

Where is the peak of oil prices?

6 Sept 2023

1. Macro Opportunities for Higher Oil Prices:

Prior to the extension of production reduction measures by Saudi Arabia and Russia, international oil performance was relatively strong, reaching a new high for the year, with a strong tendency to break the regional pattern. From the macroeconomic perspective, if the high base effect weakens, inflation will continue to recur. Therefore, the Federal Reserve will maintain the current high interest rate environment for a longer time. The market will take this part of the expectation into account. Unless there are risk events similar to the previous banking industry, it is difficult for the short-term macro to have a bullish direction. Based on the weakening expectation of the US economic recession and the logic of betting on a bottom in the global manufacturing industry, the macro bearish factors have gradually subsided, and macro funds in the crude oil market have also begun to retreat from short positions in late June and early July, giving international oil prices an opportunity to break through upwards.

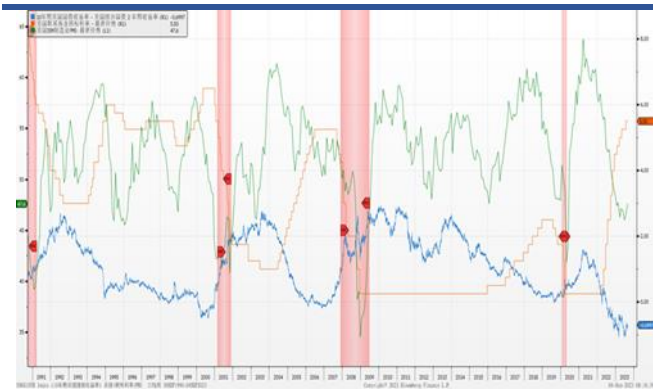
1.1 The factors supporting the expectation of a US economic recession have shifted:

There are three main factors that support the expectation of an economic recession in the United States: 1) The inversion of the yield curves of 2-year and 10-year US bonds often indicates that the economy will enter a recession; 2) The rapid increase in the growth rate of goods and services prices in the United States has led to severe inflation. The Federal Reserve needs to use measures such as interest rate hikes to combat inflation, which often has a significant inhibitory effect on the economy; 3) Geopolitics such as the epidemic and the Russia-Ukraine conflict have led to the fragility of the global supply chain, and the adverse external environment will affect the US economy.

Firstly, we see signs of stabilization and recovery in the inverted yield curves of 2-year and 10-year US bonds. At the end of August, the highest yield on 10-year US Treasury bonds reached 4.34%, an increase of nearly 50 basis points compared to the end of July, setting a new high in recent years; At the same time, the volatility of short-term US bond yields is relatively limited, and the yield curve shows a "bear steep" phenomenon. In the recent stable state of inflation, the rise of real interest rate is the main factor for the rise of long-term treasury bond. The actual interest rate, as an anchor for long-term asset valuation, further indicates that asset prices have the potential to rise. Secondly, since March last year, the Federal Reserve's interest rate hike has increased from a marginal increase to a marginal decrease today. However, due to the recent rise in oil prices and the weakening of the high base effect, inflation will continue to recur. Therefore, Federal Reserve Chairman Powell stated in his speech at the Jackson Hole meeting that fighting inflation remains the top priority of the Federal Reserve. The determination of the Federal Reserve to fight inflation has reduced the likelihood of inflation spiraling out of control, similar to in the 1970s. In the later stages, we believe that the Federal Reserve will maintain high interest rates and may continue to raise interest rates beyond expectations. From the perspective of US GDP, although nominal GDP is still declining year-on-year, actual GDP has already rebounded. In addition, according to the New York Fed's Global Supply Chain Pressure Index (GSCPI), the peak of 4.31 in 2021 has continued to decline to the latest data of -0.9 in July, indicating a rapid improvement

in global supply chain pressure.

