

# OIL PRICE DYNAMICS REPORT

Updated: December 21, 2020

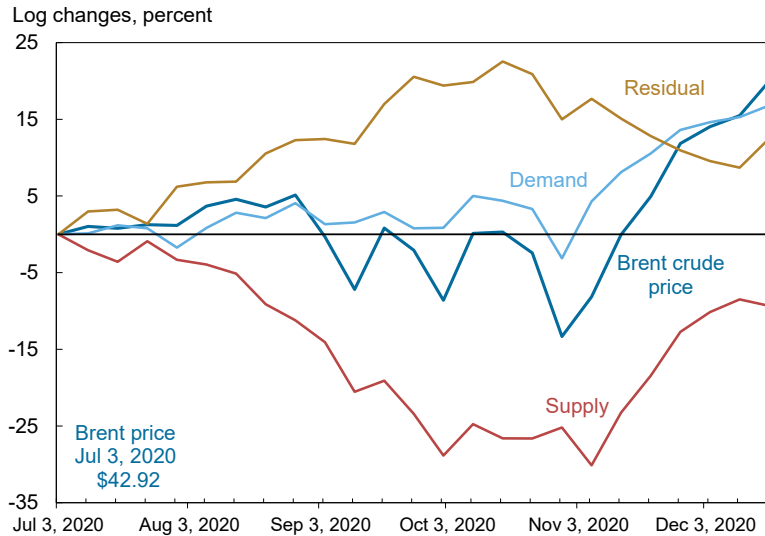
## **Higher demand and lower supply pushed oil prices higher over the past three weeks**

- Over the past three weeks, an increase in demand expectations and a decrease in anticipated supply resulted in higher oil prices. Despite higher supply expectations over the most recent week, the continued strengthening of demand expectations on net led to higher oil prices for that week. In 2020:Q3, oil prices fell owing to increased supply.
- In 2020:Q1, oil prices plummeted owing to decreased demand and increased supply, whereas in 2020:Q2, oil prices rose owing to increased demand. Oil prices rose in 2019 due to increasing demand expectations.
- Overall, between 2014 and 2017, both lower global demand expectations and higher anticipated supply held oil prices down. Since mid-2017, this trend reversed as stronger demand expectations and stabilizing anticipated supply drove oil prices higher. This lasted until 2018:Q4, when weaker demand lowered prices.

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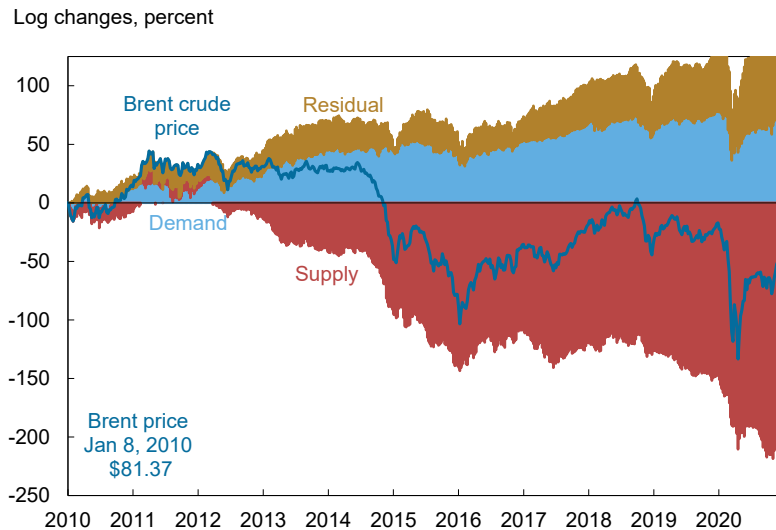
Our analysis of oil price movements does not necessarily represent the views of the Federal Reserve Bank of New York, the Federal Reserve System, or the Federal Open Market Committee.

## Cumulative Weekly Decomposition, Jul 03-Dec 18, 2020



Sources: Authors' calculations; Haver Analytics; Thomson Reuters; Bloomberg L.P.  
Notes: Residual reflects price movements unexplained by supply and demand factors. Supply, demand, and residual sum to Brent crude price.

## Cumulative Weekly Decomposition, 2010-Present



Sources: Authors' calculations; Haver Analytics; Thomson Reuters; Bloomberg L.P.  
Notes: Residual reflects price movements unexplained by supply and demand factors. Supply, demand, and residual sum to Brent crude price.

## Recent Decomposition Data

- The chart at left depicts the cumulative oil price decomposition from July 3, 2020.
- The table below presents the most recent cumulative values.

## Cumulative Percentage Changes since July 3, 2020

	Demand	Supply	Rest	Brent
Dec 04, 2020	14.6	-10.1	9.6	14.0
Dec 11, 2020	15.3	-8.5	8.7	15.5
Dec 18, 2020	16.8	-9.3	12.5	20.0

## 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.

# **Oil Price Decomposition Q&A**

## **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**

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- Groen, J., K. McNeil, and M. Middeldorp. 2013. “A New Approach for Identifying Demand and Supply Shocks in the Oil Market.” *Liberty Street Economics*, March 25.

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