OIL – WHY IT`S PRICE WILL RISE AGAIN!

29 March 2023

VF Capital Management

Dear reader,

today I`m analyzing the controversial oil market – I will talk about the price, risks, the OPEC, my bullish view on oil and why

China and Russia are currently crucial for the oil market...

Views on the future development of the oil market are divided. However, the conditions for a significant increase in oil prices this year are not bad, at least at first glance. China has ended its zero-Covid policy, and its economy is recovering strongly, leading to a sharp increase in the energy demand of the world's largest oil consumer.

At the same time, Western countries, particularly the EU, have increased sanctions on oil imports from Russia. This should lower global supply, as Russia is one of the largest oil exporters. However, the price development of crude oil currently does not necessarily reflect the expectation of an increasingly tense market.

The price of a barrel of Brent crude oil is currently at around 78 US dollars, pretty much the same as in autumn of 2021, before the start of the Ukraine war. The price rose sharply at the beginning of 2022 but has since gradually fallen back. Since autumn 2022, there has been more or less sideways movement that recently took a little dip.

Contradictory Signals from China

But why isn't the oil price reacting more strongly to China's reopening? The recently published purchasing managers' indices, which are considered a barometer of economic activity, confirmed the assumption of a rapidly recovering Chinese economy. The purchasing managers' index for the manufacturing sector not only unexpectedly shot up, but also reached its highest level in over 10 years! The corresponding index for the service sector also rose strongly and reached its highest level since March 2021.

This may have confirmed the International Energy Agency's (IEA) experts in their forecast that China's oil demand will rise to 900,000 barrels per day on average in 2023, which would account for almost half of the expected increase in global oil demand. However, this must be seen against the backdrop that China's oil imports have fallen for two consecutive years.

But other data from China does not confirm the optimism regarding a high pace of economic recovery so far. For example, trade data for January and February were weaker than expected, with crude oil imports even 1.3% lower than in the same period last year. The government in Beijing also appears to be rather skeptical.

At the ongoing National People's Congress, a growth rate of around 5% for GDP was predicted for 2023. Not only is this relatively low by Chinese standards, most experts had expected more optimism. However, I also think that the skeptical attitude is quite appropriate. The sharp increase in China's purchasing managers' indices is likely to exaggerate the actual situation and be strongly driven by relief after the long political deadlock and the end of uncertainty.

Even though the pace is unclear, of course, the economy is picking up, not least because the Chinese are catching up on what they have not been able to do or could barely do in recent years, such as traveling - if they can afford it financially. This also increases demand for fuels. On the other hand, the tough Covid restrictions have left significant structural damage to the economy, and the industrial outlook in other parts of the world, namely the US and Europe, is currently weak, which dampens demand for Chinese products.

VF Capital Management

Russia's oil imports are not (yet) decreasing

And what about the supply on the oil market? So far, the expectation of a shortage due to sanctions has hardly been met. Russia's oil imports to the EU have almost dropped to zero, but overall oil exports have recently even reached the highest level in a year. Exports are now going primarily to Asia, but with significant price discounts. Russian oil of the Ural variety costs less than $47 per barrel.

The price discounts and higher costs have caused revenue from oil and gas sales to plummet by almost half compared to the previous year. Probably not least for this reason, the Russian government has announced a reduction in production by 500,000 barrels per day in March. How things will continue from April onwards depends on the development of price and demand.

The situation is similar for diesel: Diesel exports from Russian ports reached new record levels in February, but signs of a decline are increasing. Russian diesel is also sold at a high price discount, especially to South America, Southeast Asia, and North Africa. Many tankers are apparently sent out without any specific orders. According to the commodity experts at Kpler, 3.2 million barrels of diesel are currently on Russian tankers, parked off any coast for more than seven days. These are practically floating storage facilities.

It seems to be only a matter of time before Russia's oil and diesel exports decrease significantly. The IEA also expects Russia's oil production in 2023 to be about 1 million barrels per day below pre-war levels. However, so far, the predictions of a sharply declining production have proven to be exaggerated. It remains to be seen whether things will be different this time.

The OPEC cuts the supply

If Russia delivers less oil, the OPEC countries will not compensate for it. On the contrary, last fall, OPEC+ (including Russia) decided to reduce production by 2 million barrels per day, which is supposed to be in effect until the end of 2023. However, actual cuts are not expected because production is already below the agreed target. An expansion also seems highly unlikely.

This also applies to non-OPEC countries. The USA, Brazil, Canada, and Guyana are already producing record amounts, making significant expansions difficult.

The US Energy Authority even recently reported a decline in shale oil drilling, with the number of oil rigs falling to the lowest level since September 2022.

In fact, the price development of crude oil corresponds to the development of inventories. A year ago, inventories were at very low levels, but this has since significantly eased. The commercial, i.e., non-state, stocks of OECD countries are only slightly below the 5-year average.

However, the current good supply in the oil market is also due to the release of strategic oil reserves by industrialized countries in response to the Ukraine conflict and the sharply rising oil price in the spring of 2022. For example, the USA has allowed its emergency reserves to fall to the lowest level in 40 years.

What's next?

Currently, the oil market seems well supplied, despite slowly increasing demand from China. This is also the view of the IEA, which finds an oversupply in the oil market in the first quarter and assumes a balanced market for the second quarter. According to experts, however, this will change dramatically in the second half of the year. The IEA expects a significant supply deficit of 2 million barrels per day.

However, experts are often wrong, the market is complex, and the assumptions underlying the forecasts often do not materialize. For example, the IEA expects a strong increase in oil demand in the second half of the year. But if the economic recovery in China is weaker than expected and/or the US economy falls into a recession, then the forecast becomes obsolete. Moreover, the oil supply does not necessarily have to remain stagnant, as Russia, for example, could increase its exports again if the country needs more income.

My conclusion:

China will import more oil, that is clear, but the extent is uncertain. The economic development in the USA and Europe also creates uncertainty regarding oil demand. However, I expect a significant increase in demand overall. The supply cannot keep up, it will rather stagnate, also because the OPEC states and Russia would like to have a higher oil price.

VF Capital Management

If the oil price were to rise again, this would also give a boost to the shares of the oil companies. Similar to the oil price, these have been moving sideways on balance since autumn 2022. In our actively managed portfolio, which you can copy 1:1 by subscribing to our premium investment letter (check our website for more info), we will take advantage of corresponding opportunities.

A conservative approach would be to buy the stocks of Exxon, Royal Dutch Shell, or another oil conglomerate. Including dividends, this should be a rewarding approach for the next few years.

We have a less conservative approach and are currently having a closer look at our favourite oil-company again. Last year, the stock brought us a gain of +37%. This time we expect even more: if the oil price rises back to above 100$, the stock would be worth twice as much, if it then remains at that level for several months, it should triple and even if the price for oil doesn`t change, the stock should develop very solidly with close to double-digit returns on average.