CIO Viewpoint

Too much of a crude thing: a kick in the glut!

Investment Solutions

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We have lived with the concept of negative interest rates since the 2008/2009 Global Financial Crisis. Last week, briefly, the Covid-19 crisis introduced the idea of less-than-worthless crude oil with some buyers for the first time paid to accept deliveries. The pandemic's lockdowns have slashed demand for oil and production has failed to follow, rapidly filling the readily available storage facilities and creating a dramatic surplus.

Last week's negative prices affected only West Texas Intermediate (WTI) crude. The oil market most often refers to the two most traded crude benchmarks, Brent and WTI. Brent crude, named after a North Sea drilling platform, is the benchmark for around two-thirds of the world's production. It has the advantage of low transportation costs, since its marine extraction makes it easier to ship. Priced in Cushing, WTI comes mainly from landlocked Texas, North Dakota and Louisiana, and is the reference for US production. Both crudes have similar 'light sweet' properties, meaning they have light densities and a low sulphur content, making them well suited for refining into petrol. Before the surge of US shale since 2010, which in 2018 turned the US into the world's no.1 producer, Brent crude traded at a small discount to WTI. While Brent is historically more exposed to geopolitical tensions, WTI has suffered from a lack of investment in transport infrastructure and subsequent bottlenecks.

Until last week, the two benchmarks traded largely in tandem (see chart 1). In theory, Brent crude prices should enjoy some cushion from the price crashes suffered by WTI, as they are settled on slightly different dates, in cash, and do not have the same infrastructure and storage constraints. That will not make them immune to spill over effects.

While the price collapse may be a one-off combination of the crush for space in Cushing plus the deadline for futures contracts and the coronavirus-triggered collapse in demand, it would be unwise to dismiss the wider implications for the oil industry.

WTI crude for May delivery traded below zero for the first time on 20 April, the eve of the last day of trading for May delivery futures contracts. Then contracts fell as far as -USD40.32 per barrel, as speculators, unable to take physical delivery, resorted to paying others to buy their contracts. WTI for June delivery then fell too and Brent crude traded at a low of USD15.98 per barrel.

Key takeaways

- Negative oil prices are the latest shock to the market
- The oil market is suffering from an historic supply/demand imbalance triggered by the global pandemic
- Oil producers' promised cuts don't go far enough to counter the historic collapse in demand
- This is not a buying opportunity. Our asset allocation has reflected the risk of low oil prices since the start of the Covid-19 crisis.

With the world's economies largely halted since mid-March, the oil market is running out of storage capacity. If demand does not bounce back in May and June, storage capacity could be full by the end of the quarter. Cushing, Oklahoma, where much of WTI crude is physically stocked, now has close to 60 million barrels in storage, equivalent to four-fifths of its capacity, and based on the current imbalance in the market, may be full before mid-May. Seaborne storage on tankers reached a record 160 million barrels last week, commanding record daily rates.

Propping up prices

Oil producers have tried to prop up prices. The Organisation for Petroleum Exporting Countries (OPEC) and Russia promised on 12 April to cut production by a record 9.7 million barrels per day in May and June. Overall, the world's biggest producers have now agreed to output cuts of around 13 million barrels a day starting 1 May. This includes a reduction of as much as 3 million bpd by the US. In addition, the US government has pledged to buy up to 75 million barrels to add to the country's strategic reserve.

That is all far short of what is needed to balance supply and demand. The International Energy Agency (IEA) has estimated that the collapse in demand equates to one third of global production, or almost 30 million barrels per day in April.

The US has also tried to talk up prices. President Donald Trump is mooting a block on imports or tariffs, and has threatened to 'shoot down' Iranian vessels in the Gulf that approach US shipping. Texas senator Ted Cruz joined in, addressing an all-caps tweet ("TURN THE TANKERS THE HELL AROUND") to Saudi Arabian crude approaching the American coast.

The US has become the world's largest oil producer so recently that 1970's assumptions that low prices are a positive for the American economy are still widespread. Today this is a misconception. As recently as 9 March, Mr Trump described Russia's decision to scrap its production caps that triggered a fall in oil prices as "good for the consumer".

