and most of this volume flowed directly to India and China (neither of whom were party to the UN Sanctions). This is a key point to remember this time around, because amongst all the headlines surrounding a re-embargo on Iranian oil, the fact that product will almost certainly continue flowing to Indian and Chinese consumers, means that 4m bpd will not be removed from global markets. Instead, the production baseline of 2m bpd will almost certainly be maintained.

Then there is the European question to consider. We know that the major European Powers are extremely disappointed in President Trump (what's new?!) and his decision to unilaterally pull out of the Iranian Nuclear Deal. It is therefore even possible that the Europeans will simply ignore American action entirely and continue to buy Iranian oil. Such a bold move however is without precedent, so it seems more likely that a "half-way house" will be adopted, whereby "light-touch" sanctions are applied. This type of diplomatic fudge will allow some oil to flow, but with a bit of extra red-tape thrown in, to make transactions that little more cumbersome. Should this be the outcome of EU decision making, then we could again reasonably expect the production baseline to increase - perhaps to the 3m bpd mark, which would give an overall net reduction of 1m bpd.

This would then beg the question of whether removing only 1m bpd from global oil supplies is really enough to send prices so steeply upwards? Is it possible perhaps, that markets have over-reacted? Sadly, the answer is probably not, because in a market that is already so tight for supply, even a small reduction in oil capacity is enough to send prices northwards (see our report way back in Feb 2011). Equally, whether sanctions against Iran are universally applied or not, misses the point as to how the oil industry works.

With the exception of China and India (where state entities buy crude oil), most oil in the West is purchased by private companies. The Trump Administration has indicated that those companies will have between 3-6 months to comply with new US led sanctions on Iran, or face sanctions themselves. This leaves the giants of the oil industry (Exxon-Mobil, Shell, BP, Total, ENI et al) with little choice but to comply with US wishes. Put simply, if it is to be a toss-up between boycotting Iranian oil or seeing their US assets and operations frozen, the oil majors will always choose the former. In short, the size of the US market will always outweigh the benefits of buying Iranian oil. Do remember also, that such decisions will not just be confined to the oil majors. Take Maersk (the biggest shipping firm in the world), who have already declared that their ships will no longer carry Iranian product. So that's another oil related market that is about to tighten up…

One way or another, the current omens for the oil price are looking bleak. It is just about possible that global demand will slow up in the face of high prices, because in theory, high prices should deter consumption. But price-driven, demand erosion tends to be a long-term phenomenon, rather than something that affects markets immediately. And besides, a small drop in demand would still not be enough to offset the current reductions in global crude supply, nor some of the overwhelming geo-political tensions that are being experienced in key oil-producing areas (Middle-East, Russia, Venezuela). It could be a long summer, but for all the wrong reasons…