Oil Market Report: January 2023

It's the new year so time for our annual review of the last 12 months, with some forward-looking predictions thrown in for good measure. In last year's report (https://stabilityfromvolatility.co.uk/market-reports/oil-market-report-01-22/) we once again correctly predicted the direction oil prices would take and the scale of the price movements. Even without the reckoning of the Ukrainian invasion (which we didn't predict), we still forecasted brutal price rises and the strong likelihood of a major price spike; "*we can say that the supply-demand situation remains critical and in fact the danger of a major price spike looks more likely this year than it did in 2021*". We pointed out that declining investment in oil production coupled with rapid post-Covid demand recovery was putting huge pressure on prices. We also drew attention to the incredible situation with regards gas, which by January 22 (again, before the Ukrainian invasion) was already trading at stratospheric levels. We projected that this would encourage major energy users to switch away from gas (to oil), thus putting more pressure on the price of crude.

With a backdrop like that, it was little wonder that when Russia invaded Ukraine, the effect on oil markets was seismic, with crude hitting almost $140 per barrel by March. However, if we actually consider the year as a whole (rather than the crazy months of Spring), the overall price trajectory of oil - whilst broadly in an upwards direction - wasn't perhaps as spectacular as might be assumed. On the first working day of 2022, the price of crude was $77 per barrel and yes, by March it had risen to $138. But by the final quarter of the year, prices were trending heavily downwards, such that by the final working day (30th Dec 2022), the price was actually "only" $86 per barrel – an inflation matching increase of 12% ($9 per barrel).

The devil however, is always in the detail and the $ price of crude only tells a fraction of the whole story. The first factor that ensured the Great British public experienced more than a mere $9 per barrel movement, was our old friend the exchange rate. Everyone knows the drill by now; oil is priced in $, which means it has to be converted to £ when it is sold in the UK. On the 30th December (2022) the price of diesel was $958 per tonne and the exchange rate was $1.2029 to the £ GBP. That gave a price of £796 per tonne and a pence per litre (ppl) cost of 67.32. Now compare the year-end exchange rate to the same day 12 months earlier (30th Dec 2021), when there was $1.3544 to the pound. If we applied that 2021 exchange rate to the 2022 price of diesel ($958), we actually would have ended the year at £707 per tonne (958/1.3544) or 59.79ppl. That's an increase of 7.50ppl (+10%) as a result of the falling value of sterling, which has to be added to the basic 12% increase in the core cost of crude.

"And there's more" (Jimmy Cricket, ITV, 1985-88). If there was one stand-out fuel story of 2022 it was not the price of crude, nor the crashing value of the pound, but the soaring cost of diesel. Whilst market commentators are often fixated by crude (which actually only directly affects refineries), it is finished product that matters most to consumers and diesel above all else, has the greatest impact when it comes to cost of living. And here again we had extra-ordinary movements in the price. Diesel started 2022 (4th Jan) at $677 per tonne and therefore logically should have ended the year around 12% higher ($760) if it had followed the same trajectory as crude. Imagine the scenes then, when it turned out that diesel ended the year over 40% up at $958 per tonne, which when added to the impact of the exchange rate, gave an increase of 25ppl (60%) in the cost of diesel. That certainly boots the paltry $9 per barrel crude increase well and truly out of the stands!

This brings us nicely on to our predictions for the new year, with number one being that there will be much greater focus in 2023 on refined fuels and in particular, diesel. Prediction number two is that for the first time since the Ukrainian invasion, Russia will begin to feel the pinch of sanctions and this will also be diesel related. Whereas the Western boycotts of Russian crude in 2022 simply reversed product flows away from Europe and into China and India, this will not be the case with Russian diesel (which will receive the strongest sanctions yet as of February of this year). The Asian economies all need crude to keep their refineries running, but what they don't need is ready made diesel from Russia, which would only undermine Chinese and Indian refining capacity. In effect, Russian diesel will have nowhere to go and will be removed from the market – in the West because of sanctions and in the "East" because of refinery protectionism. As a result (prediction three), we can expect a major diesel spike in the first half of 2023, along with significant damage to the Russian refining industry (prediction four). Our next forecast is that once again the correlation between diesel and crude will evaporate, but this will be short-lived as non-Russian refining capacity ramps up and soon fulfils demand. By the second half of the year, diesel will start coming down in price and re-correlate with stabilising crude oil prices. And that's our final and most bold prediction for 2023, which is that crude will be lower in price this year than in 2022. Oh...one more...oil markets this year will not be boring. They never are!