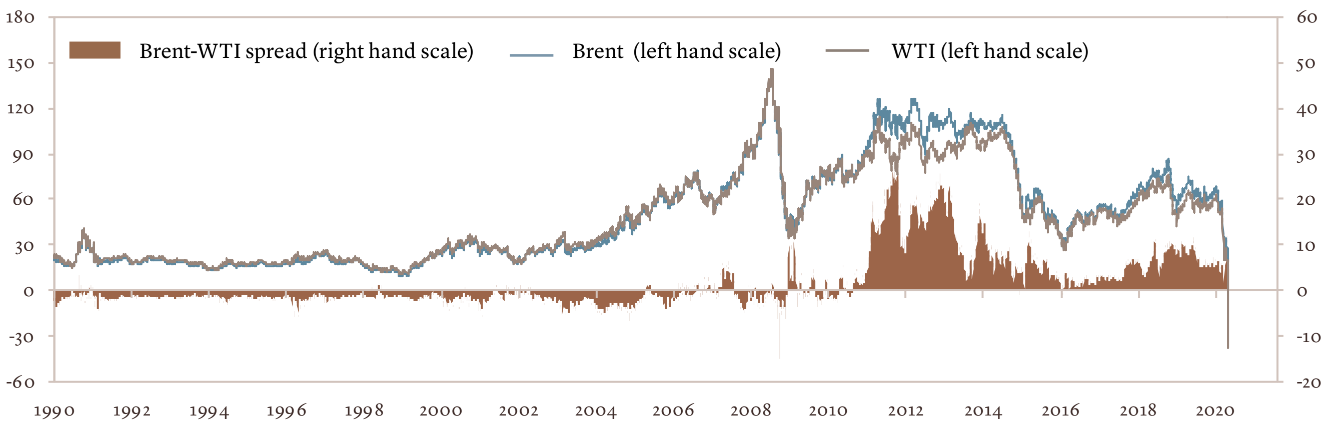
Over a barrel

Once the impact of the Covid-19 pandemic on demand fades, the OPEC+ alliance may withdraw their support for a price floor, and manage output. Our forecast for Brent crude a year from now remains USD40 per barrel, as prices should eventually be driven by the marginal costs of production. 12-month contracts are trading at USD35 per barrel, with limited upside potential and an unattractive risk/reward profile. In the very short term, the outlook is entirely dependent on the speed that demand recovers (see chart 2). That, in turn, depends on how quickly containment measures lift and industry demand and travel resumes.

The Covid-19 pandemic has stressed the fragility of oil firms and the states that rely on oil revenues. The industry must now navigate an uncertain future for demand as the world recovers from confinement. While the immediate cause of the collapse in demand is only temporary, it is also likely that demand may experience a broader shift and may not entirely recover in the near future. Will the experience of lockdowns encourage consumers to travel less, work from home and push for alternative energies to keep their cities cleaner? Within the industry, the experience of such volatility will certainly undermine appetite for capital expenditure, which had already

1. An historic collapse

Prices in USD/barrel



Sources: Bloomberg, Lombard Odier calculations dropped by around one quarter this year. That will undercut US shale investments, the foundation for the US's rise to No. 1 oil producer.

Portfolio positioning

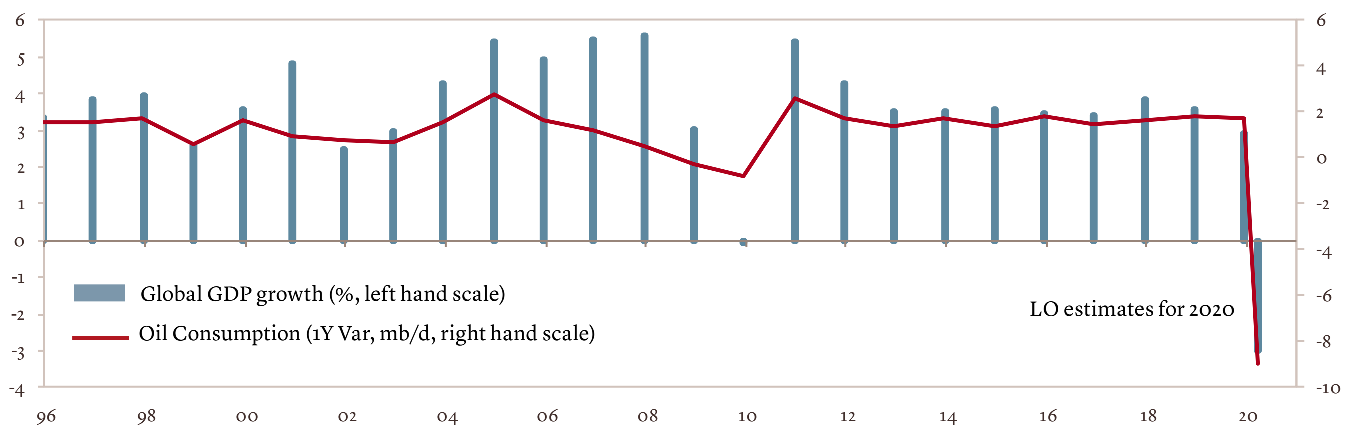
In addition to reducing portfolio risk because of the threat of a second wave of pandemic infections, our asset allocation in recent months has also assumed lower oil prices. As such, our portfolios did not suffer from oil price moves.

In the medium term, a low oil price is of course a support for consumers, and so for most developed markets. Nonetheless, there will clearly be losers, and oil price volatility undermines both emerging market assets and US high-yield credit. This is why we have underweight positions in high-yield and emerging debt, in both local and hard currencies. We have also refocused our emerging equity investments to favour emerging Asia, a region that will benefit from low oil prices as a net importer and which has a headstart in containing the virus and normalising economic activity.

Our foreign exchange positioning, long the yen and renminbi versus the US dollar, is also a result of balancing opportunities for oil importers, such as Japan and China, and challenges for oil producers, such as the US.

Last month we pointed out that any sign that oil storage was reaching capacity would lead to a brutal, if temporary, fall in oil prices. Last week's collapse to negative prices proves that, until the underlying demand/supply quandary is resolved, prices will stay low and volatile. In January 2019, we replaced our direct exposure to oil with positions in gold. This historic drop in oil prices does not represent an investment opportunity at this stage.

2. Out of balance



Sources: Bloomberg, Lombard Odier calculations

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