The Major Risks
Facing the Oil Market

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The oil market remains on a razor's edge, highlighted by the relatively large price swings over the past month due to concerns that many major Chinese cities could be facing extensive lockdowns. Meanwhile, market participants are still trying to assess the fallout of Russia's invasion of Ukraine (i.e., sanctions).

In tandem, we expect the price of crude oil to be quite volatile, trading in a fairly wide range, say US$90 -120/bbl. ("barrel of oil") or so, unless there is a major development that could lead to a sharp break-out to the up or downside. This article reviews the downside and upside risks facing the oil market.

The key downside scenarios of which we need to be mindful are:

1. A sudden end to the war with a long-lasting peace agreement – but this prospect appears pretty remote.
2. Global oil supply picks up significantly, especially among non-OPEC+ countries. However, the rather muted recovery in U.S. crude production, which was once considered a major swing producer, suggests such a scenario remains distant due to ongoing investor demands that U.S. producers maintain capital discipline.
3. Global oil demand contracts sharply in response to monetary tightening by the world's major central banks. However, it's worth noting that the International Energy Agency's ("IEA") projections released earlier this month have average global oil demand rising by 1.8 mb/d to 99.4 mb/d ("million barrels per day") in 2022, in spite of new lockdowns spreading across China. Or, another way, though the Middle Kingdom accounts for roughly 15 per cent of global oil demand (the second largest share after the U.S.), its entire economy would need to be locked down for an extensive period to really cut into global oil demand.

Conversely, upside risks essentially revolve around the following:

1. EU sanctions on Russian imports of crude oil. This prospect has risen as Germany is now supportive of this idea despite concerns that even higher oil prices could further undermine Europe's economic recovery. However, a new roadblock has popped up as Hungary remains reluctant to approve the embargo given the country's heavy dependence on Russian oil. Otherwise, it appears that the EU wants to stop importing both crude oil and refined products from Russia by the end of the year.
2. The West imposes secondary sanctions on countries that continue to purchase Russian crude oil. We believe this is highly unlikely as it could lead to a sharp deterioration in international relations on multiple fronts. However, without secondary sanctions or further self-sanctioning, Moscow should be able to reroute its oil products to other willing buyers, as has largely been the case so far. This is not only helping to ease the pain on Russia's economy but also preventing international crude prices from heading much higher.
3. A sharp decline in OPEC+ production as Russian output, in particular, is under pressure. The IEA reported that Russian production fell by 1 mb/d in April. Note that OPEC+ missed its aggregate production target by a hefty 2.7 mb/d in March, compared to January's miss of 900 kb/d ("thousand barrels per day"). Nevertheless, the oil cartel is expected to stick with its recent strategy and lift production by 400 kb/d for the month of July when it holds its next Ministerial Meeting on June 2.

Key takeaway

If the pandemic did not already show it, predicting the future price of crude oil has truly become a fool's game. What we can confidently say is that the oil market is likely to experience more major twists and turns in the coming months. However, the balance of these risks for oil prices appears to be tilted more towards the upside.

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