Towards an Oil Price Spike? $100 Oil a Barrel Is a Distinct Possibility

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An oil price spike is starting to look increasingly possible, with a rerun of 2008 not entirely out of the question, according to a new report.

The outages from Iran are worse than most analysts expected, and bottlenecks in the U.S. shale patch could prevent non-OPEC supply from plugging the gap. To top it off, new regulations from the International Maritime Organization set to take effect in 2020 could significantly tighten supplies.

Put it all together, and "the likelihood of an oil spike and crash scenario akin to the one observed in 2008 has increased," Bank of America Merrill Lynch wrote in a note. BofAML has a price target for Brent at $95 per barrel by the end of the second quarter 2019. In 2008, Brent spiked to nearly $150 per barrel.

The supply picture is looking increasingly worrying, with Venezuela and Iran the two principal factors driving up oil prices in the fourth quarter. Notably, the bank increased its estimate of supply losses from Iran 1 million barrels per day (mb/d), up from 500,000 bpd previously.

U.S. shale can partially make up the difference, but the explosive growth from shale drillers is starting to slowdown, in part because of pipeline bottlenecks. BofAML sees U.S. supply growth of 1.4 mb/d in 2018 but only 1 mb/d of growth in 2019.

That means that there isn't the same upward pressure on WTI as there is on Brent, largely because infrastructure bottlenecks in the shale patch keep supplies somewhat stuck within the United States. And it isn't just in West Texas where the constraints are causing problems. "[B]ottlenecks in the Permian basin could well extend to other areas such as the Bakken or the Niobrara, and we do not even rule out temporary export capacity constraints in the Gulf Coast as domestic output overwhelms logistics," BofAML said in a note.

Meanwhile, the demand side of the equation is not as clear. For now, demand still looks strong. The IEA puts demand growth for 2018 at 1.4 mb/d, and Bank of America Merrill Lynch agrees. But BofAML says three important demand-side factors to watch, which could undermine the high price scenario.

First, the dollar is strong, which would likely prevent a run up in prices in the same way as in 2008. Second, higher debt levels in emerging markets means that many countries are in a weaker spot than they were in 2008. Third, capital could continue to flee emerging markets because of rising interest rates from the Federal Reserve, U.S. corporate tax cuts and U.S. tariffs.

Why the focus on emerging markets? Beyond the possibility of contagion, emerging markets represent the bulk of oil demand growth, so any faltering would upset the global demand picture. The strong dollar, higher debt and capital flight means that "significant [emerging market] oil demand destruction could follow if Brent crude oil spikes above $120/bbl," Bank of America Merrill Lynch said.

Nevertheless, there are some ingredients in place that could lead to dramatic price spikes, even if the corresponding demand destruction makes the spike only temporary. BofAML puts total global supply outages at around 3 mb/d, only a bit lower than the recent peak of about 3.75 mb/d in 2014. And that doesn't take into account the unfolding losses from Iran. In other words, if Iran loses around 1 mb/d of supply due to U.S. sanctions, as looks increasingly likely, total global supply outages could balloon to their highest in about two decades, not seen since the roughly 5 mb/d of outages during the 1990-91 Persian Gulf War.

Finally, the 2020 IMO regulations will force marine fuels to lower sulfur content from 3.5 percent to 0.5 percent. This will lead to a sharp increase in demand for diesel and other low sulfur fuels as the deadline for implementation approaches. "[T]he transition to a lower sulfur fuel specification will not likely be smooth," BofAML notes.

At a minimum, it appears that bearish sentiment from within the oil and gas industry has evaporated. Bloomberg notes that on the earnings calls of 22 major energy companies for the third quarter, not once was the phrase "lower for longer" mentioned, the first time since 2015 that was true. It wasn't too long ago that blistering U.S. shale growth was thought to have permanently lowered the marginal price of production, which would lead to a period of lower oil prices for the foreseeable future.

That mantra seems to have been fleeting as a growing number of analysts see higher prices ahead with concerns about the possibility of triple-digits.

> "The market does not have the supply response for a potential disappearance of 2 million barrels a day in the fourth quarter," Mercuria Energy Group Ltd. co-founder **Daniel Jaeggi** said in a speech at the S&P Global Platts Asia Pacific Petroleum Conference, according to Bloomberg. "In my view, that makes it conceivable to see a price spike north of $100 a barrel." Meanwhile, the co-head of oil trading at Trafigura, another top oil trader, said that $100 oil was possible by the end of the year.

One of the key factors that will determine whether this happens or not is how Saudi Arabia responds.

> "Our plan is to meet demand," said Saudi **Energy Minister Khalid Al-Falih**. "The reason Saudi Arabia didn't increase more is because all of our customers are receiving all of the barrels they want." His comments came after the OPEC+, which ended with no plans to increase output.

The Wall Street Journal reports that Saudi Aramco has told its customers that might be running short on Arab light crude in October, and that in the long run, it won't be able to meet demand if Iran is knocked offline.

> “[W]e are heading to a price spike, likely $90 to $100” an oil trader told the WSJ. “It’s not just Iran that will suffer. It’s going to have a boomerang effect with rising gasoline prices” in the U.S.

Worse, Saudi Arabia has officially said that it could cover for Iran’s losses, even if most of Iran’s production goes offline. In the past, Saudi officials have suggested that they could produce up to 12.0-12.5 mb/d if it the market needed it. But Saudi sources told the WSJ that producing “11 million is already a stretch, even for just a few months.” With output already up to about 10.4 mb/d, that leaves a significantly smaller pile of spare capacity than is commonly thought.

> “It’s tearing higher,” said **Ole Hansen**, head of commodities strategy at Saxo Bank A/S, according to Bloomberg. “Technicals and fundamentals seem to be pointing in the right direction at the moment and that can be quite a potent cocktail.”

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