Figure: 10y-2y US Treasury yields bottomed out and rebounded



Source: Bloomberg/Haitong Futures

Figure: Actual Yield Upward



Figure: Long term US bond yields climb

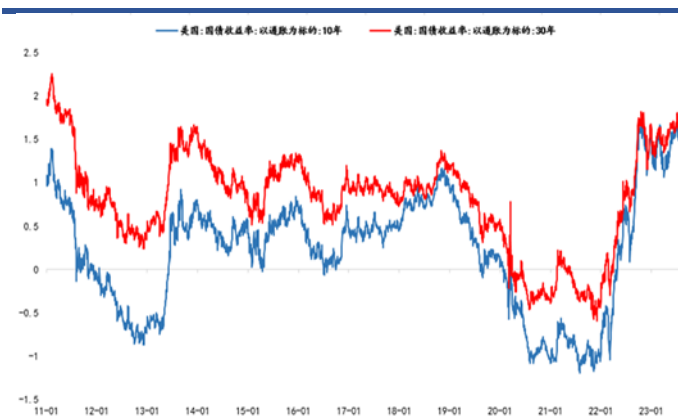
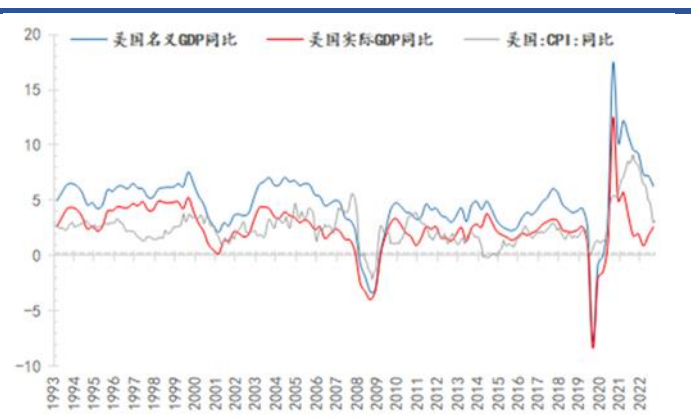


Figure: Real GDP recovery in the US



Source: Bloomberg/Haitong Futures

1.2 The Bet of a Bottom in Global Manufacturing:

The new orders for the ISM manufacturing industry PMI in the United States have continued to fall below the boom and bust line since September 2022, and have contracted for 12 months until August. Currently, there is a cyclical bottom oscillation; The manufacturing PMI has continuously fallen below the boom and bust line since October 2022, and is currently experiencing periodic bottom fluctuations. At present, the global manufacturing PMI in August is 49, showing a trend of stabilizing and fluctuating. After the outbreak of the epidemic in 2020, the global supply chain was disrupted and companies generally had insufficient inventory; In 2022, after the Russia-Ukraine conflict, the inventory accumulated by enterprises continues to decline. At present, it is close to the bottom of the inventory, and the inventory cycle of the manufacturing industry may soon start, which will bring new driving force for the recovery of the manufacturing industry. At present, it seems that the US capital goods new order index has risen with the US stock market, and with the expansion of the fiscal deficit, consumer spending on goods has shown a rebound trend.

