Ukraine invasion: few mitigating factors for oil prices

- We have revised our oil-price forecast on the back of the Russia-Ukraine crisis, incorporating a sizable geopolitical risk premium throughout our forecasting horizon. We expect Brent prices to remain above USD 100/bbl into 2023.

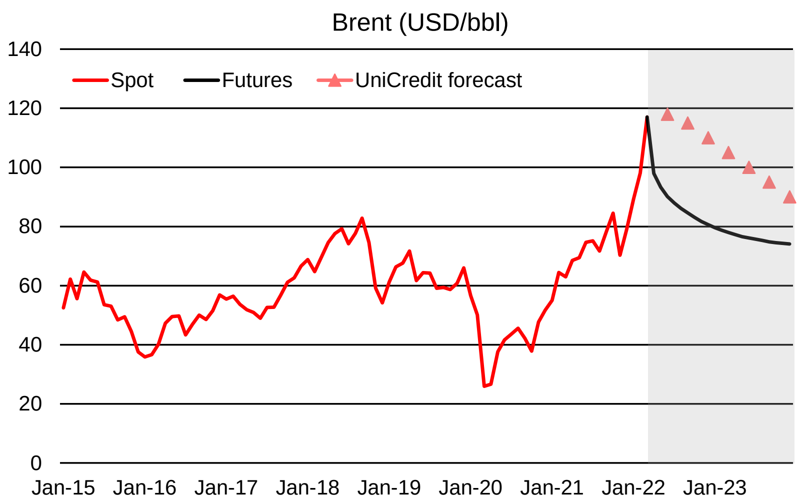
- The shock brought about by the invasion of Ukraine has come at a time of tight supply, low spare capacity and recovering demand. In addition, costs related to the shipping of Russian oil are soaring.

- We see few mitigating factors in the short term. OPEC+ does not have the appetite to revise its tapering strategy, and US shale production is suffering from two years of under investment. Equally, the deployment of strategic petroleum reserves is not a solution. Any drop in global oil demand would likely have a marginal impact on oil prices given the current backdrop of supply tightness and geopolitical uncertainty.

Sizable geopolitical risk premium

On the back of Russia's invasion of Ukraine, we now expect Brent to average USD 110/bbl (up from USD 76/bbl) in 2022 and USD 98/bbl (up from USD 66/bbl) in 2023. In our view, and assuming that tensions de-escalate by the end of 1H22 without affecting energy flows from Russia, Brent is likely to peak at USD 120/bbl next quarter before starting to decline towards USD 90/bbl at the end of 2023. Since the invasion of Ukraine is likely to have lasting diplomatic, economic and political ramifications, we have penciled in a sizable geopolitical premium compared to our original forecast of USD 65/bbl at the end of 2023, but also compared to the futures that predict a rapid price normalization (chart 1). Given the nature of the shock brought about by the crisis, which has triggered an unprecedented structural geopolitical shift, we expect Russia-related uncertainty to remain a persistent market-driver throughout our forecasting horizon.

