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OPINION | COMMENTARY

What's Giving the World Oil Market the Jitters

Topping the list are Greece, Iran, China—and, strange as it may seem, the U.S.

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Fear and fundamentals are driving down oil prices. The fear arises from the unknown risks of the Greek and Iranian negotiations, and the panic in China's stock markets. These fears have acted as triggers, bringing much greater clarity to the fundamentals of an oversupplied oil market.

Oil has lately become a very volatile commodity. Early this year, it fell below $50 a barrel. By mid-May, it had rebounded to $67 a barrel, which was thought to be a "new normal," on which plans could be based. But in the last several weeks, prices fell almost 20%—though they've bounced back a little in the past few days.

Greece, a country of 10 million people that consumes fewer than 300,000 barrels a day, does not matter directly to the global oil market, in which the demand is for 94 million barrels a day. But the potential unhinging of the euro, and the danger of political contagion to other southern European countries, portend weakening in Europe's weak economic recovery—and this would be a drag on oil demand. Thus Greece's possible exit from the euro is reason for investors, seeking safety, to also exit commodities.

Adding to the anxiety is the widely shared perception of Greek negotiators' incompetence and confusion. The no vote in Sunday's referendum may have strengthened Prime Minister Alexis Tsipras at home, at least temporarily. But it also reduced his flexibility to negotiate, and further frayed any remaining trust his European interlocutors may have in him. They are close to giving up on Mr. Tsipras, save for their commitment to the European Union and humanitarian concern about the Greek people.

China is another story: 1.4 billion people do matter a lot to the oil market. Indeed, between 2004 and 2014, China alone accounted for about half of the world's total growth in the demand for oil, according to the BP Statistical Review of World Energy.

However, growth in the Middle Kingdom has slowed over the past few years, bringing to an end the torrid supercycle in most commodity prices. The effect of this "China chill" on oil was later in coming. But the signs of further economic slowing last summer was one of the central factors leading to the collapse of prices—after years of apparent stability—that began last November.

Since late 2008, when Beijing moved early and successfully to stimulate its economy during the Great Recession, there has been widespread confidence that China is the one country that can decisively and effectively manage economic challenges. That confidence has been shaken with panicky stock markets down as much as 40% as of Wednesday, although they rebounded in the past few days. The fear is what a stock market bust portends for the wider economy. A further slowing in Chinese growth would downshift China's and the world's demand for oil.

The Iranian nuclear negotiations are going down to the wire, although the wire does keep getting pushed back. But at this point both sides have a huge vested interest in reaching a deal. Any agreement will of course require further negotiations over the inevitable disagreements about what was actually agreed to. The effects of all this on Middle East stability are far from clear.

Still, the possibility of a nuclear agreement and with it the lifting of sanctions on Iranian oil exports is rattling the market as positive and negative words alternate out of Switzerland. This is where fear translates into fundamentals.

Iran has substantial oil floating offshore stored in tankers—40 million barrels according to an estimate by IHS, where I work. Several international organizations and IHS estimate that Iranian oil fields could put 400,000 to 600,000 barrels a day of additional production into the world market over several months.

And then what?

Saudi Arabia gives no indication that it is willing to surrender sales to make room for Iran. It has stepped up output to very high levels, 10.3 million barrels a day, or perhaps even higher, as have the other Persian Gulf countries.

Meanwhile, Iranian officials have said that, as soon as sanctions are lifted, they will seek to maximize exports. This points to a battle for market share between the Gulf states and Iran, especially for Asian customers. A battle for market share means lower prices.

Moreover, any additional Iranian oil would flow into a market where a supply surprise is now unfolding. It was widely assumed at the beginning of this year that the decline in prices beginning last November would deliver a body blow to the surge in U.S. shale oil production, especially as large independents slashed drilling budgets by as much as 40%. Many investors had been making bullish bets on the expectation of a falloff in U.S. supply.

The body blow never landed. Since November's collapse in prices, U.S. crude oil production has risen half a million barrels—to 9.6 million barrels a day from 9.1 mbd—not all that far from Saudi Arabia's 10.3 mbd and Russia's 10.6 mbd. This is the result of a variety of factors including greater efficiencies and innovation in operations.

IHS estimates that by the end of this year every dollar spent in developing new shale oil wells in the U.S. will be 65% more productive in terms of additional oil extracted than in 2014. There may be a dip in output over the summer. But IHS expects that U.S. output will resume its growth later this year and into next.

Perhaps, with its banks closed and its ATMs out of cash, Greece shortly will decide that it should make a deal. Perhaps the differences over the timing of lifting of sanctions, "intrusive" inspections and arms sales cannot be bridged, and there will be no nuclear deal with Iran. And perhaps Chinese authorities may well find their way to bring sustained calm back to their financial markets, preventing damage to their economy.

In any of these circumstances, the oil price would rebound somewhat. But barring a geopolitical disruption, the realities of an oversupplied market and rather weak demand will, for now, continue to weigh heavily on the price of oil.

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