Figure: US ISM Manufacturing&Non Manufacturing PMI

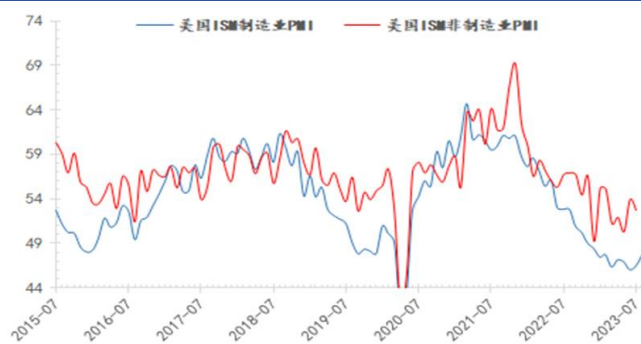


Figure: Increase in new orders for capital goods



Source: Bloomberg/Haitong Futures

Figure: Increase in fiscal deficit

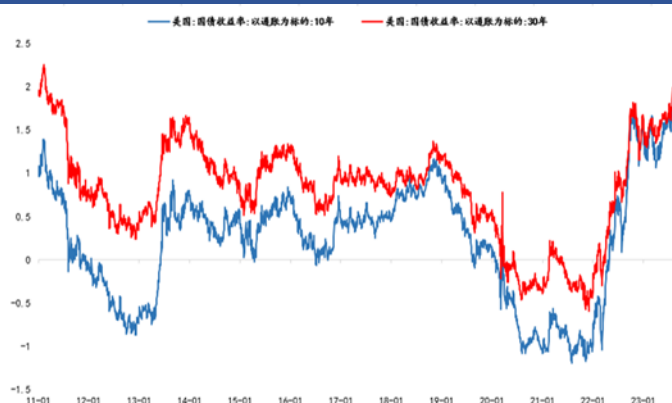
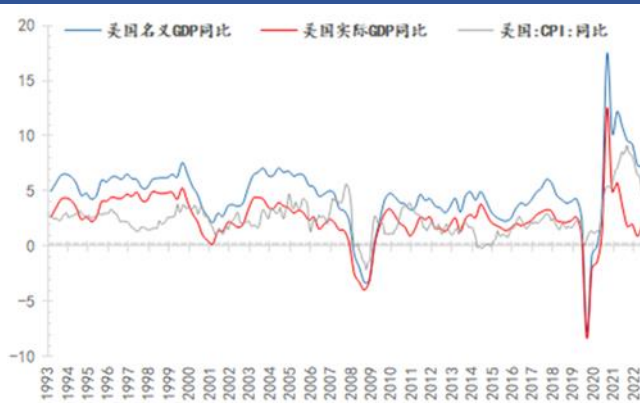


Figure: YOY increase in commodity consumption expenditure



Source: Bloomberg/Haitong Futures

2. The Fundamental Basis of Higher Oil Prices:

2.1 Inventory

Inventory is the most intuitive data for the supply and demand pattern, and generally speaking, there is a negative correlation between inventory and price trends. We saw a trend of destocking in the US commercial crude oil inventory in March, but at that time, the oil prices from March to June did not reflect the fundamentals, and the market mainly relied on the logic of trading macro bearish. However, after the macro impact weakened in July, the oil price trend began to trend towards strength. On the other hand, the monthly difference is generally viewed as a funding perspective, and we can also use it as an extension of inventory indicators, which is a leading indicator of inventory. When the monthly difference is in the contrango structure, it indicates an oversupply of crude oil and is more likely to accumulate inventory; The back structure indicates a shortage of supply and a tendency towards destocking. This year, although the monthly difference fluctuates slightly, the trend is higher, and it has a back structure from negative to positive. The predictions of the three major institutions have also reached a consensus in the past two months from June to July, believing that the second half of the year will be spent on inventory; In February May, the three major institutions had divergent expectations for future inventory, mainly due to the uncertainty of demand.

Figure: The decline in commercial crude oil inventories in the US



Figure: M1-M4 lifting



Source: Bloomberg/Haitong Futures

2.2 Supply

Inventory is only a result of supply and demand data rather than a cause, and the fundamental contradiction leading to destocking lies in the reduction of OPEC+ production. Due to the highly monopolistic nature of global crude oil supply, major producing countries can adjust their supply independently, thereby affecting oil prices, with OPEC+ quotas and production being the focus of market attention. Since the end of last year, OPEC+ has been reducing production in order to counter the pessimistic expectations of macro level demand, until several waves of production cuts have also occurred this year. The main reason why Brent crude oil station reached \$90 this time is that Saudi Arabia has announced a voluntary production reduction of 1 million barrels per day for an extension of 3 months until the end of December this year; Meanwhile, Russia has also announced that it will continue to voluntarily reduce 300,000 barrels per day until the end of December this year. After the news was released, oil prices quickly jumped and continued to rise. The decision by Saudi Arabia and Russia greatly exceeded market expectations. The balance sheets of the three major institutions previously included Saudi Arabia's gradual withdrawal from voluntary production cuts in the fourth quarter's balance sheet. However, in the end, Saudi Arabia and Russia directly extended the voluntary production cuts by three months.

From the perspectives of Saudi Arabia and Russia, in the absence of other countries increasing production to seize market share, maintaining high oil prices to increase fiscal revenue makes continuous production cuts possible, indicating the determination of oil exporting countries to defend their own interests. According to the latest EIA weekly data, the inventory of the US crude oil market has dropped to a new low since January 2021. With the supply and demand gap already emerging, Saudi Arabia and Russia continuing to reduce production will cause the crude oil market to reduce supply by nearly 120 million barrels again for the remaining period of the year. This makes the supply tension in the crude oil market even more severe, and the strong pattern of oil prices becomes difficult to shake in the remaining period of 2023.

