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Negative oil prices may be behind us

Oil markets made history in April, with NYMEX WTI trading into negative territory for the first time. While much of this was technical in the lead up to the May-20 contract expiry, it also reflected the state of the physical oil market, where we have seen significant demand destruction. But we think the worst is behind us now

A gas station attendant fills motorcycles in Peshawar, Pakistan

Source: Shutterstock

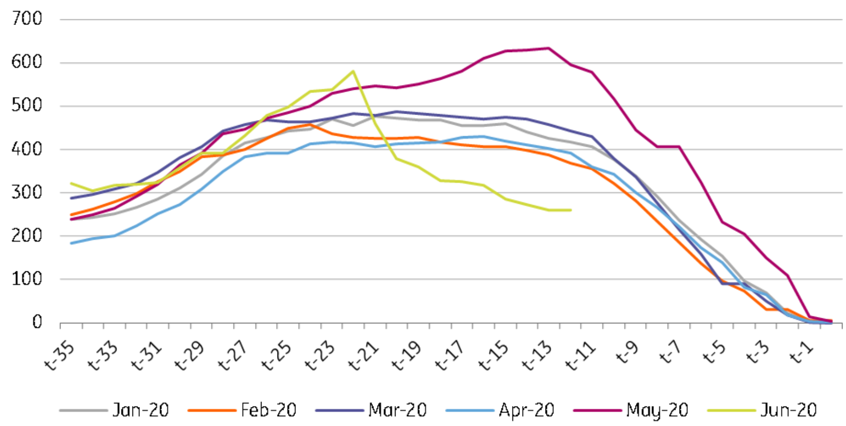
The month oil prices went into the red

April will be remembered as the month where WTI oil prices traded into negative territory, with the May contract trading at a low of -US$40.32/bbl, a day before the contract expiry.

Much of this extreme weakness had to do with the expiry of the May contract, with longs desperate to close out their position or face having to take physical delivery of oil at Cushing, the WTI delivery hub. Looking at the open interest in the May contract, going into the penultimate trading day, open interest was still significant, and hence the need for these positions to be closed out ahead of expiry.

However the fact that prices had to trade down to these levels to find a buyer clearly highlighted the oversupplied environment, and concerns over storage. At the time, storage at Cushing was around 79% full, but clearly less was available, with space booked up in anticipation of large stock builds in the future.

WTI contract open interest (000 lots)



Source: Bloomberg, ING Research

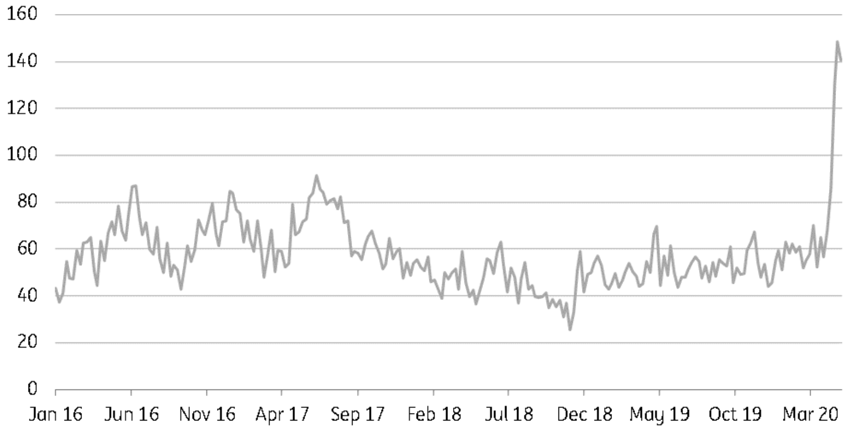
Could we see a repeat?

Having now seen negative prices, the question is whether we could see a repeat this month for the June contract. While it initially appeared we could, with storage expected to be an even bigger issue, dynamics have changed somewhat. The scale of stock builds at Cushing has slowed down more recently, while we are seeing some early signs that demand is starting to recover. This is evident with a pick-up in refinery run rates in the US, along with a modest increase in gasoline demand.

Meanwhile, on the supply side, a number of US oil producers have announced production shut-ins, with some of these reductions starting in May already. The gradual demand recovery, along with falling US supply should slow the rate of inventory builds from the US in the weeks and months ahead, reducing the prospect of negative WTI prices.

