21 April 2020

MARKET FLASH UPDATE

Oil prices fall below $0!

By now, most people would have seen the somewhat unbelievable headlines plastered across the front page of news websites, such as: **'Oil prices crash below US$0 for first time amid devastating glut'**. This is inevitably followed by confusion around negative oil prices, and thinking *why the price of petrol at the pump is still so expensive??* Some of our investors may also be concerned as we had just initiated some exposures to energy equities for Q2 2020.

How can oil prices fall below $0?

The negative prices in the headlines reflect prices for the May futures contract for the US WTI (West Texas Intermediate) which closed at -$37.63 on 20th April.

It is important to note that the May contract expires on 21st April 2020, meaning trading volumes thin out in the days leading to 21 April 2020 as traders close their positions. If you combine selling pressure, illiquidity and short-term pessimism, it can be a very volatile mix.

Many reasons have been posited to explain such unprecedented declines: including passive ETFs rolling their positions (i.e. selling May contracts and buying June contracts), insufficient storage causing fire sales, or demand destruction from reduced transportation arising from lockdowns. **All of these concerns tend to be shorter-term in nature, and do not materially impact the long-term fundamentals for oil.**

Get paid to buy oil?

Do negative prices mean that you can get paid $37.63 while receiving a barrel (119 litres) of oil? If this seems almost too good to be true: It is.

At its worst, WTI traded at -$40 in a 3-minute window. Some traders were lucky enough to buy 99 contracts at that price. This is a small proportion of the ~250,000 contracts traded on 20th April, which were already lower volumes than normal.

Since then, WTI has recovered to $1.40 for most of the Asian trading day. But in order to enjoy these prices on the last day before the contract expires, you have to own an oil tank to store the physical oil that will be delivered.

Longer term prices, and prices elsewhere not dropped so drastically

What do we mean by longer term prices? Actually, it's not that far away. A month ago, WTI prices for the August contract were at $26. Today, after yesterday's crash, August prices are also at $26. That means that markets are looking past the immediate volatility, and agreeing that prices in a few months are similar before and after yesterday's crash.

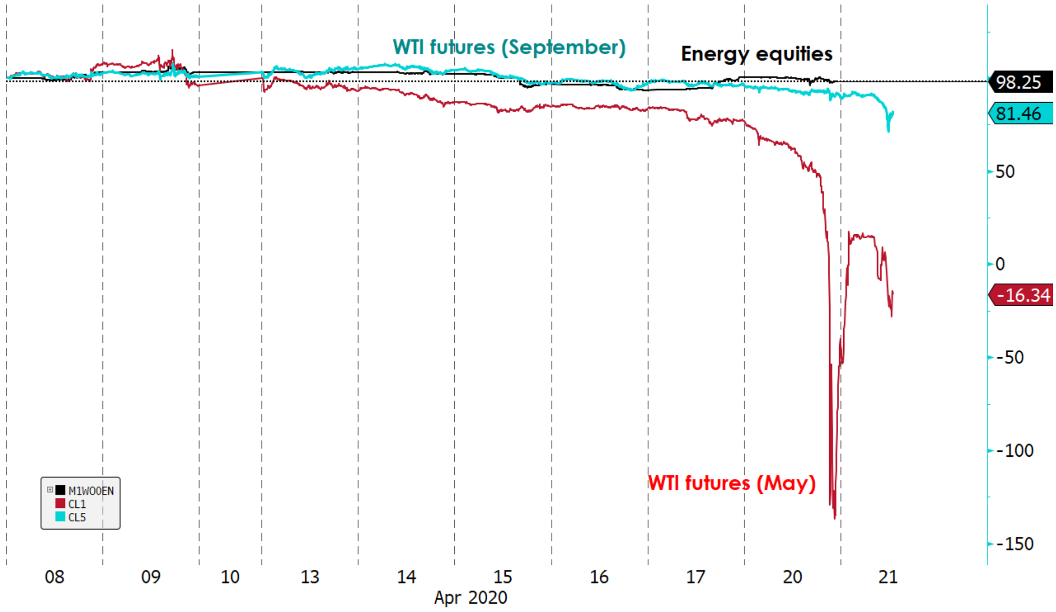
WTI is one of two benchmarks for oil. The other, Brent, is an international benchmark reflecting about two thirds of world production, and is holding at $20 even for the immediate contract. This means that the stresses being seen for the WTI are localised, and do not reflect prices globally.

Indeed, the outlook for WTI in a few months, and for buyers of oil elsewhere in the world are not as dire as headlines indicate. Oil prices, nevertheless, have dropped meaningfully from the highs in January, which create opportunity.

What is the impact on our portfolios?

As a reminder, we had 0% allocation to energy when oil fell by 66% and energy equities by 51% over Q1 2020, and had avoided outsized losses then. Consequently, we were in a good position to take advantage of low prices, which we did so by allocating to energy equities.

We do not take lightly the possibility of low oil prices for longer; which is why we favour the larger, more well-capitalised energy companies that will be able to survive a prolonged downturn. Indeed, **these companies have been more resilient even as oil prices were volatile over the past week** (refer to figure below). While the oil prices in the news (the May contract) are down -284% for April, global energy equities are up 4%. The following shows how different performance was for the May contract, compared to the September contract or energy equities in the past week:



Source: Bloomberg

It is also important to remember that energy is only one out of the many differentiated investments we have in our multi-asset portfolios, and which are expected to take turns to do well.

What's next?

We cannot predict the future, but can prepare for different outcomes. Not to dismiss the unique situation today with economies on hiatus, but oil is an important resource for global growth, hence long-term prices are likely to be much higher than current levels. Accordingly, the low prices today are offering a very good risk/reward for investors who are looking for long term returns.