GLOBAL OIL SUPPLY GLUT CONTINUES TO CONSTRAIN ENERGY SECTOR PRICING DURING CORONAVIRUS PANDEMIC

By Paul Franzen, CFA®

Negative oil prices in our lifetime? West Texas Intermediate, the standard pricing benchmark in the U.S. petroleum sector, briefly went into negative territory on April 20th before snapping back to close in positive territory on April 21st. In effect, a seller of oil was willing to pay a buyer to take that oil off their hands. This brief move into negative pricing was unprecedented and dominated financial market headlines for much of that week as a result. Commerce Trust Company Senior Equity Analyst Paul Franzen, CFA®, shares his thinking on what's ahead for the commodity that fuels global commerce.

WHAT IS THE BIG PICTURE STORY FOR OIL TODAY? WHY HAS OIL FALLEN SO MUCH THIS YEAR?

Oil prices have fallen almost 80% this year from $61 per barrel on January 1st to $13 per barrel on April 27th. There are two main forces driving this year's oil price decline. They are the decrease in global demand for oil as people shelter in place because of coronavirus coupled with a market share war that was specific to the oil market.

Before coronavirus, world-wide demand for oil was roughly 100 million barrels per day. The impact of billions of people around the world sheltering in place has caused oil demand to drop by roughly 30 million barrels per day, or a decline of roughly 30%.

The market share war erupted in early March after the Organization of the Petroleum Exporting Countries (OPEC), as well as other large oil-producing countries, failed to reach agreement on extending and potentially deepening their coordinated oil supply cuts that had been in place for years for the purpose of supporting oil prices after the 2014-2015 oil price collapse. Russia, Saudi Arabia, and other countries had grown weary of holding back their own production levels in recent years while watching the United States become the world's top producer of oil and continuing to take market share. When the talks to potentially extend and deepen the coordinated oil supply cuts broke down on March 6th, those countries were then free to pump as much oil as they wanted. On March 9th, the news of this new market share war sent oil prices crashing, down -27% that day.

WE HAVE HEARD OF NEGATIVE INTEREST RATES, AND NOW WE ARE ALSO HEARING ABOUT NEGATIVE OIL PRICES. WERE OIL PRICES REALLY NEGATIVE AND WHAT DOES THAT MEAN?

The most commonly quoted price for oil as used by the media in the United States is that of the contract for West Texas Intermediate, or WTI oil. This oil price briefly went into negative territory on April 20th before snapping back to close in positive territory on April 21st. It is quite odd to consider a negative oil price as it effectively means that a seller of oil is willing to pay a buyer to take that oil off their hands. This brief move into negative pricing was unprecedented and dominated financial market headlines for much of that week as a result.

WHAT CAUSED OIL PRICES TO FALL BELOW ZERO?

A common saying among traders when explaining a decline in the price of a security is that there were "more sellers than buyers." This is actually a fairly accurate description of what is happening in this instance based on how oil is priced. Each month, financial players in the oil market who do not have the ability to accept the physical delivery of oil barrels have to ultimately sell their oil futures contracts to a physical buyer (like a refinery). Oil prices fell below zero as there were a lack of physical buyers of oil because oil storage tanks have almost filled up leaving nowhere to put the oil being sold.

HOW LONG BEFORE STORAGE TANKS ARE FULL, AND WE RUN OUT OF ROOM TO STORE OIL?

Storage facilities for WTI oil are expected to completely fill up sometime in May based on the current pace we are adding oil to storage. With nowhere left to put the oil, prices are falling to levels that cause oil producers to "shut in" their oil wells (stop producing). Oil prices are likely to remain below $25 through mid-year with the potential for short-term declines to very low or negative values.

IS ANYTHING POSITIVE HAPPENING REGARDING THE OUTLOOK FOR OIL PRICES?

Yes, one recent change is that given the severity of the situation, OPEC and other countries have agreed to lower their oil production levels once again. Also, the low oil prices are causing producers in the United States and elsewhere to lower their production levels. Eventually, declining oil production levels around the world combined with improved oil demand as countries around the globe begin to open their economies back up should help bring the oil market into better balance.

STOCKS OF COMPANIES IN THE ENERGY SECTOR HAVE ALSO BEEN HIT HARD THIS YEAR. IS THE DECLINE WARRANTED AND WHAT SHOULD INVESTORS DO?

Energy is the worst-performing sector in the S&P 500 year-to-date, falling by roughly 40% through late April. The year-to-date decline in both the oil and oil production company values within the sector is warranted in our view. The eventual recovery for Energy stocks is likely to be a long and arduous one, potentially with several casualties along the way, including many dividend cuts and even some bankruptcies. For investors considering stocks in the Energy sector, our view is that it is important to consider those energy companies with diversified operations, strong balance sheets, and proven management teams as these are the mostly likely to maintain their dividends.

Commerce Trust Company
Wealth | Investments | Planning®

1-855-295-7821 | commercetrustcompany.com

Commerce Trust Company is a division of Commerce Bank.

ABOUT THE AUTHOR

PAUL FRANZEN, CFA®

Vice President, Senior Equity Analyst

Paul is a senior equity analyst for Commerce Trust Company. He covers the energy, financial services, utilities, and real estate sectors while providing stock recommendations for the company's Fundamental Process and routinely communicates investment messages to portfolio managers. Prior to joining Commerce Trust, Paul was the subject-matter expert responsible for analyzing and issuing stock recommendations on approximately 20 utilities covering over $4 billion in firm name holdings. Paul was also a panelist speaker for the American Gas Association and a three-time winner of Forbes "Best Brokerage Analysts" distinction. He earned his bachelor's degree in finance from Kansas State University in 1999, graduating cum laude and holds the Chartered Financial Analyst® designation. Paul also is a member of the CFA Institute and the CFA Society of Kansas City.