Oil Market update

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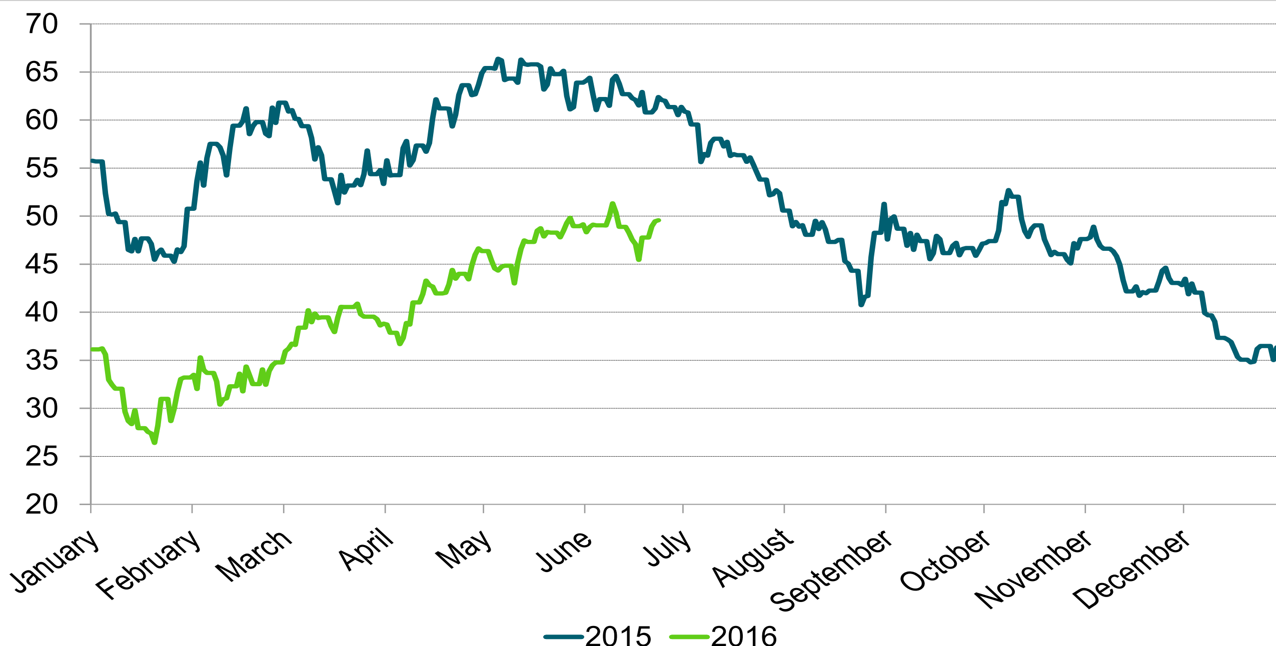
A tighter balance

- **Oil price forecast lifted on a tighter balance**
We remain firm in our expectation for an oil price recovery and although we see US shale activity being reactivated at USD 50/bl, we still believe USD 60 is in sight this year. We have updated our supply-demand balance and now expect a significantly tighter balance with higher demand and less Opec supply, we have lifted our oil price forecasts to USD 48/bl in 2016 and USD 55/bl in 2017.

- **US shale reactivation, but USD 50/bl not enough to drive production higher**
USD 50/bl has been enough for US shale oil rigs to start to revive. We estimate that some 20–70 high end rigs are needed to turn US shale oil production from decline to sideways by the end of the year and we expect this to happen at USD 50/bl. We view that closer to USD 60/bl is needed to activate another 100 to 150 high end rigs needed to drive US shale oil production back into solid expansion.

- **Supply starting to hurt with the risk for more losses to come**
Besides declining US crude production since April 2015, April and May this year gave the first emerging signs that the steep declines in oil prices as well as oil investments since 2014 were starting to bite and impact the supply side. This is directly due to lower investments and indirectly because lower income to governments in oil producing countries such as in Nigeria and Venezuela is leading to second round effects. Global crude oil production data for June and July will be crucial in deciding whether we live in a world as depicted by the US EIA and the IEA where non-Opec production stays fairly steady y/y to 2017 or whether the emerging decline in April and May was the start of an acceleration that could become clear when data points become available for June and July.

2015 and 2016 dated Brent oil price (USD/bl)



Source: SEB

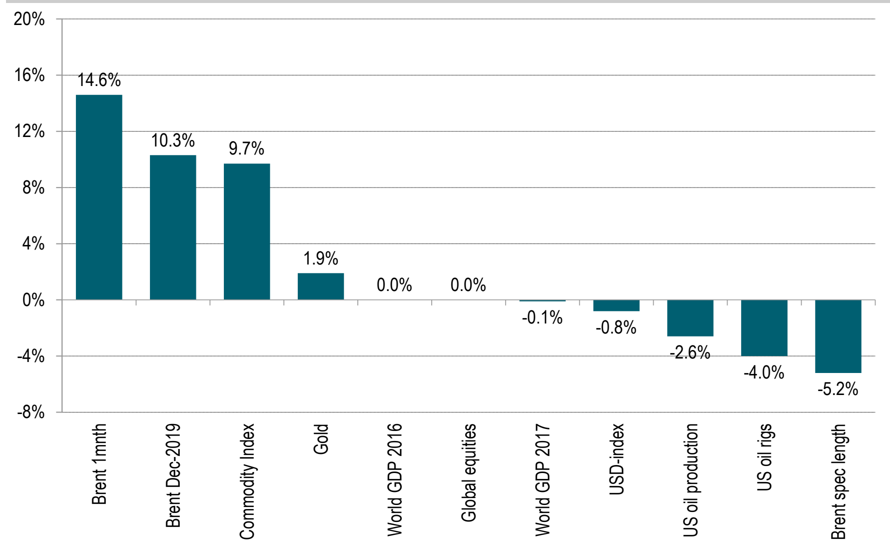
Important. All disclosure information can be found on pages 15 – 17 of this document

