PICTET 1805

Flash Note

Oil price

WTI likely to remain close to USD55

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> Last August, a significant gap between the spot oil price and its fundamental long-term equilibrium had opened up, signalling the risk of higher oil prices.

> After a rally of 25% since the end of August, the WTI price has now closed the gap with its long-term equilibrium and therefore further significant pressure, either upwards or downwards, appears limited at this stage.

> Meanwhile, clear signs that US oil production is losing steam have appeared in recent months. This, in addition to political turmoil in Saudi Arabia, is likely to support oil prices in the months ahead.

> However, the fundamental long-term equilibrium price is expected to remain in a range of USD55-USD58 next year for the WTI.
>
> So, after a further possible surge in the short term, oil prices are likely to converge towards their equilibrium of USD55-USD58 for WTI and USD61-USD64 for Brent.

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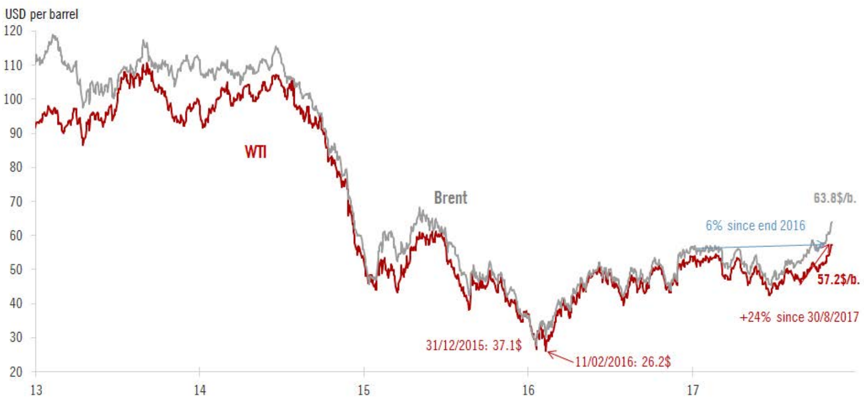
Limited upward potential

Last August, the long-term oil price equilibrium for the WTI was USD55 per barrel compared to a spot at USD47. This USD8 gap signalled the risk of higher oil prices in the short term. Recent developments have tended to confirm this prediction *(chart 1)*. The WTI rose by 25% from end-August to 7 November, to reach USD57. Now that the gap prevailing some weeks ago has closed, it is time to revaluate our expectations for oil prices out to end 2018.

Since its inception, our estimation of the long-term oil price equilibrium has proved to be a reliable indicator for future medium-term oil price dynamics. At this stage, this calculation is telling us that oil is fairly valued, suggesting limited upward pressure on prices ahead.

Chart 1: WTI and Brent oil price



Source: Pictet WM - AA&MR, Thomson Reuters, 8 Nov., 2017

Weakness in US oil production could support price in the short term

Recent developments have brought noticeable changes to the outlook for the supply-demand balance. First of all, the steady decline in the value of the US dollar since the end of 2016 has been stopped. In fact, the dollar appreciated by 4% between end September and 7 November *(chart 2)*.

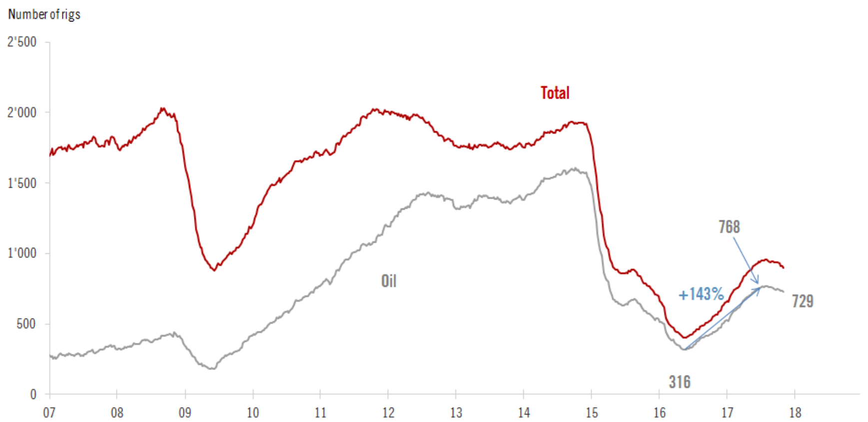
Second, world economic activity has gained steam. In its last update, the International Monetary Fund revised its world GDP growth forecast up to 3.6% in 2017 and 3.7% in 2018.

