ANALYSIS
Asia-Pacific

Traffic signals: A crude oil trading terminal of Qingdao Port, China

DOWNSTREAM

Is Chinese oil demand starting to crack?

Signs of weakness abound. But the country's robust consumption of gasoline remains a wildcard for the market / DAMON EVANS

CHINA has an outsized influence on world oil and remains the most important market to watch, and it's sending some confusing signals. Since the start of the year turmoil has gripped the country's equities and a weakening currency has fueled concerns about the strength of the nation's economy. Nonetheless, Chinese crude imports registered a record high in December.

While apparent demand, which does not include topping up the strategic petroleum reserve (SPR), was impressive in 2015 at 11.2m barrels a day – expanding some 5% year-on-year – oil data from the fourth quarter finally started to reflect weaker economic activity. This is likely to persist in 2016.

In November, apparent oil demand growth dropped 2.7% year-on-year – the first such fall since July 2014 – on the back of decelerated gasoline demand and a slowdown in the sales growth of diesel. Gasoline-demand growth, which inexplicably fell 13.6% year-on-year in November, is expected to have averaged around 10% for the full year, bolstered by rising car ownership.

The deceleration towards the end of 2015 is no real surprise. What was unexpected was the pace of adjustment, says the International Energy Agency (IEA). The agency's data show Chinese crude and petroleum product demand growth eased to an estimated 200,000 b/d year-on-year in the fourth quarter, compared with the 0.8m b/d addition seen in the third quarter and 0.7m b/d during the first two quarters.

A bearish consensus has emerged, estimating growth will average some 300,000 b/d, down from 0.5m b/d last year. A number of reasons have led to this.

First, the weakening of the renminbi against the dollar makes crude imports more expensive. Second, in mid-January China set a $40/b oil-price floor below which no fuel-price adjustment will be made to curb pollution and curtail demand growth. This will cut the demand response to oil prices below $40/b, sending a signal to Opec that its largest customer believes oil prices are too cheap. The organisation is indirectly funding China to develop more efficient energy use and diversify away from oil. Refiners will not benefit from the floor price as Beijing has set up a fund to accrue the savings from lower prices. Nor will consumers, as the government has already aligned fuel

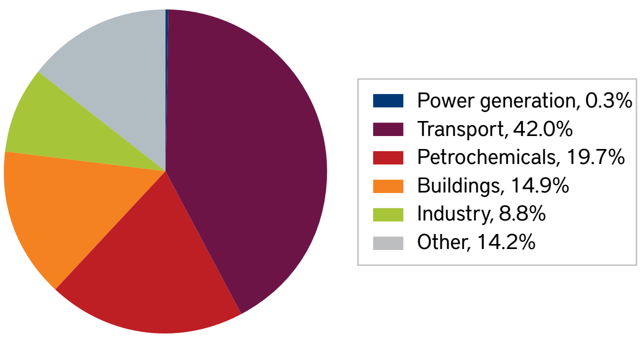

FIG. 1: Thirsty drivers: China's oil demand by market segment
Source: *China NBS, Bernstein*

prices with the crude price equivalent of $40/b. Third, there are signs that the SPR is near maximum storage capacity with the second phase close to full. Fourth, heavy manufacturing and exports will continue to decline this year.

Despite waning industrial activity, which has seen consumption of diesel and fuel oil continue to weaken, an increasing appetite for transport fuels should ensure oil-demand growth does not collapse, as China shifts towards a more consumer-driven economy. That's as long as the economic rebalancing, which has had a shaky start to 2016, goes according to plan. The last thing Beijing wants is a panicky recession full of unforeseen risks.

Rajiv Biswas, Asia-Pacific chief economist for consultancy IHS Global Insight, expects China's economy to grow at a relatively firm pace of around 6.3% in 2016, down from 6.9% last year, when full year growth slowed to its lowest level since 1990. He says the risk of a hard landing, in which growth slows to 5% or less, is relatively low, with a probability of 25% that it will happen in the next two to three years.

Still, overall energy demand is weak compared to economic growth rates. Blended energy consumption for the fourth quarter expanded by just 1.5% year-on-year, which was the lowest level since the financial crisis. The numbers seem very low relative to economic growth, even with the rebalancing taking place – which could suggest further downward pressure on the economy, says Neil Beveridge of research house Bernstein.