Since last time…

Since our last update in mid-April, we observe the following changes to market indicators:

- What stands out overall is that the oil price has seen continued strong gains without any tailwind from industrial metals (+0.6%), without help from equities in general (+/-0%) or EM equities especially (-2.2%) and marginal revisions lower for global growth. Even speculative positions in Brent crude have pulled back. Thus the price gains in Brent crude oil since April have come on the back of oil's own tightening fundamentals
- The front-month Brent crude oil price has gained 15% in a continuation of the gains since mid-January on the back of continued declines in US crude production and oil rigs and with additional help from outages in Nigeria and Canada as well as emerging signs of accelerating supply declines in for example China (-7% y/y). In addition oil demand growth has continued to grow at a steady, solid pace.
- Commodities in general have gained 10%.
- Global growth expectations are mostly unchanged although the Bloomberg consensus 2017 GDP forecast is down a bit
- The strong rise in speculative length in Brent crude oil seen up until April has shifted and net long positions have fallen by 5%
- Activity in the US continued to slow with the rig count continuing to slide (although it is reactivating now) and production is taking its toll and is down with a "run-rate" of 0.7m bl/d year-over-year.

Change in market indicators since our last report (13 April)



Source: SEB, Bloomberg

A tighter balance

We remain firm in our expectation for an oil price recovery and although we see US shale activity being reactivated at USD 50/bl, we still believe USD 60 is in sight. Because we have updated our supply-demand balance and now see a significantly tighter balance than last time, we have also lifted our oil price forecast.

Our estimate of the supply-demand balance has tightened from an oversupply of 1.1m bl/d to a near-balanced market this year and, in 2017, at a 0.7m bl/d deficit versus our previous expectation of a 0.4m bl/d oversupply. The tighter market balance mainly results from:

- Demand for 2016 has been revised up by some 0.3m bl/d largely due to base effects from revisions of oil demand higher for 2014 and 2015 with higher demand primarily in emerging markets.
- Opec production has been much less than we had forecast despite the Iranian comeback being much faster and larger than expected – instead, output from Saudi Arabia, Nigeria and Venezuela was much less than we had predicted.

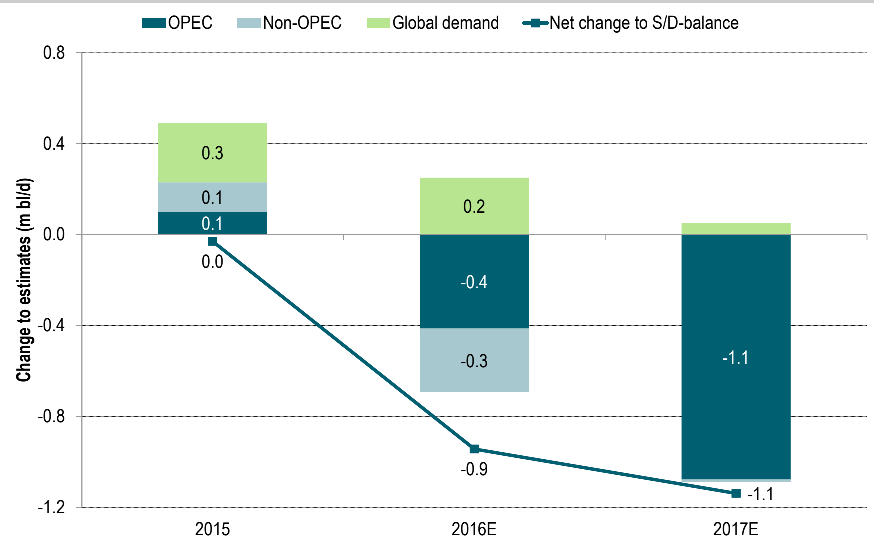
In addition to the tighter market balance, we now see early signs of production impacts from the massive capex cuts and that non-Opec, non-US has started to decline. As such, this has made us on the margin even more bullish on the oil price and we have increased our oil price forecasts for Q3 2016 by USD 5/bl, Q4 2016 by USD 10/bl to USD 55/bl and for 2017 by USD 5/bl to USD 55/bl.

