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The big squeeze: Why the oil market could remain tight in 2016

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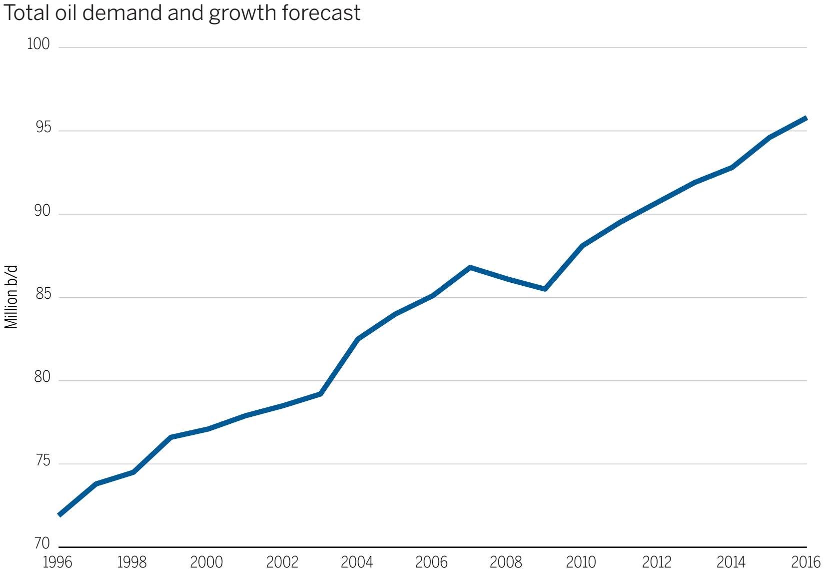
A MAJOR REASON WHY I AM POSITIVE ON THE ENERGY SECTOR TODAY is because of misperceptions around oil-market tightness and resulting asset mispricing. The market is tighter than the price of oil implies and will likely remain so because of rising global demand and overly optimistic supply-side forecasts.

Continued demand growth and supply constraints

The world's thirst for oil does not seem to be abating. The International Energy Agency (IEA) predicts a 1.2 million barrel per day (b/d) demand increase in 2016 (Figure 1). While the recent global accord on climate change may eventually lead to decreased demand for fossil fuels, that shift will be very long in coming and is unlikely to change near- to medium-term oil demand trends.

Figure 1
Oil demand growth continues
Total oil demand and growth forecast



Source: IEA

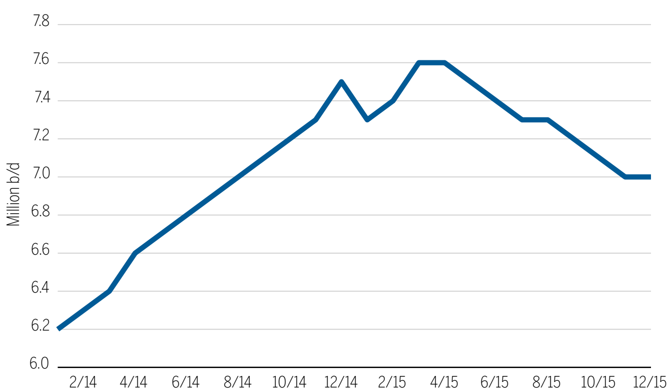
At the same time, the supply side will contribute to market tightness as well. Non-OPEC production is likely to fall, given large spending cuts in exploration and development. **Figure 2** shows a fall in US onshore oil production, while **Figure 3** shows a significant corresponding decline in the US rig count, relative to history. The US onshore oil-producing regions are notable because drilling activity has fallen by over 60% and new wells in these areas have very high first-year decline rates of 40% – 70%.

According to the Energy Information Administration (EIA), the US production outlook continues to dim, with the latest forecasts showing a year-over-year drop to 440,000 b/d by the end of 2015 and a decline of 610,000 b/d versus peak production in March 2015. By comparison, during 2014, year-over-year US production increased by 1.3 million b/d. The EIA's forecasts align with estimates from several oil-service companies I have met with recently that are forecasting additional declines in North American production of 900,000 b/d in 2016. Outside the US, growing anecdotal evidence indicates that production is already waning in Mexico and Colombia and that total non-OPEC ex-US production will fall further in 2016.

Figure 2

US oil production is falling...

Lower-48 (excluding Gulf of Mexico) production

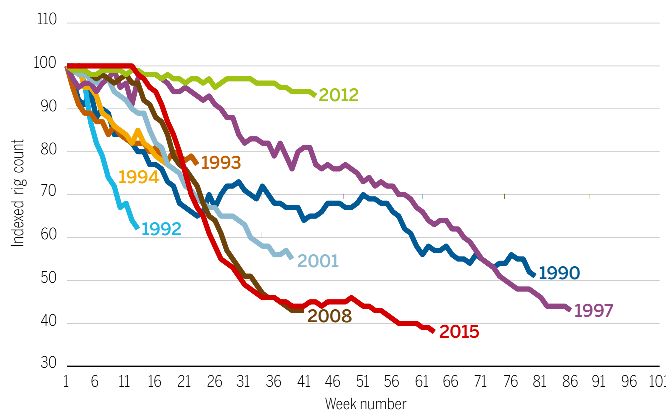


As of 8 December 2015 | Source: EIA

Figure 3

...as is the US rig count

2014/2015 US rig-count decline versus history



Source: Baker Hughes

OPEC supplies at risk

The outlook for OPEC production lends further support to the view that the market will tighten in 2016. One key misperception is that the market is significantly oversupplied. In contrast to this view, **Figure 4** shows that OPEC spare capacity as a percentage of global oil consumption is a mere 1% — a limited buffer in the event of a supply-side shock. During a recent meeting with one global oil-services company, management shared its view of underappreciated market tightness this way: OPEC has merely moved spare capacity from the ground into the market. Equity valuations do not currently reflect the low level of OPEC spare capacity.

