IHS Forum explores key drivers of volatility in the oil market and what they mean for shipping

Combining oil and water

China's economic growth, the withdrawal of sanctions on Iranian energy shipments, and decisions about US crude exports are the three key drivers of the oil market identified by speakers at an IHS Forum held as part of London International Shipping Week. Combined with two significant influencers – developments in the global oil refinery sector and freight market cycles – these are the factors that need to be watched most carefully, according to Jan Randolph, director of sovereign risk at IHS Economics and Country Risk, Abhishek Deshpande, chief oil analyst at French investment bank Natixis, and Jeremy Penn, CEO of the Baltic Exchange.

KEY POINTS:

- China is going through a structural change from a manufacturing to a consuming economy
- The lifting of sanctions on Iran and on US exports will combine to keep oil prices low

The most significant driver of them all, the speakers agreed, is China. Its slowing economy – from 7% growth to 5% or even 4% – has had a material effect on the volume of iron ore, crude oil, and many other commodities. The consequent reduction in demand has brought about a fall in the crude oil price and stimulated a shift in purchasing power from energy producers to consumers of more than USD1 trillion over the past year. Western economies and 'Asian Tigers' have benefited the most; Gulf Cooperation Council states have funds in reserve to ride out a medium-term period of low prices, but Russia and former-Soviet economies are suffering. Meanwhile, there is strong evidence that the commodity super-cycle is over and little prospect of resurgence for several years.

An IHS position statement suggests that Chinese GDP growth will average 6.6% a year up to 2020, slightly lower than the official target of 7% a year. Low pricing is expected to encourage crude oil consumption in China from 10.2 million barrels/day (b/d) to 11.4 million b/d, stimulating imports from 6.4 million b/d to 7.6 million b/d by 2020. The company expects this to be a positive development for shipping because imports from the Atlantic basin will increase tonne-miles.

Economic slowing in China has had a significant impact on neighbouring countries' own economies. Hong Kong and Taiwan are most affected while the economies of Australia, Japan, Singapore, and South Korea all generate more than 25% of their revenue from exports to China.

An agreement signed in July by the UN Security Council's five permanent members and Germany (P5+1) regarding Iran's nuclear programme should result in crude oil export sanctions being relaxed or removed by 1Q16. This has the potential to increase Iranian exports by 0.5 million b/d by the end of the next year. IHS does not believe the shipping markets will see much effect until mid-2016. This additional crude can be expected to maintain the pressure to keep the oil price low, perhaps even a little lower than the current level up to end-2016.

The third driver is whether the US government lifts its ban on exports of crude oil and how such a decision would stimulate production. Exports have already increased by 0.5 million b/d over the past year, although this was mostly from Alaska to Canada. On the southern border, US condensate export restrictions were relaxed in 2014 and it is expected that a crude swap deal with Mexico will be agreed. The IHS expectation is that US crude oil export restrictions will be relaxed in late 2016 or early 2017, which would encourage production to increase from 9.3 million b/d to about 10.5 million b/d by 2020. By then, exports should hit about 2.3 million b/d, two-thirds of which would be shipped to Asia.

"What's happening in China is not cyclical – it is structural and it's deliberate"
Jeremy Penn
CEO, Baltic Exchange

While decisions taken by China, Iran, and the United States can be expected to stimulate volatility in the oil markets, a shift is taking place in the refining sector that will influence trade and shipping. Europe's mature refinery business is going through a process of rationalisation, which will continue beyond this year. The economics of refining in Europe remain challenging, not helped by a further reduction in crude oil consumption. All of the expansion in this

sector is coming from Asia, the Middle East, and Latin America. The Forum heard that Middle East crude oil consumption is forecast by IHS to increase by 1.2 million b/d up to 2020, more than half of which will be for domestic demand; Asian oil consumption is expected to rise by 1.7 million b/d in the same period on the back of increased regional demand, with net exports decreasing.

IHS OUTLOOK:

Growth in capacity 2015–20

- Aframax fleet to grow by 26% to 125 million dwt
- Suezmax fleet to grow by 39% to 99 million dwt
- Tanker freight rates to decline slowly. Very large crude carrier (VLCC) TD3 Middle East Gulf-Far East forecast by IHS to slip from USD16 per tonne to USD10 per tonne by end-2019
- VLCC fleet to grow by 32% to 272 million dwt

Penn underlined the view that the slowing of China's economy is in line with the stated vision of a shift from a manufacturing to a consumer economy. "What's happening in China is not cyclical – it is structural and it's deliberate," he told the Forum.

"Headline growth will trough at 5–6%." This understanding, echoed by both Randolph and Deshpande, has a fundamental significance for the oil business and the volatility of the oil market. Reduced demand for crude in the dominant Asian economy at a time of increased supply from both Iran and the United States will ensure the oil price remains under pressure over the next five years.

That's good news for tankers despite an increase in fleet sizes. All of the three drivers and the key influencer will raise shipping tonne-miles, but an increased orderbook should leave rates close to where they are today.

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