New and old oil price forecast (USD/bl)

	Q1/16A	Q2/16A	Q3/16E	Q4/16E	2016E	2017E	2018E+
Old	34.5	45	50	45	44	50	60
New	34.5	45.8	55	55	48	55	60
Change	*0*	*0.8*	*5*	*10*	*4*	*5*	*0*

Source: SEB

Changes to supply-demand balance (m bl/d)



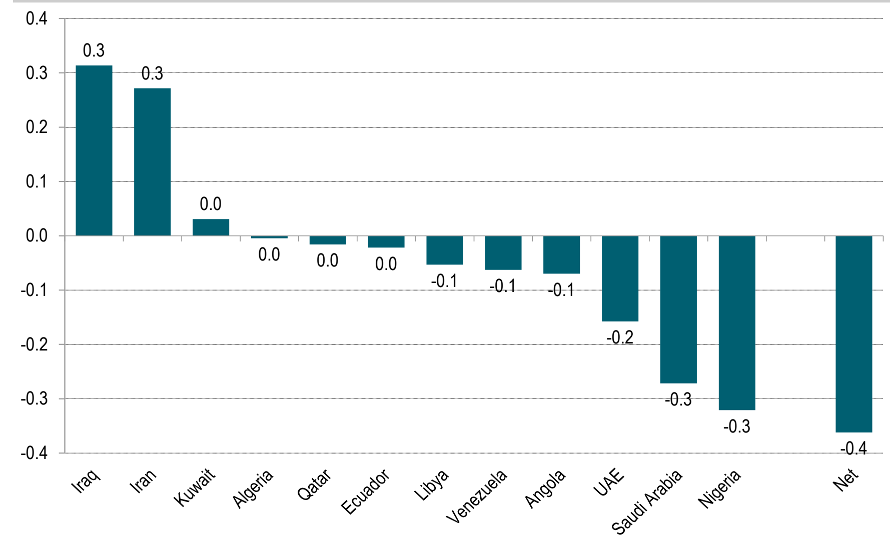
Source: SEB

SEB's supply-demand balance (m bl/d)

	2013	2014	2015E	2016E	2017E
DEMAND					
OECD	46.0	45.7	46.2	46.3	46.3
of this:					
US	*19.0*	*19.1*	*19.4*	*19.6*	*19.6*
Europe	*14.3*	*14.1*	*14.2*	*14.2*	*14.2*
Non-OECD	45.9	47.2	48.6	49.8	51.1
of this:					
China	*10.3*	*10.8*	*11.4*	*11.7*	*12.0*
TOTAL DEMAND	**91.9**	**92.9**	**94.8**	**96.1**	**97.4**
Growth (%)		*1.1*	*2.0*	*1.4*	*1.4*
SUPPLY					
Opec	31.3	31.1	32.6	32.9	33.4
Opec NGL	6.3	6.5	6.7	6.9	6.9
Non-Opec	53.8	56.2	57.6	56.4	56.3
of this:					
Non-Opec & non-US liquids	*43.6*	*44.3*	*44.7*	*44.1*	*43.7*
US crude oil production	*7.5*	*8.7*	*9.4*	*8.6*	*8.6*
US NGL & other	*2.8*	*3.2*	*3.5*	*3.7*	*4.0*
TOTAL SUPPLY	**91.5**	**93.9**	**96.9**	**96.2**	**96.6**
Growth (%)		*2.6*	*3.2*	*-0.7*	*0.4*
Supply/Demand-balance	**-0.5**	**1.0**	**2.1**	**0.2**	**-0.7**
Global stock change (m bl)	*-164.3*	*358.9*	*782.2*	*62.6*	*-257.4*
Call-on-Opec	*31.8*	*30.1*	*30.4*	*32.7*	*34.1*
Call-on-US crude oil	*7.9*	*7.7*	*7.3*	*8.4*	*9.3*

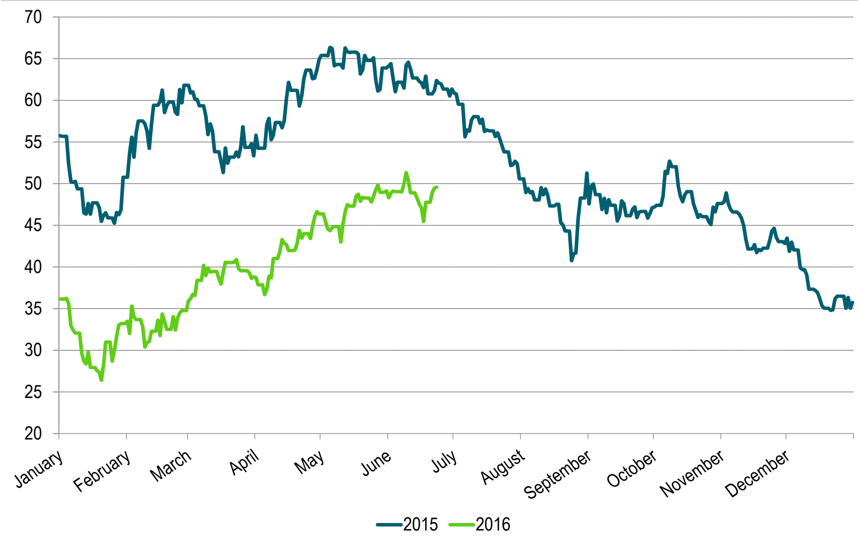
Source: SEB

Changes to 2016 Opec production forecast (m bl/d)



Source: SEB

2015 and 2016 Brent crude oil price (USD/bl)