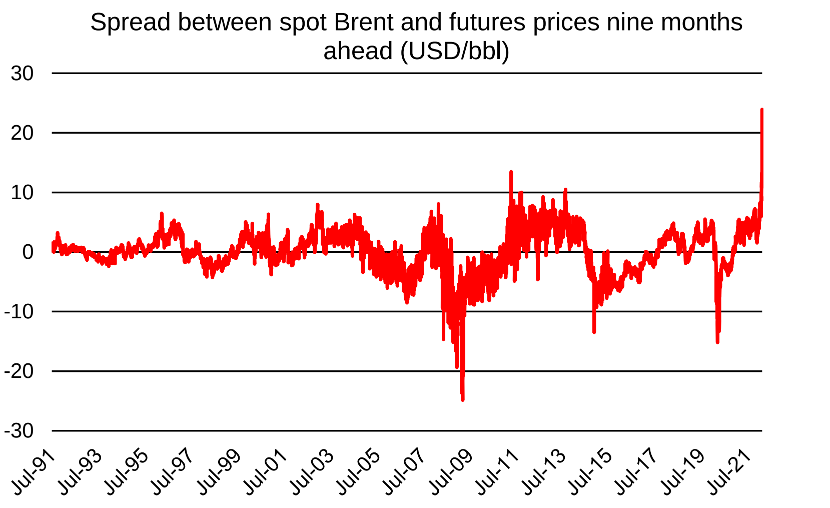
CHART 1: BRENT PRICES TO STAY HIGH



Source: Bloomberg, UniCredit Research

To offer a sense of the size of the geopolitical risk premium associated with the Russia-Ukraine conflict, Brent prices are now around USD 40/bbl higher than they were at the beginning of the year and are up by 50% YTD. The spread between spot Brent prices and futures nine months ahead is currently above USD 20/bbl – a level never reached since the 1990s (Chart 2). This is a sign of the short-term pessimism of the market and medium-term optimism. However, history shows that the futures curve adjusts only gradually. So, the gap between front and back positions might close quickly if a diplomatic solution is not found and if the market perceives lasting geopolitical uncertainty.

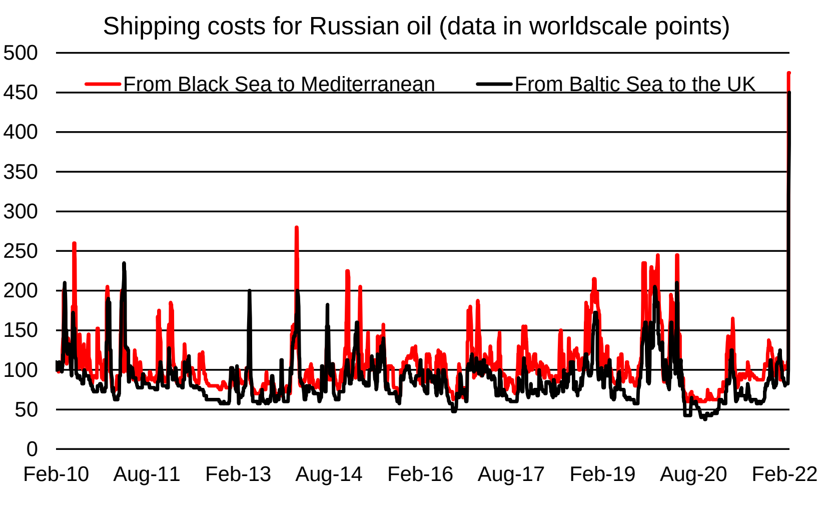
CHART 2: GAUGING THE GEOPOLITICAL RISK PREMIUM



Source: Bloomberg, UniCredit Research

This rising geopolitical risk premium not only reflects the risk of damage to oil facilities during the military conflict or potential Western sanctions on natural gas/oil but it also incorporates soaring insurance costs to ship Russian oil. This is shown in Chart 3, which shows shipping prices for oil coming from the Baltic Sea and the Black Sea (freight rates are usually expressed in so called worldscale points). Freight rates for both routes have more than tripled in a couple of days, as crude-oil buyers struggle to find shippers willing to send their vessels into Russian ports. This is part of a broader phenomenon of “self-sanctioning”. Market participants are simply refusing to deal in Russian oil, even if Western governments allow it within the sanctions they have imposed on Russia in response to its invasion of Ukraine. According to Bloomberg reports, this is due to confusion about what is legally permitted, fears about reputational damage or moral objections.

