CIO thinks that the oil market will tighten further, supporting higher prices. (ddp)

Oil losses likely to reverse on tight market

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Oil extended its losses for a second week as concerns over a deteriorating demand outlook continued to weigh on the market. Brent crude is down 6.6% for the week, taking the cumulative drop over the past two weeks to 9%. It is now some 30% lower than the peak it reached earlier this year when the war in Ukraine broke out.

Earlier this week, OPEC cut its forecast for 2022 global oil demand growth for a fifth time since April and further trimmed next year's figure, citing mounting economic challenges including high inflation and rising interest rates. China's COVID-19 cases remain a concern, while Federal Reserve officials have reiterated their commitment to raising rates to curb inflation.

However, we think that the oil market will tighten further, supporting higher prices. OPEC+ is scaling back its production this month, with exports so far this month down more than 1 million barrels per day (mbpd) versus October. The upcoming European ban on Russian crude is likely to weigh on Russian oil production. Meanwhile, we continue to expect oil demand to keep rising. Hence, we forecast Brent crude to recover to USD 110/bbl in 2023.

A gas-to-oil switch in generating electricity this winter should support demand. While there is weakness in demand as a result of slower economic growth in Europe, users are switching to oil for power generation due to elevated gas and coal prices. This should bolster oil demand during the Northern Hemisphere winter. We also expect some Asian countries to burn more oil for the same reason. Overall, we expect oil demand to rise at an above-trend rate of around 1.6mbpd next year.

Some OECD countries may have to buy oil for strategic reserves. With the end of sales of more than 1mbpd of oil from OECD strategic petroleum reserves, a faster drop in commercial inventories is likely. In fact, unless the International Energy Agency coordinates another global release, we believe some OECD member states in Europe and Asia may have to refill their tanks next year to meet the obligation of holding emergency oil stocks equivalent to at least 90 days of net oil imports.

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China's recent policy support has reduced growth risks. The recalibration of its property and pandemic responses signals that economic growth remains an imperative for Chinese policymakers, and we expect China's GDP to expand by around 5% in 2023. With our base case of a permanent end to snap lockdowns early in the third quarter of 2023, strong year-over-year growth in China's oil demand can be expected following this year's low base.

We continue to think selling volatility in crude oil is an appealing strategy, and recommend risk-taking investors to add long positions in longer-dated Brent oil contracts, which we think have underpriced the potential for energy prices to stay higher for longer. We also favor global energy equities as the sector's valuations are at a 50% discount to their 10-year average, and we like value stocks, which tend to perform well when inflation is high.

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