Source: SEB

US shale reactivation

The moment has again come to put the US shale oil profitability, capacity and light-footedness to the test. Last year, the implied US shale oil rig count rose by 47 rigs from 423 to 470 during July and August after the WTI crude oil price had averaged close to USD 60/b during May and June. Since then, the movement in the rig count has mostly been sideways or lower in response to low oil prices. During the last eight weeks, however, the rig count decline seems to have bottomed out at 226 rigs and has now risen three weeks in a row in response to a WTI 15 months forward crude oil price which has averaged about USD 50/b over the last eight weeks. This is typically the lead – lag reaction time span we have observed during the last year between price action leading to rig count reaction. The total shale oil rig count gain over these three weeks is 13 rigs equating to 4.3 rigs per week. The average weekly gain during July and August equated to 5.2 rigs per week so still slightly short of that pace. The top end shale oil players earlier this year stated that they would add rigs if the oil price increased sustainably to USD 50/b. So far it is hard to say if this is sustainable or not, but the fact is that we now have had two months with the WTI 15 month forward price at USD 50/b and the US shale rig count has started to rise. Producers we have talked to in the US shale oil play are not showing any over-enthusiasm about an oil price of USD 50/b. Thus producers are not crawling on top of each other in order to get back into drilling more, but they have started to increase on the margin in the area where rig productivity and profitability is the highest – namely in Texas.

Depending on DUCs, we estimate that only 20-70 additional Tier 1 rigs are needed at end-2016 to keep production flat; an additional 110 rigs are then needed on top of this to shift US shale back to an expansion of maybe 1m bl/d per year

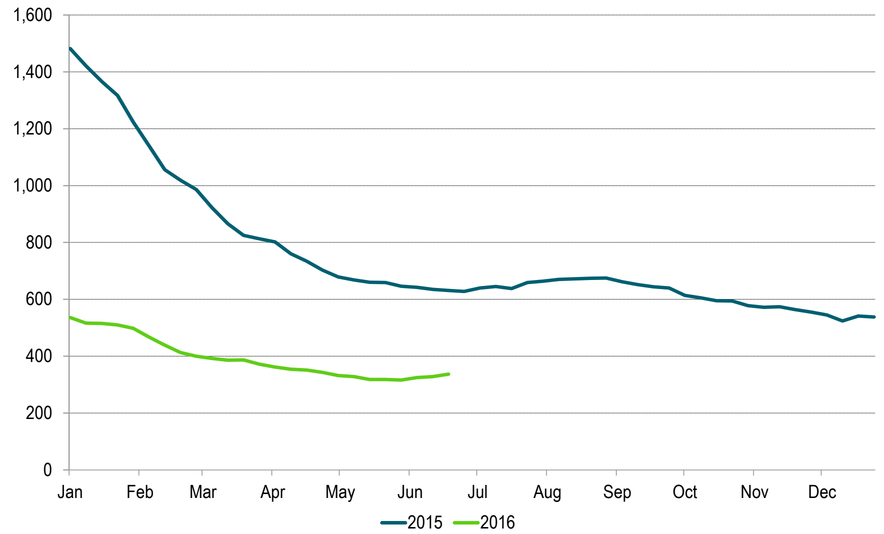
The decline rate in the already existing US shale oil production is going to ease towards year end as the large pool of already producing wells increasingly pass their first initial period of very steep production declines. It will thus get increasingly easy to counter the so called legacy loss in existing US shale oil production. Depending on the level of already drilled, but not yet completed wells, we estimate that only some additional 20 to 70 high end rigs in Texas are needed by the end of 2016 in order to shift US shale oil production from decline to sideways, steady state production. An additional 110 such rigs are then needed to shift US shale oil back to an expansion rate of 1 mb/d per year. Thus if the weekly US shale oil rig count increases by 2.5 rigs per week, then 70 additional rigs will have been added until end of year. If 6.5 rigs are added per week, then 180 rigs will have been added.

But higher rig count is needed and significant production uplift will take time… and money

In our view, a sustained WTI oil price of USD 50/b is probably sufficient to bring US shale oil production back to a steady state, sideways production by the year end. However, if an expansion rate of 1 mb/d per year is needed from the US shale oil space, an oil price of USD 60/b is probably needed. Money and time is however also needed in order to bring US shale oil production back to such an expansion rate. With a large part of the US shale oil space struggling economically there will obviously be some delayed responses from a large proportion of the players.

