DME

Coronavirus wreaks havoc on Middle East oil markets

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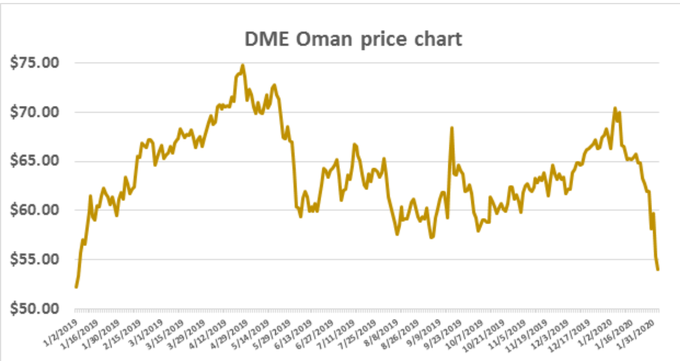
The best laid plans are often derailed by an external event that few could have predicted with any certainty, and the oil markets have succumbed to such an event with the coronavirus outbreak gripping the commodities sector.

Just a month into the New Year forecasts for 2020 have been thrown into disarray as Oman crude oil prices - which act as a proxy value for the Middle East - have fallen more than $16/b from the January peak as concerns over the fate of the Chinese economy and wider global GDP strike fear across commodities and financial markets.

From the $70.45 per barrel high in the wake of the strike on Iran's General Soleimani, Oman crude trading on Dubai Mercantile Exchange slumped to around $54/b on Feb 4 - levels not seen since the start of 2019.



The coronavirus outbreak has effectively shut down two thirds of China's GDP according to Bloomberg, with Economists anticipating that the virus will deal an even greater blow to the Chinese economy in the near term than the SARS epidemic, which wiped an estimated 0.8% percentage point from GDP growth in 2003.

The immediate impact saw Asia's largest refinery-the state-run Sinopec Corp – slash refinery throughput for February by around 600,000 barrels per day (b/d), which is the equivalent of roughly 12% of their average daily throughput.

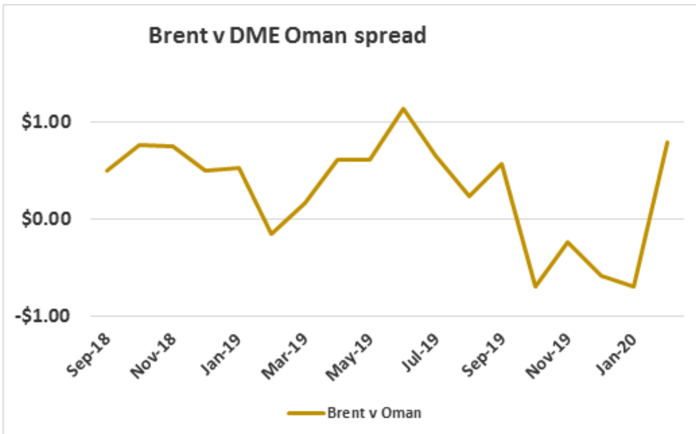
BP said overall Chinese demand has dropped by around 1 million b/d already, and a sustained reduction in demand will have a major impact on oil demand growth for 2020.

Brent/Oman reversal

The overhang of light sweet crude and relative shortage of heavier barrels due to a combination OPEC+ cuts and sanctions on Iran, had been narrowing the spread between Oman and its North Sea Brent counterpart throughout 2019 and into 2020.

In the mid-2010s the Brent/Oman spread averaged around $3/b but the onslaught of shale into international markets had flipped the spread into negative territory by the fourth quarter of 2019.

But the sharp decline of trade in China and the wider Asian markets has hit Middle East crude harder, with the Brent/Oman moving from an average of minus $0.70 in January to +$0.80 in the first few days of February.



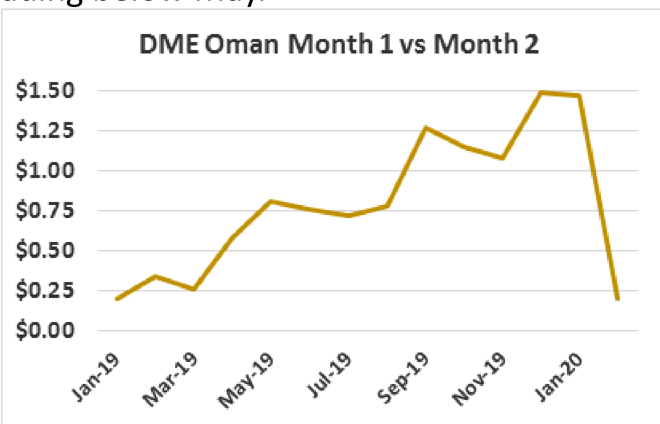
Saudi Arabia was China's top supplier of crude oil in 2019 averaging around 1.67 million b/d, followed by Russia at 1.55 million b/d. China is the world's top importer of crude oil at over 11 million b/d.

The lockdown across China is already having wide implications for oil demand, including the key transport fuels gasoline, diesel and jet, while naphtha demand for the petrochemicals industry is hit by factory closures.

Market structure

Middle East crude markets have been largely backwardated since 2017, whereby prompt-loading barrels command a premium to those loading further forward.

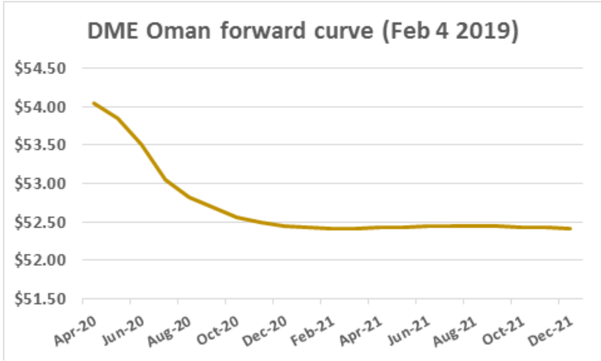
Healthy demand and disciplined production cuts from the OPEC+ group had lifted the front-month M1 vs M2 spread to $1.00-$1.50/b since last September, but in early February the M1 vs M2 spread (April vs May) has tumbled to around $0.20/b. In the North Sea, Brent has slipped into contango, with April trading below May.



The forward curve has also flattened considerably with the sharpest losses coming at the front of the curve.

For instance, in January the difference between the front-traded month (March) and December was around $6/b, but spread between the new front-month (April) and December now stands at under $2/b.

The average forward price for the remainder of the year as of February 4 stands at around $53/b, compared to most bank and analysts' predictions for a 2020 average of above $60/b.



OPEC Reaction

Reuters reported that OPEC and its allies are considering cutting their oil output by a further 500,000 b/d in a bid to rebalance the markets following the tumble in demand. The producer group along with allies including Russia (known as OPEC+) are looking at advancing the scheduled March meeting to Feb. 14-15, or even earlier

The Wall Street Journal said another option under consideration was for a temporary cut of 1 million b/d by the Saudis to support the market. OPEC+ has been reducing oil supply to support prices, agreeing in December to cut output by 1.7 million b/d until the end of March.

Oil is not the only fuel to be hit hard and the already oversupplied LNG market was sent spiraling down to record lows as the Platts Japan-Korea-Marker (JKM) Asian benchmark tumbled to its lowest ever level of around $3.50 per million British thermal units (mmBtu) in early February.

So while not quite a Black Swan event yet - given that coronavirus events have been with us before in the form of SARS and MERS - the latest outbreak can be considered as something of a Grey Swan that has thrown the 2020 oil outlook into disarray.