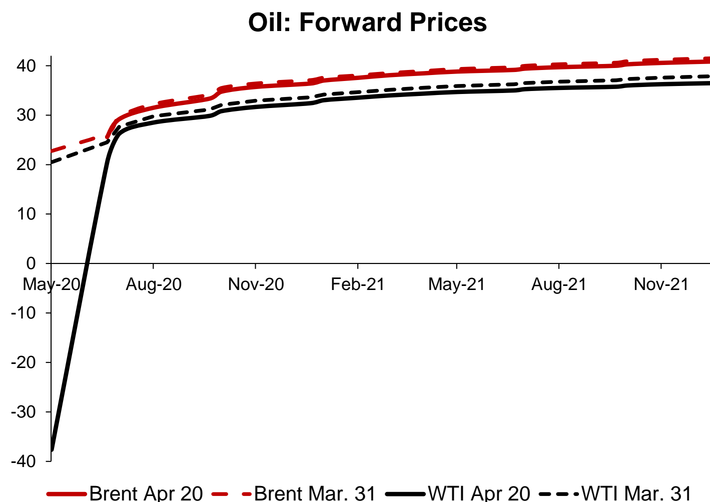
GIAM Macro & Market Research- Market Commentary

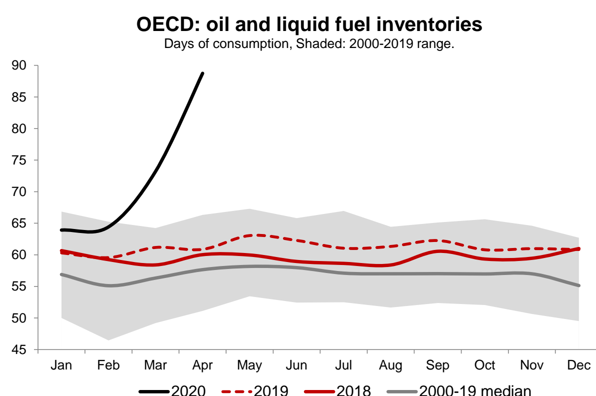
Oil contracts turn negative amid collapsing demand and storage shortages

- **Yesterday the short-term forward price for WTI oil turned negative for the first time in history. This was mainly due to the way contracts are settled, but highlights the impact of the collapse in demand on inventories.**
- **The US-brokered deal to cut global production by 10% is proving inadequate as global demand is dropping by 30%**
- **Weak demand following uncertain growth prospects and inventories will keep a big pressure on prices and we do not see any scope for increases before Q3.**
- **The outlook of lower for longer prices is starting affecting oil producing countries and step up the stress on the overleveraged US shale sector.**

In another sign of the unprecedented nature of the COVID crisis, yesterday future prices for WTI oil to be delivered in May **dropped to US$-37/bbl**. Unlike Brent, contracts on WTI entail a physical delivery at a specific delivery point (Cushing, Oklahoma) of oil to the counterparty. **As capacity in the US has reached its limits, investors are actually paying to prevent storage shortages on delivery**. Movements in the other parts of the curve were much smaller. This indicates the belief that dislocation in the oil price will be followed by a rapid downward readjustment in supply.



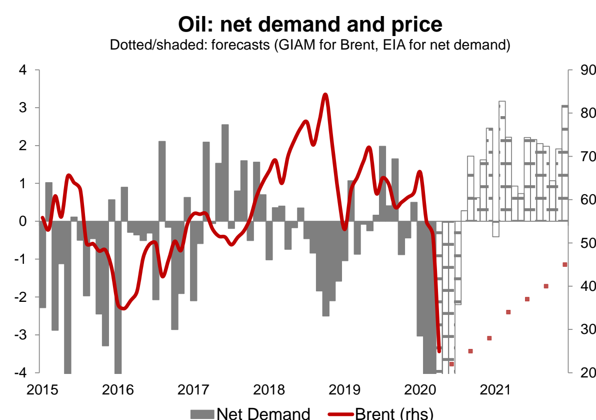
This unprecedented event highlights the huge imbalances that are burdening the oil market. Oil inventories in OECD countries (the only ones for which we have reliable data) are at an historical high.