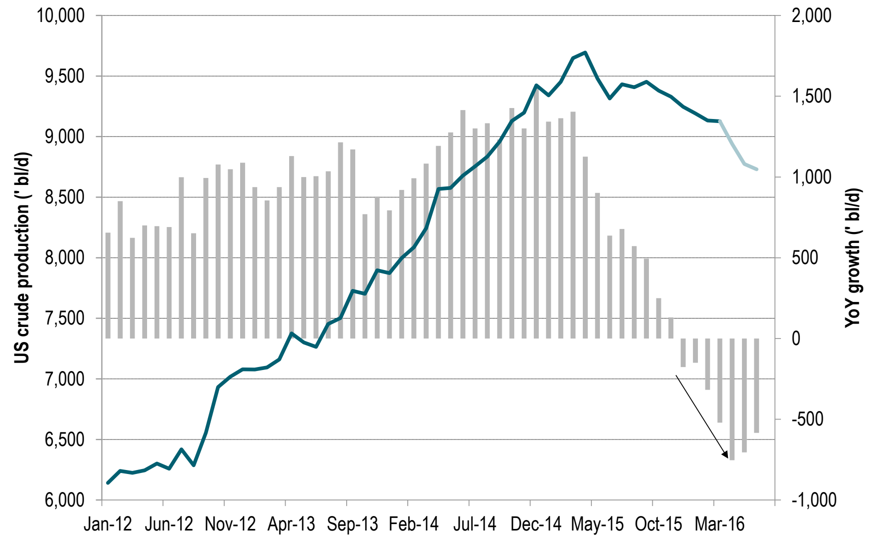
We estimate that the 13 shale oil rigs added in the last three weeks will add some 120 kb/d on the balance in 12 months if they are maintained in operation versus what would otherwise have been the case without them. Thus if the supply/demand balance in H2 2016 and 2017 is only in marginal surplus or marginal deficit of up to +/- 500 kb/d, then US shale oil activity should easily be able to adapt and thus contain prices at around USD 50/b. However, if more rapidly and unexpectedly a deficit of 1 mb/d or more unravels, then a price signal of USD 60/b or higher is probably needed in order to propel US shale oil back into action.

US oil rig count 2015 vs 2016



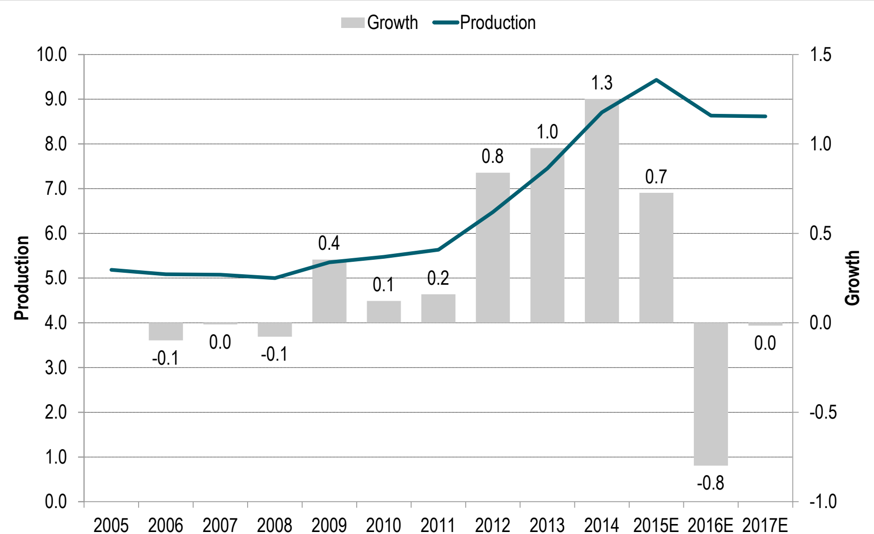
Source: SEB, Bloomberg

US oil production and YoY growth (m bl/d)



Source: SEB, Bloomberg

US production forecast (m bl/d)



Source: SEB

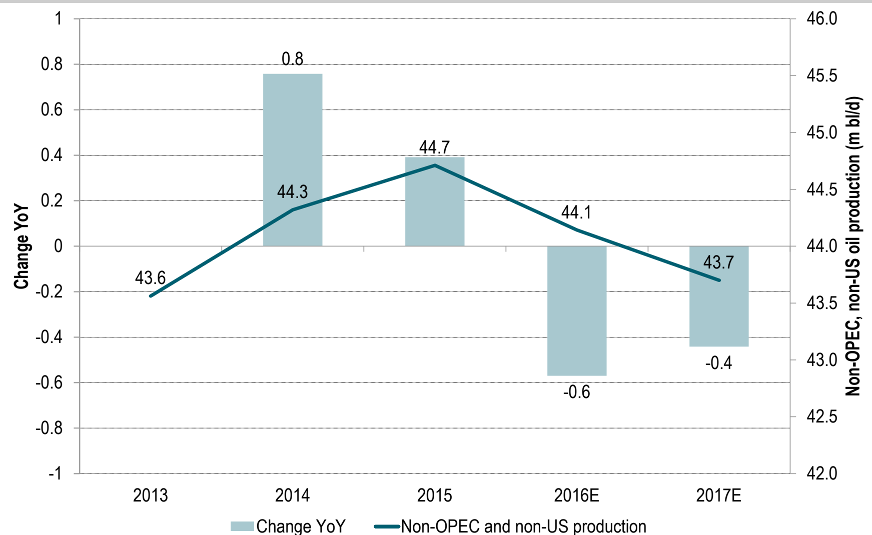
Declines and disruptions

Temporary, permanent or structural?

May saw global unplanned crude oil supply outage rise to 3.6 mb/d according to the EIA, the highest since its monthly record started in 2011.

In addition to the unplanned outage, we now see early signs of production impact from the massive capex cuts in the industry. The US is the most prominent with an annual decline rate of 0.7m bl/d while we also see indications of a structural decline in for example China and Mexico. As such, we have increased comfort in our estimates that non-Opec, non-US production will change from a 1%-2% growth to 1% decline rate.

Non-Opec, non-US production (m bl/d)



Source: SEB

The accidental outage:
Wildfires in Canada contributed to an outage of 0.8 mb/d on average in May with more than 1.1 mb/d at the most. The Canadian outage is typically of accidental nature and will come fully back in a couple of months. Some 0.4 mb/d is likely to be offline in June with supply normalizing towards the end of July unless disrupted again by returning wildfires as the wildfire season has only just started.