Bullish signs Demand for transport fuels will continue to support the oil market. Bernstein predicts gasoline will grow by 7.5% and jet fuel demand climb by 9.2% this year, more than offsetting weaker industrial demand growth for diesel and fuel oil. Road and air transport now make up about 42% of oil demand, making it the largest demand segment in the country.

Heady vehicle sales last year, forecast to continue in 2016, support this outlook. Chinese car sales are expected to top 20m in total last year, triggering a near 20% jump in the country's fleet. The robust sales, most of which will be oil-powered, imply gasoline demand expansion of around 400,000 b/d in 2015, reckons the IEA. But the agency has a caveat. A more conservative estimate puts it at half this level, implying many cars were idle or partially used, which potentially stores up persistently strong gains in gasoline demand for years to come.

Jet-fuel demand will also continue to expand. Not only are passenger numbers climbing by around 12% per year, but demand is also helped by a shift from domestic to international travel.

It's hard to ignore other bullish signals. Crude imports surged 9.3% to 33.19m tonnes, or 7.82m b/d, year-on-year, in December, the highest level on record. Imports were up 21% from November. Given the marginal cost of China's own production is higher than international oil prices Beijing will take every opportunity to top up its tanks.

Although the data on the SPR is not great, industry players believe there will be more physical-storage constraints this year, putting a dent in strategic buying. Import volumes under 25m tonnes per month (around 6m b/d) – the average monthly level seen in 2014 when China began buying strategic barrels in earnest – would signal a slowdown in filling the SPR.

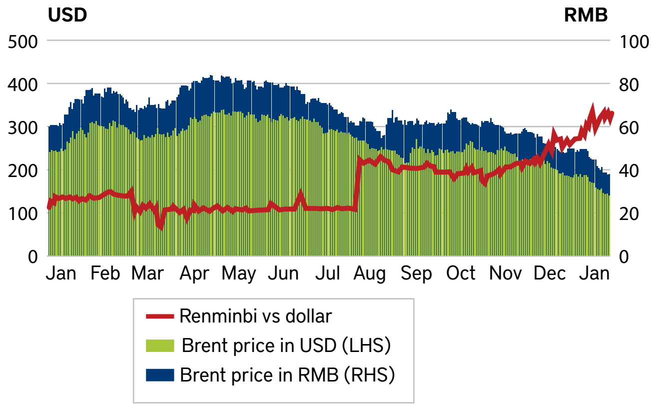

FIG. 2: Currency impact: US dollar vs RMB in the oil stakes

In 2015, China consistently imported around 27.8m tonnes each month, or 6.68m b/d. Some analysts expect monthly import levels to frequently test above the 28m tonnes-a-month threshold this year. But aside from storage constraints, a weaker currency could slow buying.

Analysts at Bernstein do not expect the country to sustain its fill rate, estimated at 250,000 b/d. However, crude imports will be partially offset by falling domestic production and higher demand from small independent refineries, known as teapot refiners, after the government relaxed controls on refined fuel exports last year.

The country's products exports hit an all-time high of 0.975m b/d in December, helping boost the average for 2015 to 0.693m b/d, another record, and 21.9% higher than 2014. But for the larger oil balance, this is merely a substitution for fuel oil and so does not result in incremental demand, says Chi Zhang, an analyst at investment bank Barclays.

Buoyed growth Gordon Kwan of Japanese investment house Nomura reckons concerns about China's oil demand in international markets are overdone. Domestic supply may fall, he says, bolstering demand for foreign crude.

China is not just a major crude importer, it is also among the five largest oil-producing countries. As Kwan points out, the focus on the price war between Saudi Arabia and US shale producers has obscured an important trend: China's oil production probably peaked last year and could enter structural decline this year.

CNPC and Sinopec reported domestic oil output falling by 3-5% during 2015 as onshore production aged. The national oil companies' mature fields increasingly need costly enhanced oil-recovery methods to maintain flows, meaning falls in volume could accelerate. Meanwhile, Cnooc's offshore production growth will slow and is not expected to be enough to offset falling output.

For the time being at least, China will continue to be the engine of growth for global oil markets as it continues to defy gloomy predictions. A year ago, forecasters projected a sharp slowdown in 2015 to about 2% demand growth. Yet it came at around 5%. Paul Horsnell at investment bank Standard Chartered, expects China's oil demand growth to outperform again this year.

Only time will tell. But traders will be closely watching the coming demand data points for signs of further strain. If first-quarter data disappoint, expect the re-balancing of global oil markets to be pushed back further into 2016 or even 2017. **PE**