The decision by Saudi Arabia and Russia to ramp up production to drive US producers out proved untimely as it was almost immediately followed by a sharp contraction in demand as lockdown policies cut air travel and transportation. **The US-brokered deal, signed last week, to cut global production by around 10% proved in the end ineffective.** OPEC and Russia's pledged to cut output by 10 million barrels, but the actual reduction may not be larger than 7 mn; moreover cuts will not become effective before mid-May and will affect the market with a few weeks' lag. This is **too little given that oil demand is projected to shrink by around 30% in the short run.**

Assuming that the gradual easing of the lockdown measures continues, **demand for fuel may have bottomed in these weeks**. Yet the pick up will clearly be weak and be easily met by existing inventories; as a consequence **the supply glut will remain sizeable at least until the summer**. Then, always assuming a gradual resuming in activity, demand and supply will be more in the balance, allowing the Bent to go back to 30 US$/bl by year-end. Longer run, the gradual rise in price will continue, **but we do not see the Brent exceeding 45 US$/bbl by the end of 2021.**

Risks are clearly tilted to the downside, however: First, there is no certainty on the outcome of the gradual easing of global lockdowns. A return to restrictive measures may be needed, curtailing again activity. Second, and more specific to the oil market, the production cuts enacted throughout this year may be reversed quite quickly, especially by large producers.

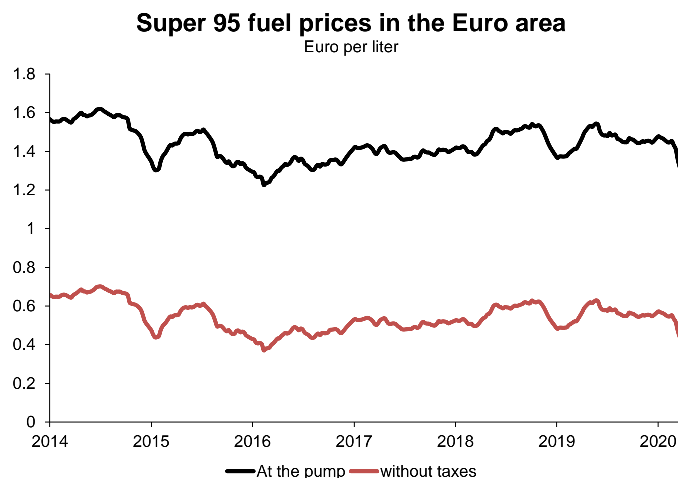


The sharp drop in oil prices and the prospect of structurally low demand due to the reshaping of world trade post Covid-19 is the latest of the several headwinds the industry faces, starting from heightened environmental concerns which will likely dampen consumption. All this is taking its toll. **Mexico, whose fiscal receipts are tightly linked to the output of the state-controlled PEMEX oil company was downgraded by S&P and Fitch, which also downgraded Colombia**. Large producers in the Gulf have so far been spared, as their production costs are rather low (around 10 US$/bbl) and their fiscal and balance of payments positions are rather healthy. However, **Saudi Arabia needs oil prices at around 80US$/bbl to balance the government budget, a level that it is unlikely to be seen again over the next few years**.

Stress is increasing sharply in the US shale industry; a wave of defaults among overleveraged small independent producers, which cannot cope with prices below 40US$, was already evident before the crisis. Now the prospects look even dimmer. According to industry estimates, **only 5% of produces are profitable with prices below 30 US$/bbl**, and the tighter financial conditions make a return of interest by investors

unlikely. Consequently, **the industry will face a big restructuring, resulting in a sharp cutback in investment and productive capacity.** This may pose an upside risk to prices beyond 2020, assuming that demand restarts growing at a sufficiently strong pace.

The macroeconomic upside form ultra-low oil prices is limited at the moment. Firstly, oil prices account for a limited share of retail fuel prices and restriction to travels (likely to remain at least partially in place until the autumn) will prevent household and firms from enjoying any positive impact on consumption.



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