As we move into 2016, I believe that OPEC production may disappoint to the downside, particularly given high — and likely unrealistic — production expectations for Iran and Iraq. Iraq has contributed approximately 1 million b/d to OPEC's oil production growth year over year, over half of the cartel's total 1.8 million b/d year-over-year growth. This level will likely prove unsustainable in 2016, as large exploration and production (E&P) companies are exiting Iraq because of security concerns and poor economic returns. Kurdistan and Iraq are both struggling to pay E&P companies, and the market seems to be overlooking the striking fact that the rig count in Iraq has declined by 60% in 2015. Notably, this bearish production outlook contrasts with current market expectations that Iraq will be one of the largest sources of incremental oil production growth through 2018 (**Figure 5**). At this point, this expectation seems improbable. The expectation for growth in production from Brazil also seems unrealistic, given Brazil's ongoing political headwinds.

The market's expectations for incremental volumes from Iran are overly optimistic as well. Iran has asserted that it can bring 500,000 b/d to market immediately, and eventually ramp up to an additional 1 million b/d. Based on my conversations with equipment and service and E&C companies, I believe there is a risk of disappointment in terms of the timing and magnitude of Iran's production goals. Apart from the Iranian government's continued antagonistic approach to its dealings with the West, the country has several high hurdles to overcome before it can increase production. Iran needs to incentivize E&P, E&C, and oil-service companies to enter the country, and it needs to substantially build out its infrastructure, which requires time and money. Contrary to consensus expectations, I believe that it will take Iran longer to meaningfully ramp up production and that they are unlikely to reach those stated goals anytime soon.

Lastly, there are signs that Iranian production may already be reaching the market surreptitiously. As **Figure 6** shows, Iraqi production of 4.25 million b/d in July and 4.3 million b/d in September 2015 were above that country's sustainable production capacity of 4.18 million. This means that Iran may be sneaking barrels of oil out of the region through its neighbor, with incremental production volumes already being sold.

Figure 6
Has Iran already ramped up production?
2015 OPEC crude production, million b/d

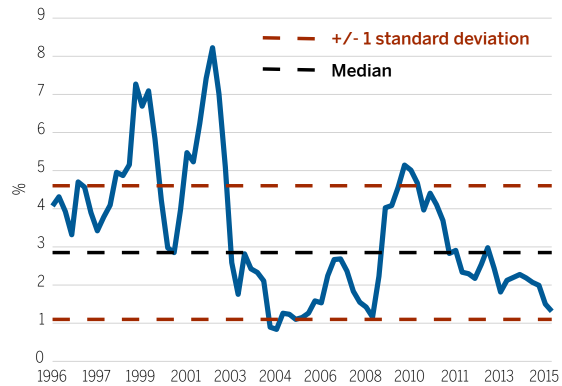
	July	August	September	Sustainable production capacity[1]
Iran	2.87	2.87	2.88	3.60
Iraq	4.25	4.17	4.30	4.18

[1]Capacity levels can be reached within 90 days and sustained for an extended period | Source: IEA

Conclusion

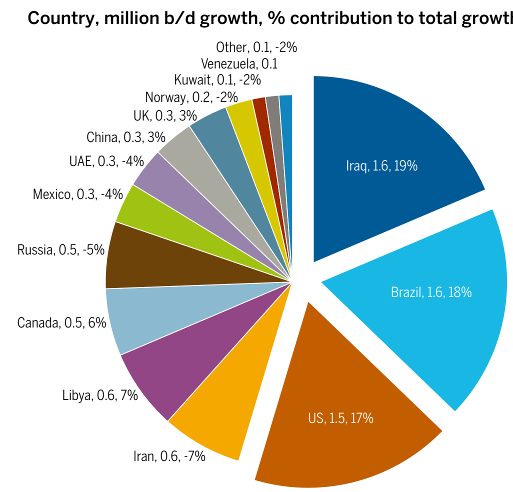
Rising global demand for oil, falling non-OPEC production, and downside risks to OPEC producers Iraq and Iran should contribute to an increase in the call on OPEC (the amount of oil the cartel needs to produce to maintain price stability). Not only do I expect oil-market tightness to continue, but current equity prices also do not adequately reflect this situation, a fact that underscores my positive outlook for the global energy sector.

Figure 4
The oil market remains tight
OPEC spare capacity as a percentage of global oil consumption



As of 30 September 2015 | Source: EIA

Figure 5
Iraqi oil production expectations may be unrealistic
Expected contributions to production growth, 2014 – 2018



As of December 2014 | Source: Bernstein

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