CHART 3. COSTLY RUSSIAN OIL

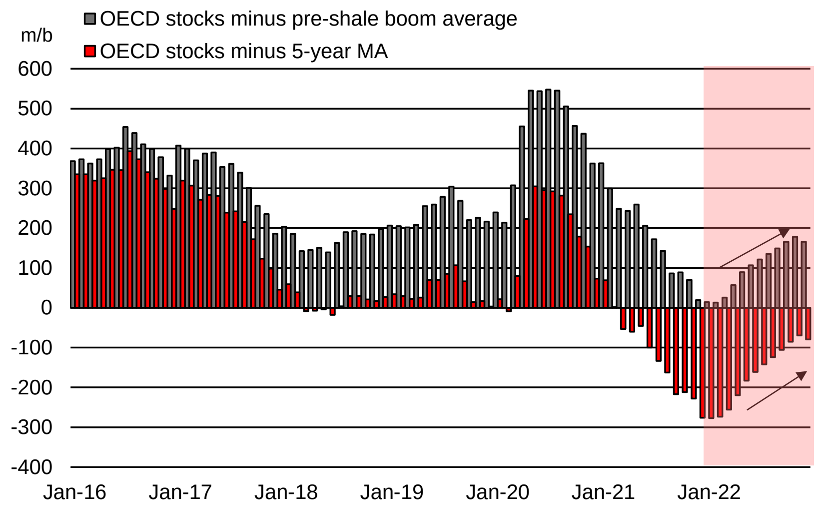


Source: Bloomberg, UniCredit Research

Tight physical market

The Russia-Ukraine conflict is taking place at a time when the physical oil market is rather tight. OECD inventories, whether measured as the differential between the pre-shale-boom average or the five-year moving average, are extremely low. This is because demand that arose during the economic recovery that followed months of pandemic-related restrictions worldwide has not been met by an equally strong recovery in supply. OPEC+ has been very conservative with regard to the tapering of its output cuts. However, as we have argued for a long time, we expect the market to gradually shift from a situation of undersupply to one of oversupply in 2Q22, as shown in Chart 4. The underlying assumption is that there will not be any major disruptions to energy flows from Russia and that OPEC+ will continue to add 400,000 b/d to production quotas until its pre-pandemic production level is fully restored.

CHART 4. VERY LOW INVENTORIES



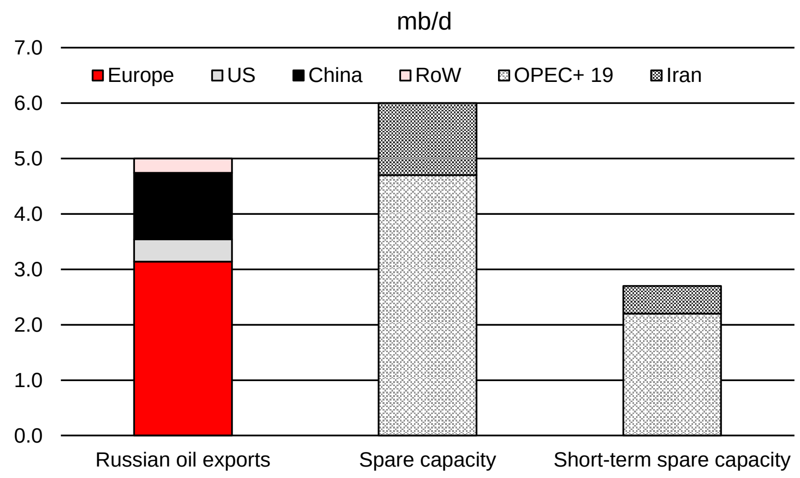
Source: International Energy Agency, UniCredit Research

What if Russia cut its oil supply?

Russia exports around 5mn b/d of oil worldwide. Europe and China (see Chart) are the major buyers. In a risk scenario in which energy supplies are affected to some extent for a short period of time, we expect the price of Brent to peak at around USD 130/bbl before gradually returning towards USD 95/bbl at the end of our forecasting horizon. In such a scenario, there would be few mitigating factors. This forecast does not incorporate spillover effects from the curtailing of natural-gas supply – which would likely push Brent prices even higher.

OPEC+'s spare capacity (production that can be activated in less than 90 days) amounts to 6mn b/d, including also sanctioned oil from Iran. However, short-term spare capacity (that can be activated in less than 30 days) amounts to just 2.5mn b/d. Therefore, if Moscow decided to cut its oil exports to zero or if the West decided to sanction them, then there would be an output shortfall of about 2.5mn b/d, and this would likely send Brent prices towards USD 150/bbl (in our risk scenario, we assume that oil supplies will only be partially curtailed). In addition, current figures pertaining to OPEC+'s spare capacity should be taken with a pinch of salt. In January, its production was 910,000 b/d below target because other countries, such as Nigeria and Angola, have struggled to meet their production quotas. In General, as it was confirmed by yesterday's review meeting, OPEC+ has no appetite to revise its tapering strategy, even when prices are substantially higher than what it thinks it is optimal for a stable market. Equally, an Iranian nuclear agreement seems within reach, and we think that Washington is aware of a need to reach an agreement quickly. Nevertheless, it will take a few weeks for Teheran to bring its barrels of oil onto the market once a deal has been signed (no more than 500k b/d initially).

