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WHEN OIL PRICE TURNS NEGATIVE…
FIRST TAKE & IMPLICATIONS

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WHEN OIL PRICE TURNS NEGATIVE… A SIGNIFICANT MARKET IMBALANCE

Source Bloomberg

An oversupplied oil market creating an overhang on oil prices

Oil price declined by more than 70% this year with oil price volatility spiking up to 150% on the back of the coronavirus crisis and in a price war context. Contrary to other assets, the oil price has not recovered since March 23rd , quite the contrary as losses have amplified.

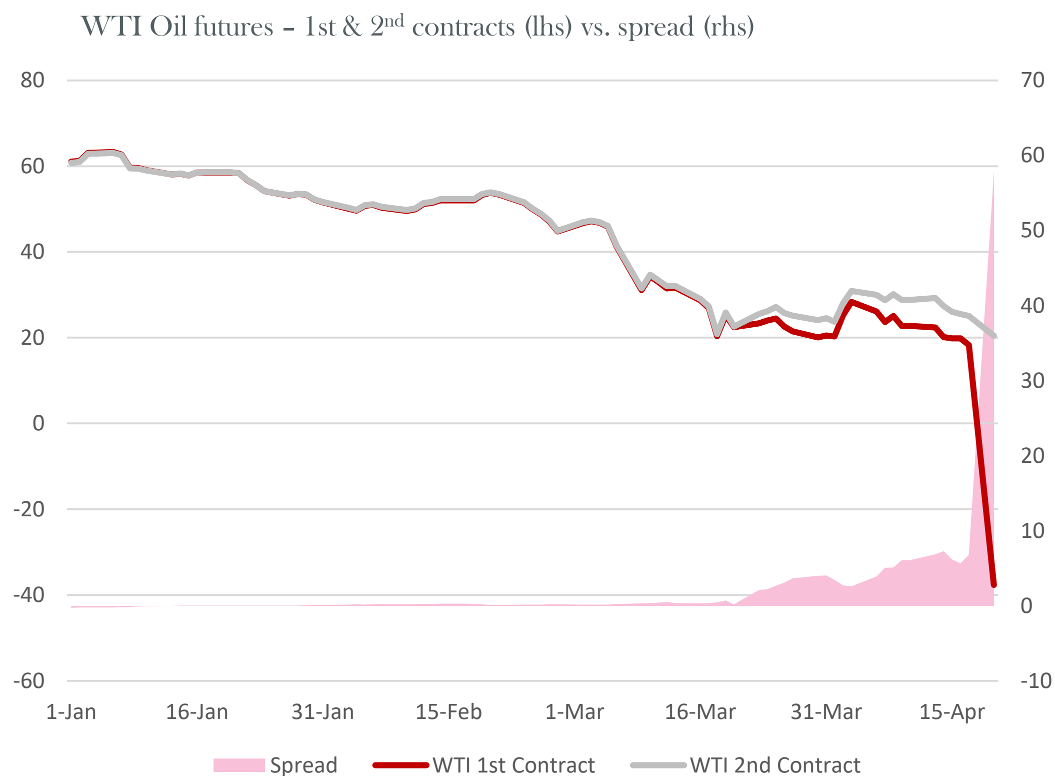
Due to the COVID-19 crisis, oil demand is collapsing in an already oversupplied market. The initial failure of a production curtailment agreement by the OPEC+ members in March did not help. According to the International Energy Agency (IEA), global **oil demand is expected to fall by a record 23.1 mln barrels /day year on year in Q2 2020 and by 29 mb/d in April 2020** alone.

Finally, the OPEC members agreed on April 8th to reduce production by **9.7 mln b/d** starting May 1st in an unprecedented cut. Unfortunately this move may prove to be too little and come too late to stabilize the oil market and further oil price compression.

Consequently **with oil demand falling faster than production, the result is a sharp inventory build up especially in landlocked locations.** According to the Energy Information Administration, the total storage capacity at Cushing, OK amounts to 76 mln barrels expected to be fully utilized by mid May at current pace.

WHEN OIL PRICE TURNS NEGATIVE
WTI NEGATIVE PRICE = MAJOR DISLOCATION

WTI Oil futures – 1st & 2nd contracts (lhs) vs. spread (rhs)



Source Bloomberg, Banque Eric Sturdza

What happened with the WTI contract price on April 20th?

On April 20th, the West Texas Intermediate price, the American crude oil benchmark, tumbled. More precisely, the **WTI May 20 future contract** ended the day in **negative territory**, reaching intraday **USD -37.6**. This move is historic and reflects the oil market dislocation.