Figure: Changes & Forecast of OPEC Crude Oil Production

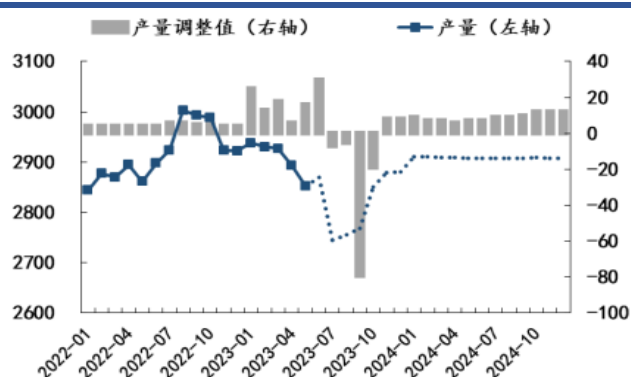
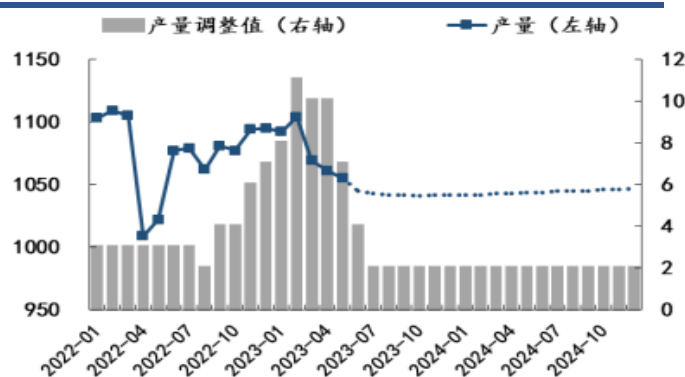


Figure: Changes & Forecast of Russia Crude Oil Production



Source: Rystad/Haitong Futures

2.3 Demand

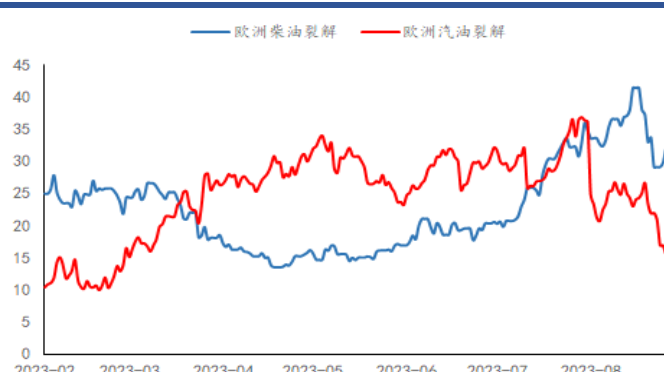
From the perspective of gasoline demand, after the peak gasoline demand in the third quarter reaches its peak, demand will seasonally decline. However, based on the low inventory status of gasoline in the United States, combined with the fact that the third quarter is a hurricane prone season in the United States, gasoline has some short-term support. At the end of the third quarter and the beginning of the fourth quarter, gasoline began to switch to winter specifications. The decrease in octane composition requirements can allow more low-priced butane to be added to winter gasoline, leading to a decrease in gasoline costs. From a trading perspective, there may be a logic of weakening gasoline profits in advance trading.

Recently, diesel has been a core concern on the demand side. Due to sanctions imposed by Europe and the United States on Russian refined oil, Europe has shifted to importing diesel into the Asia Pacific Middle East region. Recently, the seasonal increase in diesel demand in the Asia Pacific region and the maintenance of some refineries have led to a decrease in diesel exports to Europe, and diesel profits have stabilized and rebounded. A few days ago, China's third batch of finished oil export quotas were officially issued, totaling 12 million tons, an increase of 33% month on month and 140% year on year. As of now, China has issued three batches of export quotas, totaling 39.99 million tons, an increase of 2.74 million tons compared to last year. The issuance of product oil quotas will have a bearish impact on overseas diesel in the short term, but in the medium to long term, the demand for diesel is still stronger than gasoline. In the later stage, it is necessary to observe whether the global rise in refined oil products can match the strength of crude oil.