Furthermore, market players have been very cautious about holding a position in the WTI June contract, which will expire later this month, fearing that we could see a repeat of the May 20 expiry. Open interest has fallen significantly in recent weeks, with positions rolled further down the board, this should mean market participants who do not have the capability to take physical delivery will likely not hold their position in the final days of the contract's life.

Global crude oil floating storage (MMbbls)



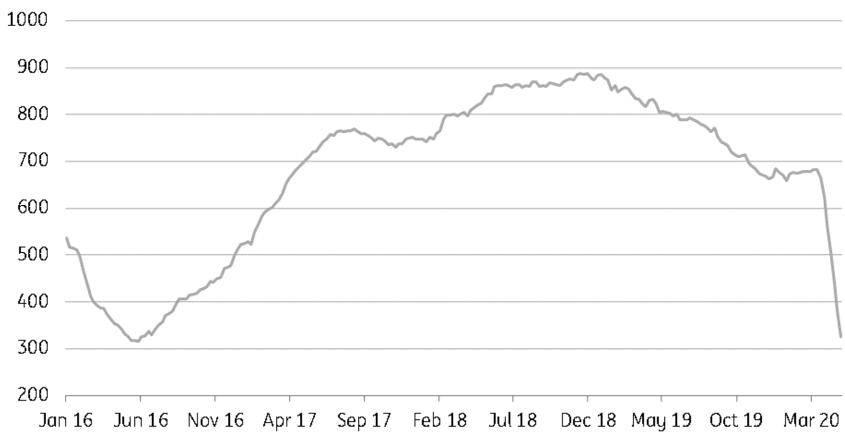
Source: Bloomberg, ING Research

What about negative prices for Brent?

There has also been growing interest over the prospects of negative prices for ICE Brent. While this is possible, we believe that this is unlikely. Firstly, ICE Brent is cash-settled, and so the urgency to close a position ahead of expiry is not as strong, given there is no risk of having to take physical delivery, unlike the WTI contract. Secondly, Brent is a seaborne market, and so does not suffer from the same capacity constraints as the WTI landlocked contract.

Meanwhile, from a fundamentals perspective, it seems that there has been a shift in at least global floating storage for crude oil, with total floating storage having fallen for the first time since March. Although admittedly it still remains near recent record levels, and we would need to see several weeks of consecutive declines to confirm a change in the trend.

US oil rig count



Source: Baker Hughes

Outlook for the rest of the year

We believe that the worst is behind the market now. The main driver behind this assumption is that we should see a gradual recovery in demand over the course of the year.

Although saying that, we are unlikely to see demand back at pre-Covid-19 levels in 2020. This is something that we are more likely to see happen in 2021. Clearly, the key risk is if we do see a second wave of Covid-19, which leads to a tightening in restrictions once again.

We believe that the worst is behind the market now

Supply will also contribute to a more constructive outlook. OPEC+ production cuts got underway on 1 May, which will see 9.7MMbbls/d of supply taken off the market for the next two months, while we are still set to see sizeable cuts of 7.7MMbbls/d over the second half of this year.

Meanwhile, we are also set to see sizeable reductions from producers outside of OPEC+. The bulk of these reductions will take the form of market-driven declines, with current prices just too low, while there will be some producers who follow mandated cuts. Recently, Norway announced that it will be cutting output in an effort to stabilise the oil market.

However clearly, the focus is on the US. It is looking less likely that we see mandated cuts from producers there, with the Texas Railroad Commission at least saying the idea of pro-rationing is “dead” for producers in the state. But the US will still see significant market-driven production declines. US oil rig activity has fallen by more than 50% since mid-March, whilst some producers have gone even further and announced plans to shut in existing production from this month. This suggests that US output by the end of this year could be between 2-3MMbbls/d lower than current levels.

When taking into consideration the demand recovery and fall in supply, the market should transition from surplus to deficit over the second half of this year, allowing it to start drawing down the significant inventory build from the first half of this year. While the scale of stock means prices are unlikely to trade back to pre Covid-19 levels this year, we think ICE Brent will average almost US$45/bbl over the second half of the year.

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