The WTI May 2020 future contract is a physically settled futures contract, meaning that investors holding long positions three business days before the 25th of the month shall take physical delivery of the commodity no earlier than the 1st calendar day of the delivery month, May 1st in this example. The contract size is 1'000 barrels and the delivery location is Cushing, OK.

At a time when no storage capacity was available in Cushing, non professional investors that were long and willing to roll their future position on the June maturity had **no other option than to pay a premium to get rid of their May contracts in order to avoid physical delivery.**

Do not confuse future and physical markets! Although oil price faced a significant downward pressure, this situation in which the WTI May contract ended up in negative territory reflects a **technical dislocation**. As highlighted in the graph, the June contract – more than 1'100k contracts traded on April 20th vs. 153k for the May one – closed at USD 22.6, down for the day but still in black.

WHEN OIL PRICE TURNS NEGATIVE
MARKET IMPLICATIONS

Winners vs. Losers ?

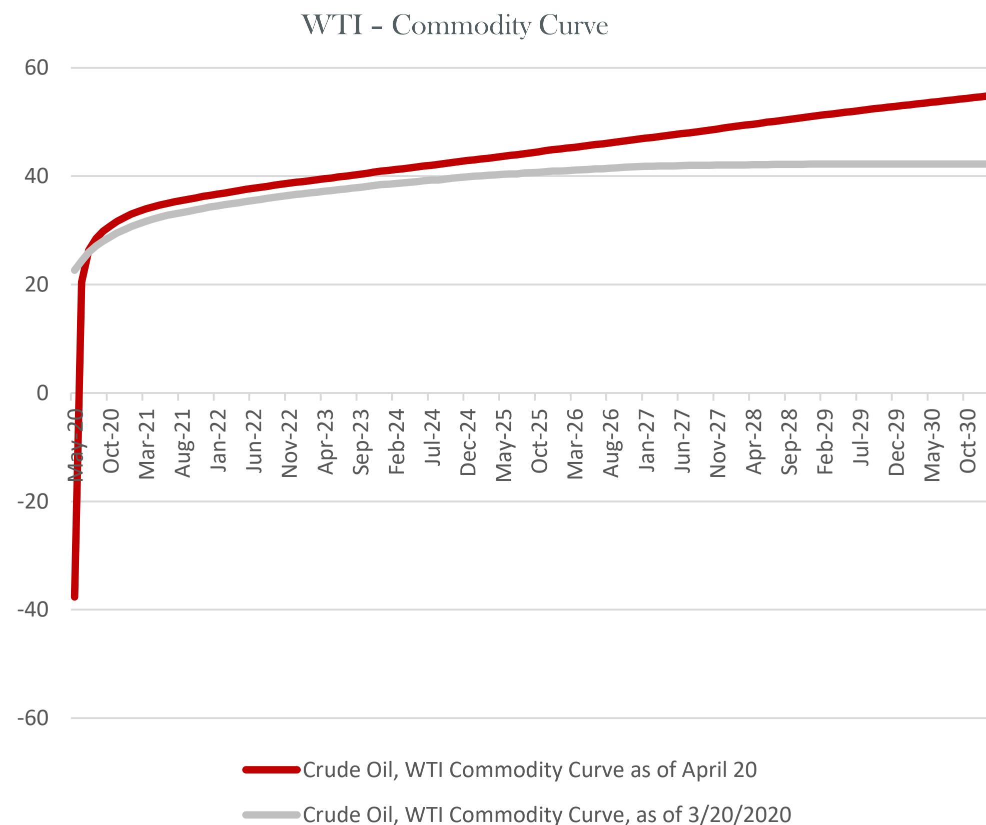
Looking at the dislocation, a few key points shall be kept in mind :

The event occurred on a **thinly traded future contract** exacerbating the move : 153k on that day for the May one to compare with 1'100k for the June one. Given the storage issues and the downward pressure, the June contract may face the same technical glitch.

US producers typically sell their production on a monthly average and many have hedged their production. A limited number of professional investors – unhedged refiners and storage operators with capacity may even profit from the situation.

Non-professional investors and **CTAs** tends normally to focus on the front of the curve. As such some of them could have been **forced sellers** and been heavily penalized.

Finally as evidenced in the commodity curve graph, the WTI curve is seriously in **contango**, meaning that investors positioned on the 1st contracts have to pay a significant premium to carry on their position on the next maturity. This should translate in serious losses for **Oil ETFs** positioned on the front end of the curve when they will have to roll their positions.



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