DALLASFED Economic Update

Energy

Hopes and Fears About Oversupply Whipsaw Oil Prices

First Quarter 2016

Oil prices rang in the new year by plummeting more than 25 percent the first two weeks of January due to concerns about global economic growth and oversupply in the oil market. Prices dramatically reversed course after mid-February, buoyed by talks of a production freeze, unexpected outages, signs of falling U.S. production and improved sentiment about the global economy. West Texas Intermediate prices ended the quarter near $37 a barrel, very close to where they were at the start of the year.

Outlook for Global Economy Affects Market

With the oil market in a state of persistent oversupply, sentiment about the health of the global economy has recently been an important driver of prices. Negative news in the early part of the year included another bout of Chinese stock market volatility and further downgrades to forecasts of global growth in 2016. Negativity became so widespread that some raised the question of whether even the U.S. might be headed for recession.

Sentiment has improved in recent weeks, though. Emerging-market equities have rebounded and the U.S. has continued adding jobs at a healthy pace, despite headwinds from the global economy. Furthermore, signs of stronger-than-expected U.S. gasoline demand, as seen in preliminary data, have contributed to rising gasoline prices. Futures prices for gasoline have increased more than crude oil prices, and the spread between the two is now back near the highs seen at the end of 2015 (*Chart 1*).

Production Freeze on Thin Ice?

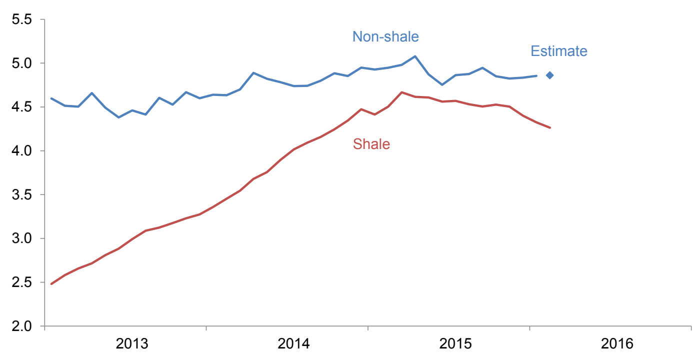
Russia and several members of the Organization of the Petroleum Exporting Countries have introduced the idea of a production freeze, and a meeting is set for April 17 in Doha to discuss further details. A major roadblock on the road to Doha is Iran, which is slowly reentering the oil market this year following the lifting of nuclear sanctions. Iran has summarily dismissed all talks of participating in the freeze until it reaches pre-sanction production levels. Saudi Arabia also made it clear on April 1 that its participation is contingent on Iran, essentially ruling out the possibility of a meaningful agreement.

Whether an agreement is reached or not, it remains unclear if the freeze would change the supply outlook for 2016 without Iran's participation. The other countries are unlikely to significantly boost supply in 2016 and, in several cases, appear to be currently producing at very high levels.

Chart 1
Gasoline Crack Spread Rebounds on Signs of Strong U.S. Demand

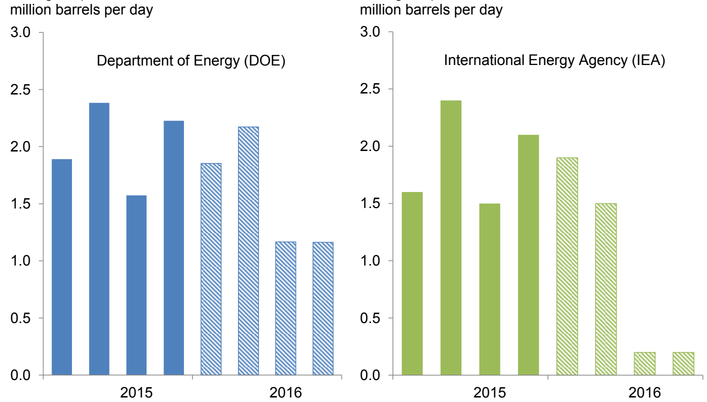
NOTE: Series is the difference in the July 2016 futures prices of gasoline for delivery in New York Harbor and Brent crude.
SOURCES: Bloomberg; authors' calculations.

Chart 2
U.S. Oil Production from Shale Declines as Non-Shale Holds Steady



NOTES: Estimate is calculated as total crude oil production in February minus shale production that month. Total crude production in February was approximated as the average of weekly production data that month.
SOURCES: Department of Energy; authors' calculations.

Chart 3
IEA Forecasts Faster Rebalancing, Lower Inventory Builds than DOE



NOTE: Shaded bars represent forecasts.
SOURCES: DOE; IEA; authors' calculations.

For example, Russian production has recently increased to levels last seen in the early 1990s.

Unlike the freeze, unplanned outages have materially affected global supply in recent months. Outages cut global production levels in February by almost 450,000 barrels per day, with Iraq and Nigeria accounting for 75 percent of the cuts.

