The increase in residual caused a rise in oil prices over the past week.

- While a slight loosening in supply offset higher demand, the increase in residual ultimately caused oil prices to go up this past week. In 2018:Q2, increasing demand expectations and decreasing anticipated supply led to rising oil prices.

- Developments in global demand expectations since 2017:Q3 have reversed the largely supply-induced weakness in oil prices throughout the first half of 2017.

- Overall, since the end of 2014:Q2, both lower global demand expectations and looser supply have held oil prices down, though this trend seems to have reversed in 2016:Q2 and 2016:Q4, and notably since 2017:Q3.
Cumulative Weekly Decomposition, Apr 06-Aug 31, 2018

The chart at left depicts the cumulative oil price decomposition from April 6, 2018.

The table below presents the most recent cumulative values.

Cumulative Percentage Changes since April 6, 2018

<table>
<thead>
<tr>
<th>Date</th>
<th>Demand</th>
<th>Supply</th>
<th>Rest</th>
<th>Brent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug 17, 2018</td>
<td>6.3</td>
<td>-1.7</td>
<td>2.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Aug 24, 2018</td>
<td>9.5</td>
<td>-0.3</td>
<td>3.1</td>
<td>12.2</td>
</tr>
<tr>
<td>Aug 31, 2018</td>
<td>10.1</td>
<td>-0.9</td>
<td>5.1</td>
<td>14.3</td>
</tr>
</tbody>
</table>

Longer-Term View of Oil Price Movements

This final chart provides a somewhat longer-term perspective by means of a cumulative decomposition from 2010 onward.

The analysis shows that excess supply became a significant driver of oil prices in mid-2012 and generally dominated price dynamics after mid-2014.
1. What is the goal of the oil price decomposition?
Our aim is to determine how much of the observed oil price change has been driven by demand and supply factors.

2. What is the modeling strategy?
Using a statistical model and a large number of financial variables, we decompose weekly oil price changes into demand effects, supply effects, and an unexplained residual.

Sparse partial least squares regression allows us to construct linear combinations from the variables in our financial market data set—called factors—which have maximum explanatory content for oil price changes.

We first use this procedure to generate factors that best capture the patterns in the data, and then examine the estimated factors to determine how they reflect demand or supply dynamics.

The model is re-estimated every week using weekly data from January 1986 through the close of business on Friday of the most recent week. Over this sample, the model can explain about two-thirds of the weekly oil price dynamics.

3. How to interpret the results?
The output of the model is used to decompose weekly changes in an accounting sense. More specifically, the weekly Brent crude price change always equals the change explained by demand factors plus the change explained by supply factors plus a residual (the weekly change unexplained by the sum of the estimated demand and supply factors).

Given the noise in weekly price changes, we choose to show the results as a cumulation from a certain starting point (usually the start of the previous quarter).

References

Authors
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