The political and economically induced outage:
Crude oil production in Nigeria fell to only 1.45 mb/d in May, the lowest since the late 1980s and down almost 0.5 mb/d versus the average for 2015. The outage is clearly of a political nature as the Niger Delta Avengers have blown up pipelines and infrastructure in response to President Buhari's changed stance towards the Niger Delta with reduced economic support to the local inhabitants and increased military presence in the area. We argue that the outage is partly also a consequence of the lower oil price and thus the reduced income to the Nigerian government which is probably partly a reason for the government's wish to reduce economic support to the Niger Delta region. Thus the lower oil price is leading to reduced production indirectly rather than directly due to reduced investments. It is worth noting however that the rig count in Nigeria is down from about 35 rigs during 2012 to 2014 to now only 25 rigs, i.e. a 30% reduction that will also have its consequences on lower production eventually. The latest petro-political development is a 30-day ceasefire (i.e. no blowing up of pipelines) between the Nigerian government and the different factions of the Niger delta guerrillas. This might restore some or all of the lost supply in Nigeria. However, reduced rig count and strained government budgets are likely to continue to hurt oil production in different ways.

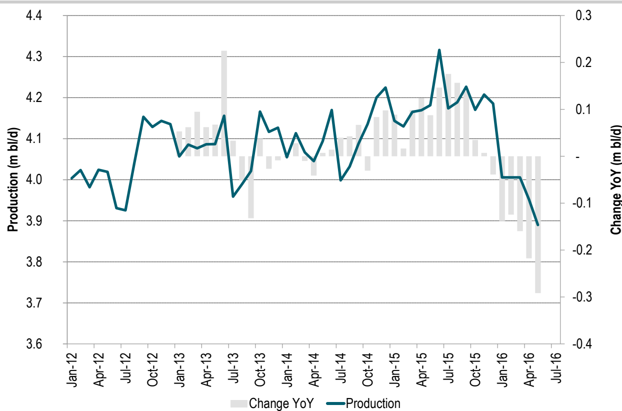
Crude oil production in Venezuela averaged 2.5 mb/d in 2015 with latest official data for May showing a production of 2.32 mb/d. In reality and unofficially it is probably closer to 2.2 mb/d potentially declining towards 2.0 mb/d towards the end of the year. For Venezuela the lower oil price is clearly a key ingredient in the lower production due to reduced investments, reduced maintenance and a negative spiral for the Venezuelan economy. The government can no longer secure a stable power supply with frequent blackouts hurting many parts of the oil industry. Oil service companies like Halliburton and Schlumberger are either leaving or reducing activity in the country due to lack of payments while Lufthansa has stopped flying there due to a lack of paying customers. We see very little light at the end of this tunnel and expect production in Venezuela to slide further.

Chinese crude oil production was down 0.3 mb/d in May (-7% y/y) versus the average of 2015. Here there is little doubt over the reason for the decline in production. It is totally a consequence of a lower oil price leading to reduced production of high cost oil. The same goes for US crude oil production which in May was down 0.7 mb/d y/y (-7%) of which 0.5 mb/d is likely to come from declines in US shale oil production.

Aside from the more accidental nature of the unplanned outage in Canada, the overall take from data in April and May is that the lower oil price is starting to bite harder on supply both directly due to reduced investments and reduced drilling activity but also due to reduced income to petro-governments leading to second round adverse effects on oil production, as seen in Venezuela and Nigeria.

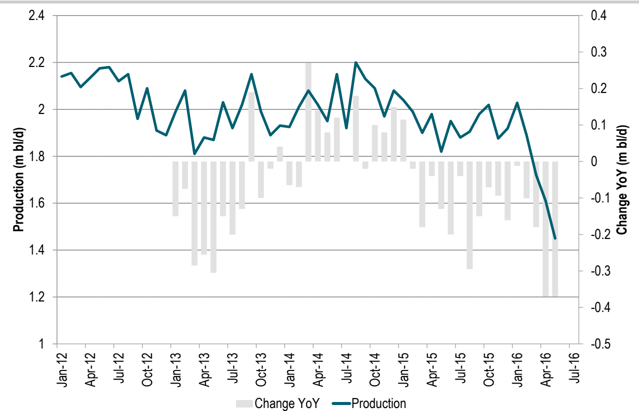
For Opec member countries this has led to a production that has been 0.4m bl/d lower than our earlier expectations, although Iran has surprised on the upside.

