Our View: Are Happy Days Here Again? – Not Quite

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The latest International Energy Agency forecast for world oil consumption is "rosy" for oil producers. In its January 2023 *Oil Market Report*, the agency states that "global oil demand is set to rise by 1.9 mb/d in 2023, to a record 101.7 mb/d." The US Energy Information Administration isn't far behind in its assessment, anticipating a global increase in oil consumption of 1.1 million barrels per day. Both agencies expect most of the rise in use to come from China. Both are also likely working from economic scenarios that assume central banks will soon halt or even reverse interest rate hikes.

These assumptions are wrong. Central banks will keep money tight, and China's internal problems will likely dampen its economic recovery and any resurgence in its oil demand. Let's take interest rates first.

Central Banks Will Stay the Course on Inflation

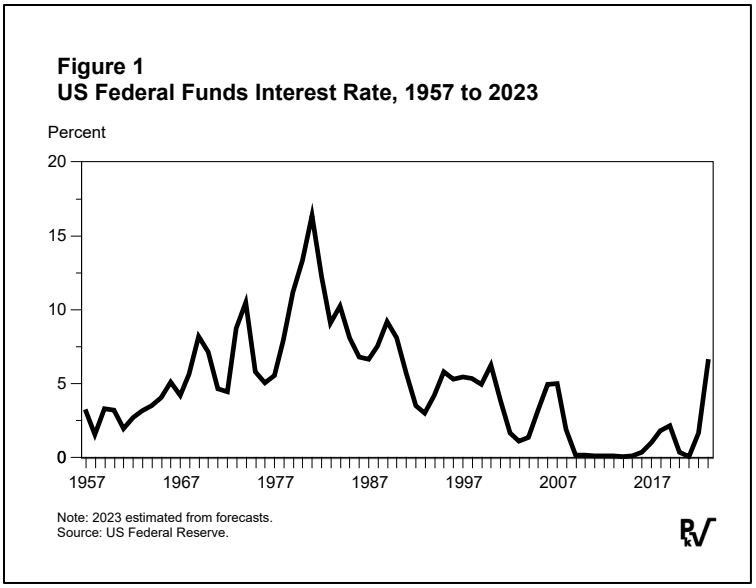
Through January and the first half of February 2023, nearly all economic forecasters believed that central banks would end their rate hikes this summer. Many were also convinced that the US Federal Reserve would not raise rates beyond five percent to avoid pushing America's economy into recession. These individuals are now changing their thinking after seeing the current data on inflation and unemployment.

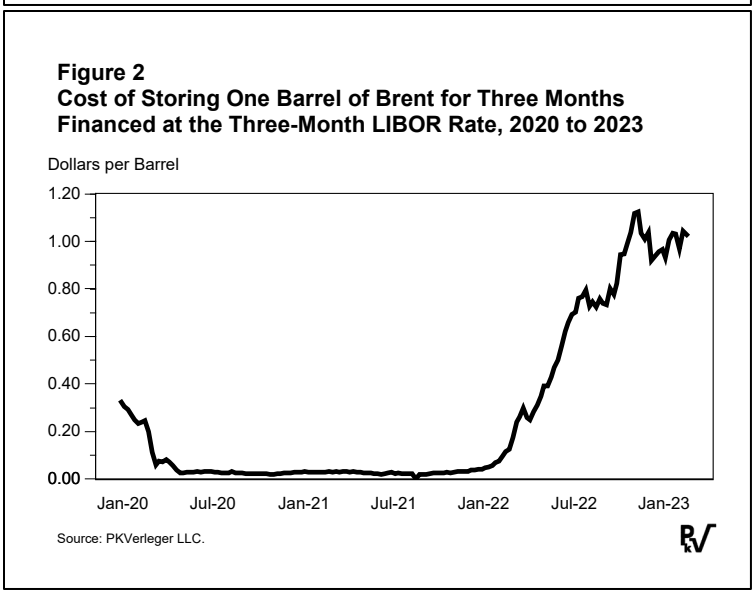
Regarding inflation, the central banks remain fixated on bringing it down to two percent. It's not even close to being there yet. In a February 14 speech to the New York Bankers Association, John Williams, president of the New York Federal Reserve and vice chair of the Fed's Open Market Committee (FOMC), said, "The inflation rate remains far too high at 5 percent. In addition, measures of underlying inflation also remain elevated and well above our 2 percent long-run goal."[1] The European Central Banks' Isabel Schnabel and the ECB's president Christine Lagarde agree with Williams.[2] Schnabel noted, "We are still far away from claiming victory" and "we may have to act more forcefully." Lagarde emphasized her bank's intention to keep rates high to "cool" the economy. These statements make it clear that central banks will keep tightening the screws on money until inflation drops to two percent, which may take a year or even two.

