Insights

THE OIL PRICE COLLAPSE – A LESSON IN SUPPLY & DEMAND

APRIL 2020

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A LESSON IN SUPPLY & DEMAND

The word unprecedented has become commonplace and what happened in oil markets last week was another such unprecedented, never seen before event. What follows is a look at the dynamics of oil markets, what happened last week and some of the knock-on effects.

A BRIEF HISTORY OF OPEC AND OIL PRODUCTION

Crude oil is a naturally occurring, unrefined petroleum product and a fundamental source of energy for the world's economy. This fossil fuel is refined to produce gasoline, diesel, and various other forms of petrochemicals. It is non-renewable, meaning it can't be replaced naturally and supply and demand heavily affect the prices and profitability of crude oil.

The Organisation of the Petroleum Exporting Countries (OPEC), founded in 1960 is the largest (by volume) holder of crude oil and natural gas reserves. It is a cartel consisting of 14 of the world's major oil-exporting nations that includes in order of importance Saudi Arabia, Iraq, Iran, UAE, Kuwait, Venezuela, Nigeria and other smaller nations. It is noticeable that some of today's largest oil producers, including the USA, Russia and China, are not members of OPEC and until the last decade, these three major producers did not have significant influence over oil markets. This has subsequently changed with the resurgence of US oil production in particular. The US shale gas boom was borne out of surging demand, higher oil prices and post 2010 the introduction of mass fracking (or hydraulic fracturing) across the USA.

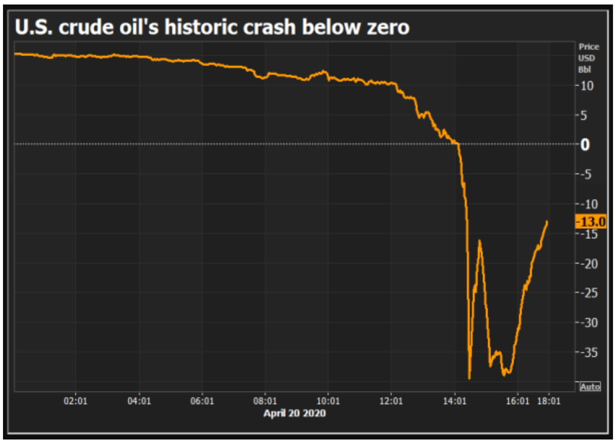
The most popular traded grades of crude oil are Brent North Sea Crude (commonly known as Brent Crude) and West Texas Intermediate (WTI). Both have less than 1% sulphur content requiring less processing in order to refine than denser grades. Brent is typically the benchmark for African, European and Middle Eastern markets dictating roughly two-thirds of the world's crude production. Brent trades on the Intercontinental Exchange (ICE) and stored in various locations around the North Sea. WTI on the other hand is the benchmark oil contract for North American markets and traded on NYMEX. Storage or delivery of the physical stock of WTI takes place in a single location, Cushing, Oklahoma.

Apart from the role that OPEC plays, the world crude oil market is all about investor anticipation of supply and demand, but sometimes even more so by consumer and investor sentiment.

EXPLORING THE CRASH – WTI PLUNGES BELOW ZERO – WHY?

Oil prices are controlled by traders who bid on oil futures contracts on the commodities exchanges. The oil futures contracts are agreements to buy or sell oil at a specific date in the future for an agreed-upon price. A WTI futures contract is for 1,000 barrels of crude, delivered into Cushing, Oklahoma, where energy companies have roughly 76 million barrels of capacity.

The contracts are executed on the floor of the NYMEX commodity exchange and have been regulated since the 1920s.



Commodity traders fall into two categories:

1. Most represent the companies that actually use and refine the oil – requiring a hedge against price uncertainty for their businesses.
2. 2. Speculators – their only motive is to make money from changes in the oil price

SO WHAT HAPPENED?

The price of the WTI May contract plunged below $0 (and traded negative) for the first time in history on Monday 20 April. The May contract was up for expiry on Tuesday 21 April. The fall is both fundamental in nature as well as technical.

Fundamental	Technical
Demand plummeted lower than supply	May WTI futures contract holders don't want to take delivery and incur storage costs as the contracts dial down into expiry
Shortage of buyers	Storage tanks for WTI have become so full and it has become difficult to find additional storage space
Price drop below $0 as suppliers are paying to get rid of stock	

The June contract, with delivery a month away, is still trading positive between $10 - $20 a barrel, but the price crash does indicate the pending future problem of storage capacity and insufficient demand. Unless oil production is immediately and significantly curtailed, the price of oil is likely to remain pressured given the supply and storage glut.

Always seek the advice and support of your investment adviser before making any significant changes to your investment positions.

This outlook and commentary does not constitute an offer and should not be taken as a recommendation from the author or Thomond Asset Management. Advice should always be sought from an appropriately qualified professional.

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