China: Production and change YoY (m bl/d)



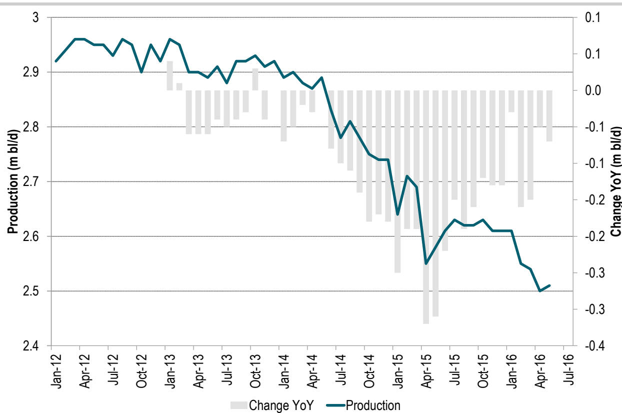
Source: SEB, Bloomberg

Nigeria: Production and change YoY (m bl/d)



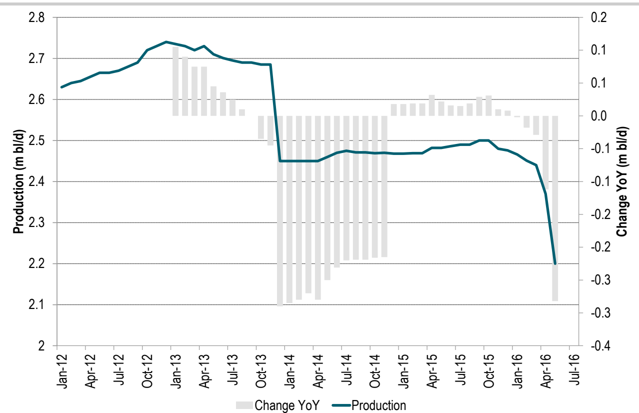
Source: SEB, Bloomberg

Mexico: Production and change YoY (m bl/d)



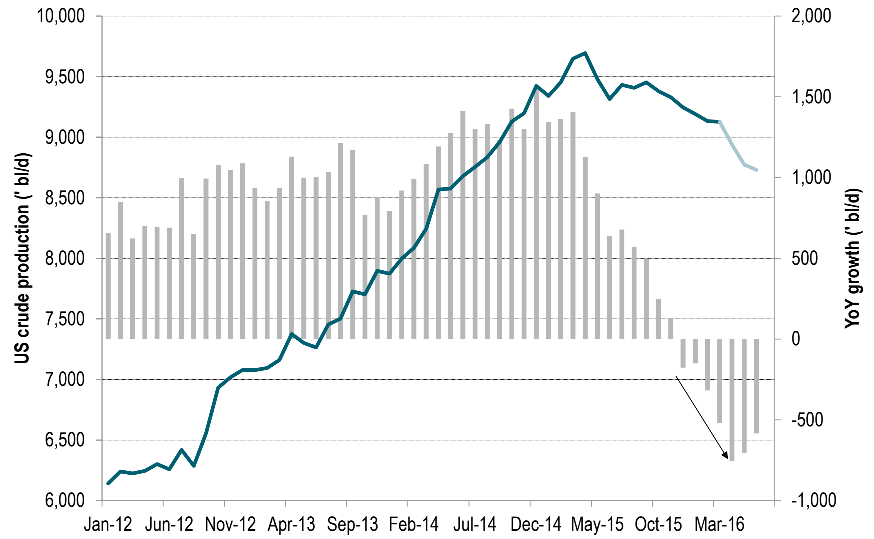
Source: SEB, Bloomberg

Venezuela: Production and change YoY (m bl/d)



Source: SEB, Bloomberg

US oil production and YoY growth (m bl/d)



Source: SEB, Bloomberg

Will/can Saudi ruin the recovery?

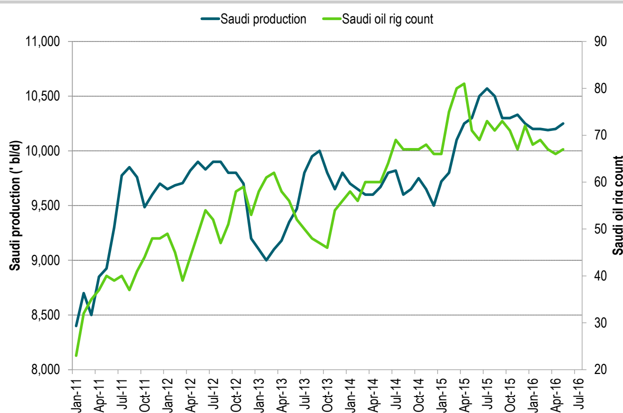
In our previous forecast we had expected Saudi Arabia to produce on average 10.5 mb/d in 2016. So far, average production is 10.2 mb/d with latest production for May at 10.25 mb/d down 0.05 mb/d y/y. While Saudi Arabia could likely produce more crude during June, July and August in order to cover elevated domestic crude demand (as it did last summer) there is no indication that Saudi Arabia is aiming to lift production higher at the moment. In our view Saudi Arabia has now gone full circle. In 2014 it lowered its OSPs (official selling prices) substantially in order to secure market share in the face of sharply rising non-Opec production. Thereafter Saudi Arabia followed up by increasing its production from 9.5 mb/d to 10.5 mb/d from end 2014 to mid-2015. There has been a widespread fear that this was in effect an economic proxy war with Iran as well as countering rapidly increasing production in Iraq. There might have been some elements of this, who knows, but first and foremost it looks like the aim of the lowering of prices and later boosting of supply was to counter the bubble of overinvestment and consequent boom in non-Opec production.

Saudi Arabia has now gone from a sharp lowering of its reference prices and boosting of production to instead lifting OSPs to Asia back towards normal historical levels while letting its production slide slightly lower rather than pushing more oil into the market.