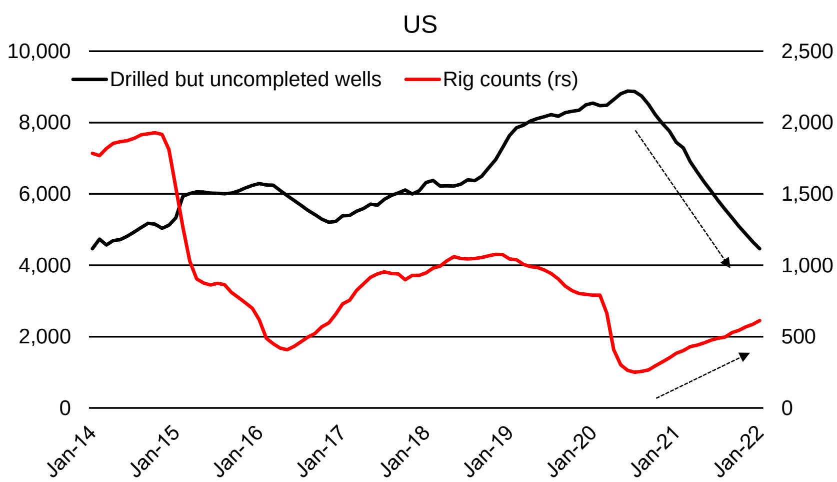
CHART 5: DON'T COUNT ON OPEC+ TO MAKE UP FOR SUPPLY SHORTFALLS



Source: International Energy Agency, UniCredit Research

In the very short term, US shale oil cannot be counted on to make up for supply shortfalls either. Shale-oil suppliers are likely to take advantage of shorter lead times between drilling and production relative to traditional oil production in reaction to favorable market conditions. However, such producers are emerging from two years of under-investment, which has weighed on their ability to ramp up production quickly in the short-term. The data in Chart 6, which shows shale-oil rig counts and the number of drilled but uncompleted wells (DUCs), indicate that the recovery in production in recent months was facilitated by the drawdown of existing wells and not by the discovery of new ones. When drilling activity grows faster than completion and production, then the number of DUCs increases – creating spare capacity that can be activated in case of need. Given that the average life of non-conventional oil wells is around 18 months, with their productivity declining rapidly over this time horizon, DUCs represent an important cushion to adapt to sudden changes in demand. At the moment, the number of DUCs is low, and to boost their numbers in a significant way (and thereby increase oil production) might take around 12 months of intense investment activity. Thus, this would take too long to facilitate a reaction to a sudden drop in Russian supply.

CHART 6. US SHALE CONSTRAINED BY UNDERINVESTMENT



Source: International Energy Agency, UniCredit Research

With regard to other mitigating factors, releasing strategic oil reserves would also not provide a solution, as demonstrated by the internationally coordinated injection of oil by consumer countries before Christmas or by a recent decision by the International Energy Agency to make available 60mn b/d of its reserves. Responding to a potentially open-ended shortfall in oil production by providing a finite supply will not succeed as a solution. In addition, if oil reserves were to fall below a certain threshold, this might push prices up, as investors would likely fear that consumer countries are rapidly depleting production buffers. Finally, a decline in global oil demand is probably the most effective mitigating factor in the short term. Such a drop in demand is however difficult to quantify because consumption is still off of its pre-pandemic levels, and most growth in demand in the coming months is expected to be driven by jet fuel as travel is expected to recover from declines brought about by the pandemic. However, given geopolitical uncertainty and overall supply tightness, the impact of a decline in demand on oil prices would likely be marginal.

Edoardo Campanella, Economist (UniCredit Bank, Milan)
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

Disclaimer

This report was completed and first published on 3 March 2022 at 16:33.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §85 WpHG). Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst’s remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst’s views, which have not been influenced by considerations of UniCredit Bank’s business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 20/1

UniCredit Research* Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

MR 22/1

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.