Chart 2: USD real trade-weighted exchange rate

Source: Pictet WM - AA&MR, Thomson Reuters, 8 Nov., 2017

Third, US oil production has hit some obstacles. The number of rigs has declined after an impressive 143% increase in in the 16 months to August 2017 *(chart 3).*

Chart 3: number of US rigs

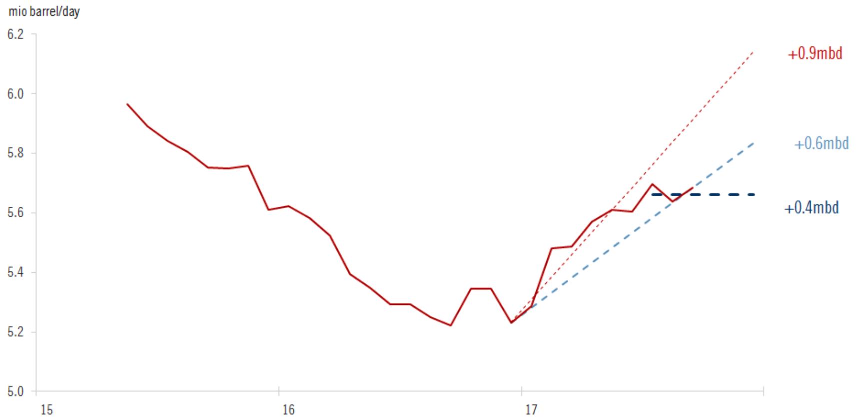


Source: Baker Hughes Inc., Pictet WM - AA&MR, Bloomberg, 8 Nov., 2017

As a consequence, US shale oil and gas production has stalled in recent months. At the beginning of the year, trends suggested that shale activity would have added 1 million barrels per day (mbd) to US oil production by the end of this year. However, it now looks as if additional output will be probably closer to 0.5mbd *(chart 4).*

Moreover, US crude inventory has fallen steadily (-15% since March) to reach its lowest level since January 2016. All in all, the loss in momentum in US oil production should help to support oil prices in the months ahead.

Chart 4: US shale oil and gas production

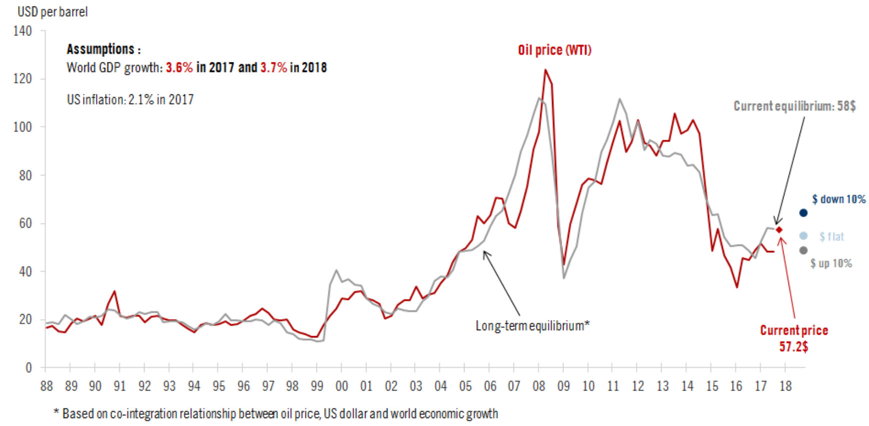


Source: Rystad Energy, Pictet WM - AA&MR, Bloomberg, 8 Nov., 2017

Oil price currently fairly valued

However, the potential for significant higher oil prices seems limited at this point. The long-term equilibrium price for WTI has risen from USD45 in Q4 2016 to USD58 now, helped by dollar weakness and strengthening economic activity *(chart 5)*. But these two factors seem to have plateaued for now. So, a significantly higher equilibrium seems unlikely at this stage.

Chart 5: WTI long-term fundamental equilibrium



Source: Pictet WM - AA&MR calculation based on Thomson Reuters data, Nov. 7, 2017

On a 12-month horizon, based on our world GDP forecast and a flat USD, the long-term equilibrium should ease back towards USD55. Only a significantly weaker US dollar (which is not in our scenario for 2018) would probably be able to push the long-term equilibrium above the USD60 threshold *(table 1)*.

Table 1:

EQUILIBRUM OIL PRICE:12-MONTH HORIZON

	US DOLLAR (real trade-weighted)		
($/barrel)	-10%	0%	+10%
World GDP (2017)			
3.2%	60	52	46
3.6%	**64**	**55**	**48**
4.2%	68	58	51

Source: Pictet WM - AA&MR calculation based on Thomson Reuters data, 7 Nov.,2017

Temporary price rise followed by a convergence towards long-term equilibrium

To sum up, less dynamic US oil production combined with stronger world economic activity are likely to support oil prices in the coming months. The recent political shakeup in Saudi Arabia is also likely to generate uncertainties about supply that could sustain oil prices. However, our fundamental evaluation of oil price equilibrium shows that at current levels oil is fairly valued. So, at this stage, there is no significant upward or downward pressure on prices. Moreover, on a 12-month horizon, the oil price equilibrium is unlikely to change significantly (USD55 for the WTI, according to our core economic scenario). All in all, while a temporary surge in oil prices is possible, the WTI can be expected to converge towards its long-term equilibrium, which is situated in a range between USD55 and USD58 (USD61-USD64 for Brent).