Figure: CRK in the US



Figure: CRK in the EU



Source: Bloomberg/Haitong Futures

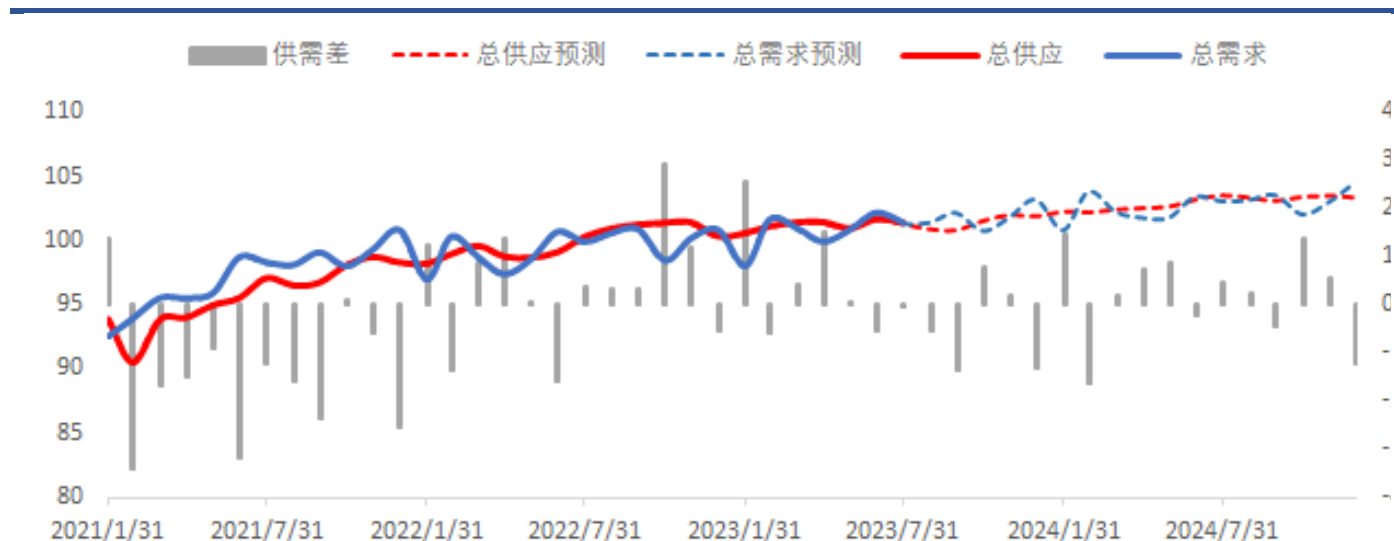
3. Where is the peak of oil prices?

After the oil price enters the high range, the peak seeking stage also needs to pay attention to two aspects of bearish, macro and fundamental. After the high base effect gradually subsides, when the extent of energy price increase is greater than the extent of core service weakening, it is easy to drive inflation up again. At the same time, this is not only a rise in the price of energy items, but also a possibility of extending to downstream chemical and other products. According to the Fed's determination to fight inflation, the possibility of another interest rate hike in the fourth quarter has increased. Due to the prolonged high interest rate environment, which has a suppressive effect on commodities, the crude oil market may once again increase its macro pricing weight. In addition, due to the strong resilience of the US economy, the market has once again shifted from recession expectations to soft landing expectations. This soft landing expectation has shown that the US is stronger than non US, and the strong trend of the US dollar has a bearish impact on crude oil.

At the same time, we do not rule out that the United States will use political means to influence the supply of non US regions. Based on the fact that the US strategic reserve inventory has fallen to a low level and it is difficult to increase production on a large scale, when US inflation rises again, hopes may be placed on countries such as Iran and Venezuela to increase

production. But before some uncontrollable bearish factors emerge, it will be difficult to shake the high price situation of oil prices.

Figure: EIA Balance Sheet



Source: EIA/Haitong Futures

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