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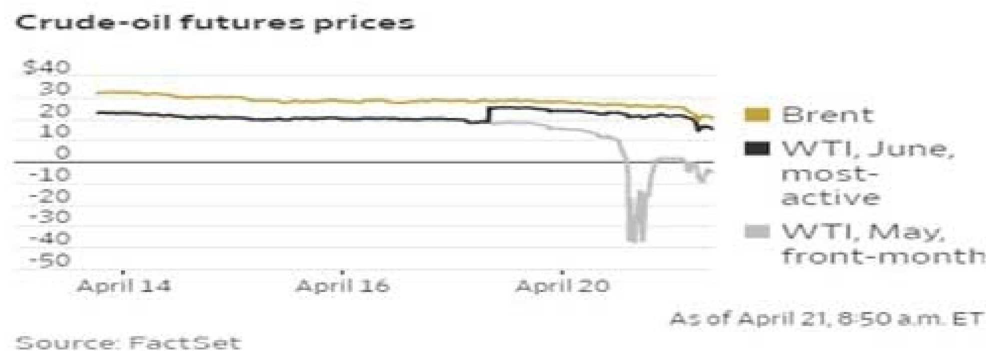
Update on Negative US Oil Contracts and the Energy Market

Executive Summary

- On April 8th, we noted that even an accord between Russia and Saudi Arabia to cut their collective oil production may not cure lower oil prices caused, in part, by coronavirus shutdowns. Even after their tentative agreement to cut production, and the Saudi's announcing this morning that they will take additional measures to stabilize the market, the price of oil has continued to slide.
- Yesterday we witnessed unprecedented price action with West Texas Intermediate (WTI) oil futures contracts trading deeply into negative territory and closing at -$37 per barrel. We primarily view this extraordinary move as a short-term, technical outcome from US commodity markets pricing in a near-complete lack of domestic storage given current supply and demand dynamics.
- While short-term dynamics may continue to produce market headlines, the US energy complex will grapple with remaining viable in a prolonged, stressed environment. We've been focused on longer-term opportunities from trusted energy managers identifying energy firms with strong management teams, assets, and balance sheets that will outlast and ultimately capitalize on current depressed prices.

What does it mean that some US oil contracts are negative?



Monthly WTI futures contracts expire today (April 21st) and legally bind a seller to deliver purchased oil to any specified pipeline or storage facility in Cushing, Oklahoma during the month of May. At -$37, a contract seller would literally have to pay the buyer $37 per barrel to take a barrel of oil off their hands.

Why did oil contracts turn negative?

Global coronavirus-related shutdowns have seriously curtailed the demand for oil with grounded flights, offline factories and idled automobiles. Concurrently, the spat between Russia and Saudi Arabia led the Saudis to increase oil production in an attempt to drive prices even lower. There are 12 million barrels of crude on the way from Saudi Arabia to the US Gulf now. Although North American oil producers have raced to shut down productive wells with a 13% reduction to the American drilling fleet just last week, they have not shuttered production quickly enough, and domestic storage capacity has reached its limits. With the current month's futures contracts expiring today with nowhere left to store excess oil, buyers and speculators have been rushing to sell or close out their contracts. As a result, prices plummeted into uncharted negative territory. The price of one barrel of WTI – which closed at $18 on Friday – ended the day yesterday at -$37.

What does the current environment mean for the oil market moving forward?

While this is certainly unprecedented territory and we may see further downside for oil prices in the near future, we note that the causes of the current situation are largely technical in nature. Heading into the day yesterday, there

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were just 108,000 open WTI futures contracts – which translates to 108 million barrels or, roughly, just one day of global production – open to change hands in May. The mad scramble into negative territory cut this number much closer to just 15,702 contracts today, meaning very little oil will actually trade hands at negative prices. Futures participants who "close out" their positions prior to expiration are under no obligation to physically receive or produce oil.

Overnight prices have already rebounded to -$5 per barrel and, more importantly, contracts expiring in May for June physical delivery stand at $15. Most market participants expect the price of oil to rebound further as we head into the second half of the year with December contracts trading at $31. If anything, these lower short-term prices may force even further production cuts in both the US and abroad.

Are there opportunities to invest in US energy?

The short answer is yes, but it is important to remember that markets are already quite efficient. For example, the cost of leasing a very large crude carrier (VLCC) is roughly in line with the price gap between the April and May contracts. There is no free lunch in buying oil at -$5 now for May delivery, storing it offshore, and selling at $15 in June.

The exchange traded funds (ETFs) that trade oil futures are already positioned in the contracts beyond April, as they are not in the business of taking physical delivery of oil. For example, although the April contracts for May delivery made headlines yesterday by plummeting $55 per barrel in a single day, the largest oil-focused ETFs were only down between -2 to -11%.

Of most interest to us are energy equities, which fell just -1 to -3% yesterday in broad index terms. Meanwhile, the S&P Oil and Gas Exploration ETF actually gained 1.5% on the day. Investors are largely looking through this short-term technical issue and expecting that this near-term pain will bring additional production cuts and result in much more balanced supply-demand dynamics when our economy eventually emerges from the virus-induced shutdown.

Despite imminent, deeper domestic production cuts and expected improved WTI oil prices, many US energy related companies will struggle to survive. Although the sector's entrepreneurs, business leaders, and employees alike are accustomed to the boom/bust cycle of oil prices, jobs, and capital investments, we empathize with the personal hardships that are materializing in the current environment. As investors stewarding wealth entrusted by our clients, we continue to focus our research and investment plans on partnering with trusted energy managers with strong track records of identifying energy companies with the right management teams, assets and balance sheets to take advantage of the current disruption in the industry.

Conclusion

In sum, we see the recent price action of the current WTI futures contract as a near-term technical outcome when unprecedented demand destruction meets an oversupply of oil. The US oil markets literally ran out of storage space temporarily, with sellers forced to pay buyers to take oil off their hands. Futures participants rushed to the exits today to "close out" their positions to avoid physical delivery. This should lead to even further cuts in US oil production on the backdrop of recently announced OPEC+ related cuts. As a result, the commodity market is predicting a rebound in WTI oil prices with contracts toward the end of 2020 pricing in $31 oil. Even at those prices, however, most American producers may become distressed, so we are focused on the handful of firms that can make it to the other side.

As always please reach out to us with any questions, comments or concerns.

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