For the oil industry, especially the refiners, traders, and marketers, the uncertainty regarding interest rates lends itself more to caution than optimism. Indeed, they may find the interest rate trend downright frightening. The current pace of interest rate hikes is the highest observed in fifty years. (Figure 1, page 2, shows the year-to-year change in the federal funds rate from 1957 to 2023.) If the trend continues through 2023, the interest rate will be above six percent by the end of the year. Such an increase would exceed the previous record rise of 4.3 percent in 1973.

[1] John C. Williams, "Our Work Is Not Yet Done," Remarks at the New York Bankers Association, Federal Reserve Bank of New York, February 14, 2023 [https://tinyurl.com/yscfkbc3].
[2] Jana Randow and Alexander Weber, "ECB's Schnabel Sees Risk Markets Underestimate Inflation," Bloomberg, February 17, 2023 [https://tinyurl.com/cvx9cmfb].

High interest rates and/or large changes in rates affect decisions regarding oil inventories. As rates rise, the cost of storage also rises. Figure 2 tracks the cost of holding one barrel of Brent for three months financed at the three-month LIBOR rate. At present, the cost is more than $1 per barrel, up dramatically from the mere pennies in early 2022.





In the late 1970s and early 1980s, the US interest rate rose from around seven percent to a short-lived high of seventeen percent. In response, companies reduced their oil holdings, and the days of forward coverage (commercial stocks divided by consumption) fell from eighty-five to sixty.

The central bank tightening happening now will have the same effect on the oil industry, slowing its inventory accumulation. While the forecasters at the EIA and IEA seem oblivious to this now, in the coming weeks, the 2023 and 2024 growth projections for the US and Europe will be revised downward and, like dominos falling, so will the projections for oil, coal, and natural gas demand. In the same time span, the IEA and EIA economists will likely wake up to what is happening in China.

China's Growth Faces Severe Challenges

In its January 2023 *Oil Market Report*, the IEA proclaimed that "China's reopening will give a welcome boost to the listless world economy. The country is set to resume its established role as the primary engine of world oil demand growth." The EIA also thinks that most of its projected growth in world oil demand will come from China. These statements make it clear that the agencies are not really paying attention to what has been happening in the country.

The Chinese people are still angry. Before, the anger was directed at the harsh restrictions imposed to keep the pandemic in check. Now it is coming mostly from Chinese retirees who are losing their benefits due to the poor financial condition of local governments. A *Wall Street Journal* article noted that "local

governments are saddled with debt."[3] Besides limiting their ability to fund infrastructure spending, the governments have also had to default on other critical obligations, as *The New York Times* reported:

> Thousands of retirees confronted local officials and the police outside a popular park in the central Chinese city of Wuhan to demand the repeal of recent cuts in government-provided medical insurance for seniors.
>
> The protest on Wednesday, the second in Wuhan in a week, was the latest sign of strain on the finances of China's local governments, which are responsible for covering much of the cost of everything from health care to heating homes. China's "zero Covid" policies, dictated by Beijing over the past three years, saddled those localities with additional costs, while a downturn in the real estate market eroded a reliable stream of revenue.[4]

That "downturn in the real estate market" is a primary reason why China's oil consumption might not rise as much as the IEA, EIA, and others expect. The local Chinese governments depend on selling land leases to builders to fund their programs. Since those sales fall short of what they need, they have also gone heavily into debt. The housing crisis in China has made everything worse. Leasing has ground to a halt due to developer defaults on their debts. For that reason and because once-burnt twice shy Chinese consumers have been shunning the housing industry in 2023, construction has slowed, and that slowdown will cut China's demand for commodities, oil not the least among them. Consequently, we may not see the one or two million barrels per day increase in global oil use projected by the EIA and IEA.

An Oil Demand Decrease? It May Happen

The circumstances described above point to global oil consumption not increasing substantially in 2023. In fact, it might even decline. One reason for this is the possibility of a gap between consumption and production developing should firms reduce their oil inventories. As noted above, rising interest rates could prompt stock liquidations of more than one million barrels per day. The impact of these draws would force oil-exporting countries to adjust their strategies. Oil prices will likely decrease if the stock-draw trend continues. Expectations or concerns such as these may explain the downward movement in the share price of the BP Prudhoe Bay Royalty Trust, our market prognosticator, which has declined from a peak of $25 in July 2022 to $10 in February 2023.

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[3] Jason Douglas and Stella Yifan Xie, "Don't Count on China to Save the World Economy, *The Wall Street Journal*, February 13, 2023 [https://tinyurl.com/3ktfft3z].

[4] Keith Bradsher, Daisuke Wakabayashi, and Claire Fu, "Thousands of Chinese Retirees Protest Government Cuts to Benefits," *The New York Times*, February 15, 2023 [https://tinyurl.com/2p82k9jw].