U.S. Shale Production Continues to Decline

Reductions in U.S. crude production are expected to play an important part in reducing oversupply in the oil market. Newly released data, while lagged, hint that these cuts began in fourth quarter 2015 and continued into first quarter 2016. U.S. crude production averaged 9.18 million barrels per day in January 2016, down half a percent from the previous month and down more than 1.7 percent from January 2015. Shale production led to the recent decline, falling more than 1.7 percent in January and another 1.4 percent in February (*Chart 2*).

Rebalancing Expected, Pace Uncertain

The oil market is currently in a state of persistent oversupply. Recent forecasts from two major energy agencies, the U.S. Department of Energy (DOE) and the International Energy Agency (IEA), suggest that the situation should improve somewhat in the second half of 2016.

While both agencies expect the balance of world oil supply and demand to improve, they disagree about the pace of the improvement (*Chart 3*). The IEA predicts a significantly tighter market in the second half of 2016 than the DOE. Neither agency, however, predicts that current bloated inventory levels will fall this year.

All forecasts are inherently uncertain, and a number of risk factors will influence what eventually occurs in 2016 and beyond. These include U.S. and Iranian production levels and the health of the global economy, among others.

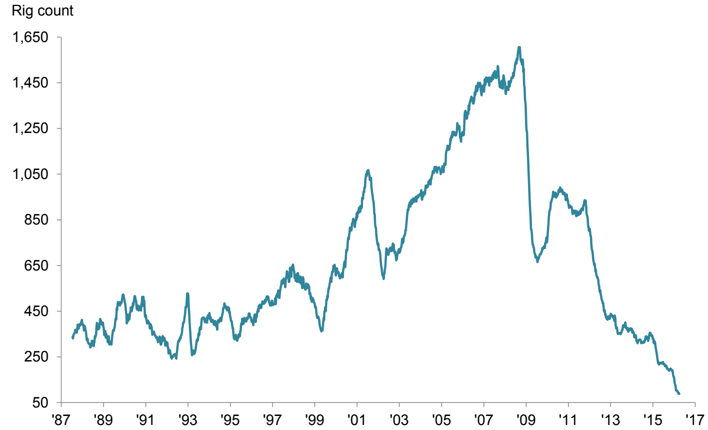
Gloomy Picture for Natural Gas, Too

U.S. natural gas prices have also faced pressure in the first quarter. Unusually warm weather due to El Niño significantly reduced consumer demand for gas for home heating, while supply has remained robust in the face of low prices. Buckling under this pressure, the spot price of natural gas averaged near $2 in first quarter 2016. After adjusting for inflation, this is one of the lowest prices seen since the 1970s. Lower gas prices have brought about further cuts to the number of U.S. rigs drilling for natural gas. There are currently 88 U.S. rigs operating, the lowest since data started being collected in the mid-1980s (*Chart 4*).

Oil and Gas Companies Enter Survival Mode

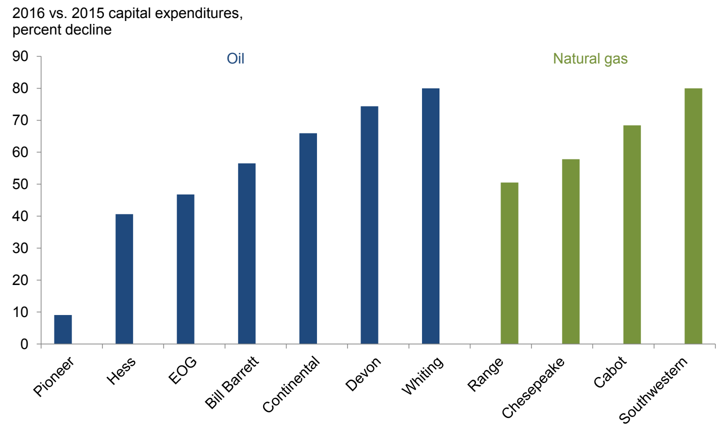
Despite forecasts of an eventual improvement in the oil market, U.S. oil and gas firms have continued to face difficult decisions about how to deal with the immediate reality of low energy prices. A number of upstream firms have announced substantial cuts to their capital spending in 2016 (*Chart 5*). Many have also been forced to lay off workers.

Chart 4
U.S. Natural Gas Rig Count Hits Historic Low



SOURCE: Baker Hughes.

Chart 5
2016 Sees Another Round of Capital Spending Cuts



NOTE: Averages are used for companies reporting a range of possible capital spending levels in 2016.
SOURCES: Company reports; authors' calculations.

Nationwide, oil and gas companies shed more than 20,000 jobs in first quarter 2016. Given current oil and gas prices, it is likely that many companies will continue to face difficulties in the quarter to come and beyond.

—Navi Dhaliwal and Michael Plante

About the Authors

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