There was a very clear statement at the last Opec meeting that there was no proxy economic production war going on between Saudi Arabia and Iran. Saudi Arabia stated clearly that it had no intention of flooding the market with oil with the sole purpose of hurting the other Opec members. In our view this took away a lot of downside uncertainty in the oil market even though there were not caps, cuts or freezes in the cards at the latest Opec meeting.

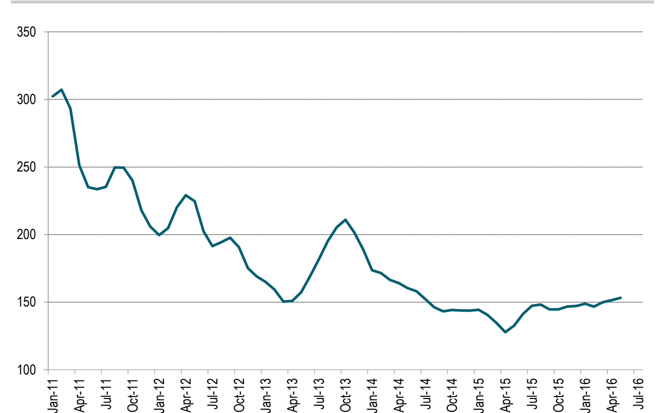
Saudi Arabia might increase production temporarily this summer, but in general it is now sitting back, holding production steady. Over the medium to longer term however we expect that Saudi Arabia will aim to increase its production over time as technological as well as environmental risks on the horizon increasingly are threatening oil's competitive position in the energy mix. One important point, however, is the declining production yield per oil rig in operation in Saudi Arabia. While we are not questioning Saudi Arabia's reserves in total and in general, it does look like there is a rising cost for Saudi Arabia to extract oil.

Saudi Arabia oil production and rig count



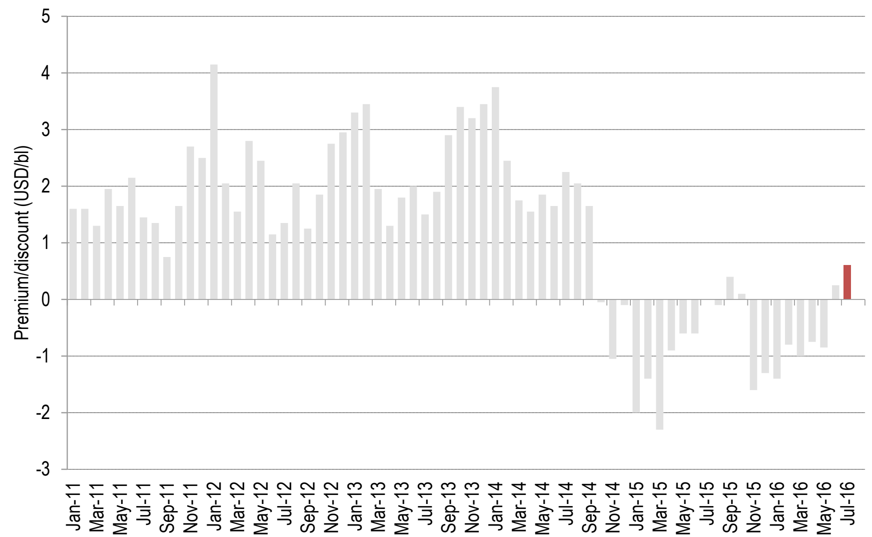
Source: SEB, Bloomberg

Saudi Arabia "rig efficiency" (production 1,000 bl/d per rig)



Source: SEB, Bloomberg

Saudi Arabia official selling price (OSP) to Asia (USD/bl)



Source: SEB, Bloomberg

Buy the sell-off if UK votes to exit

If the UK votes to exit the EU we expect Brent to sell down to between USD 40/b to USD 45/b. That would be a good buying opportunity in our view. While a Brexit would be damaging for the Brent crude oil price in the short term, we think that its impact on oil demand would be only marginally negative. Thus while overall sentiment in financial markets could be depressed for quite some time, the supply/demand balance for oil would not be impacted very much. Thus our view is to buy on Brexit. If we get a second negative round of sell-off ahead of the vote this week, with Brent crude down towards USD 45/b, we again view it as a good buying opportunity. It is true that if Brexit then actually happens, then Brent crude would sell further down, but it would not stay there long in our view.

Target prices and risks

Target price definition and associated risks
Our target price is the analyst's assessment of what total return an investor should expect over the coming six to 12 months. The target is based on fundamental equity research and other factors at the analyst's discretion. Please refer to published reports on the individual companies for a detailed description of the target price methodology.

Risk levels
The risk level is the analyst's view of the uncertainty in the earnings forecasts based on an assessment of the company's business model, operating risk as well as financial risk. We use two risk levels with the following explanations:

- **Normal risk:** All forecasts involve uncertainty and we view companies in this risk level to have normal forecast risks
- **High risk:** The earnings forecasts are more uncertain than for an average listed company due to business model, operating risk, financial risk or any other reason at the analyst's discretion. All companies with shorter track record than 12 months as a listed company are by definition classified as high risk according to SEB.

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Buy	Attractive risk/reward - at least 10% upside to target price.	53.5	9.7
Hold	Fairly valued - the shares are trading close to target price.	34.5	5.4
Sell	Unattractive risk/reward - the shares are trading above target price.	12.0	1.2
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