Philequity Corner (April 27, 2020)
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Below zero

Investors, traders, and fund managers were shocked, startled, and baffled by the recent oil price crash. For the first time in history, oil dove into negative territory as May WTI futures plummeted a record low of-$37.63/bbl. It took a perfect storm of events to precipitate the greatest crash of oil.

Collapse in demand due to COVID-19

Oil prices had been weak in past years because of changes in global supply and demand. There has been an abundance of new supply coming mainly from the US and this has put downward pressure on prices. Meanwhile, developments in renewable energy and electric cars have gradually lessened oil demand.

On February 21, oil started dropping precipitously as countries began to take stock of COVID-19’s toll. Economic activity has ground to a halt as more than 40% of the world’s population are currently advised to stay home. Moreover, oil demand is expected to contract dramatically with no air travel and no cars driving around cities.

Overflowing with supply

Last year, US crude oil production rose 11% to 12.2 million b/d, an all-time high. With the advancement of shale oil and fracking, the US is now the top oil producer in the world. Meanwhile, Saudi Arabia and Russia initially walked away from negotiations on supply cuts and chose to maintain production levels, further contributing to the surplus.

Strong output from the world’s top three producers have further tilted the market towards oversupply. According to a report from the Organization of Petroleum Exporting Countries (OPEC), market surplus may climb up to 15m b/d in 2Q20. Although both OPEC and Russia have recently agreed to supply cuts, it may be a little too late to reverse oil’s historic nosedive.

Lack of oil storage facilities

The US has run out of places to store its oil amid a growing surplus and significantly diminished demand. The Energy Information Administration (EIA) pegged total US working storage capacity at 653m barrels. More than half of this capacity has already been filled, with most of the balance already leased-out. Global storage stock is estimated to be 63% occupied at the moment. Without drastic supply cuts, these facilities may be filled in about eight weeks. This shortage has resulted in the surge of storage costs.

The super contango

Market pundits have dubbed oil’s recent move as a super contango. A contango describes a situation when longer-dated futures trade higher than their short-term counterparts. This typically occurs when the space to store the physical commodity is running out because of a supply glut. What we are currently witnessing is a contango exacerbated by a crash in demand induced by COVID-19. With no storage space and a nearing delivery date, holders of WTI May futures rushed to the exits even at negative prices instead of taking delivery of physical oil. Storage costs have gone up so much that sellers of the short-dated futures are essentially paying buyers to take delivery and store the physical commodity.

Biggest oil ETF implodes

Among the biggest casualties of the oil crash is the United States Oil Fund (USO), an exchange-traded fund (ETF) that attempts to track the price of WTI crude. Attracted by the low price of oil, retail investors who were bottom-fishing piled into USO believing that it was a good proxy for spot oil. However, USO's reliance on short-dated futures translated into huge losses when the super contango occurred. USO is down about 80% year-to-date, burning many retail investors with it. Hastened by margin calls and the forced liquidation of retail investors, the savage drop of USO dragged spot oil prices along with it. This highlights the complex nature of derivatives which do not accurately track the underlying assets. Moreover, it stresses the importance of only investing in financial instruments that one understands.

Unprecedented

The global spread of COVID-19, the staggering number of cases and deaths, the end of the longest bull market, the fastest stock market crash in history, and now the nosedive of oil into negative territory are all once-in-a-lifetime events. In answer to these historic events and challenges, governments and central banks have implemented unprecedented fiscal and monetary stimulus.

Change in lifestyle

We are witnessing many things now that that I have never seen in my whole life. I started as a stock broker in the trading floor of the Manila Stock Exchange, and so I am saddened to see the closure of the physical trading floor for the first time in my career. However, trading in the Philippine Stock Exchange goes on. As a fund manager, I continue to work from home for an extended period. My board meetings are now held in Zoom or other teleconferencing applications, and thus I am not able to see my colleagues and friends.

Abnormal times

The drop of oil futures below zero and the unprecedented market volatility are signs that we are indeed living under extraordinary circumstances. COVID-19 is a painful experience and life will never be the same after it. These life-changing events will be recorded in the annals of history. Books will be written about our experiences during this pandemic and its impact on businesses, investments, and lives.

We vigilantly monitor updates on COVID-19 and the rate of new infections. So far, the flattening of the curve and the slowing infection and death rates are encouraging signs that the lockdown is working. A continued reduction would signify that the disease is being contained. An effective lockdown also buys us time as the government strengthens our healthcare system. We are hopeful for a discovery of a vaccine as this will reinforce and accelerate the recovery of the economy and capital markets.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 8250-8700 or email ask@philequity.net.