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The Problem with Oil

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The International Energy Agency (IEA) recently warned that escalating crude oil supply "threatens to overwhelm the logistics of the oil industry — ships, pipelines and storage tanks — in the coming weeks." Apparently, that particular warning didn't get much press at the time. Yesterday, the IEA prediction came true as the contract price for May delivery of West Texas Intermediate Crude (WTI) crashed in historic and breathtaking fashion, sinking from around $18 per barrel and *blowing past zero* to close the day in negative territory at -$37.63. (It was around $60 at the beginning of the year before the coronavirus asserted itself.) As dramatic as the plunge was, the explanation is simple and the outcome could easily repeat itself in future months.

A trader invests in (or speculates on) oil by purchasing a contract for future delivery. Since these contracts require the buyer to take physical delivery of the oil, at some point before expiration the contract must be sold. Yesterday, with the May contract set to expire, there were simply…no buyers. In theory, with no buyers, speculators would be forced to take physical delivery of that oil. The fact that crude prices went negative means holders of the May contract, without the intent or capacity to store the oil, suddenly have to pay for someone to take it off their hands.

With much of the world in shutdown mode, the demand for oil and gas has evaporated, while production continues. As Bloomberg Business Week pointed out this morning, the supply of oil is inelastic in the short term. Because it's expensive to shut down wells, production typically continues…even at a loss. For a while, there was enough storage capacity to absorb much of this excess, but that capacity is nearly full. One of the remaining storage options is floating tanker ships, but that option has become increasingly expensive. According to the Wall Street Journal, the average daily storage rate on a six-month lease for 2 million barrels on what are known as very large crude carriers (VLCCs) has jumped from $29,000 per day a year ago, to $100,000 today. At the end of March, there were already 109 million barrels stowed at sea. By last Friday, the number had jumped to 141 million. The IEA expects global demand to drop by 29 million barrels per day on a year-over-year basis to a 25-year low. This number dwarfs the 9.7 million barrel per day planned reduction as outlined by OPEC-Plus members earlier this month.

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With the May contract in the rearview mirror, the June delivery contract was next in line. After closing at $20.43 yesterday, the June contract dropped to an intraday low of $6.90 this afternoon before climbing back above $13. Some of the recovery is purely hope attributed to President Trump's request that Energy Secretary Dan Brouillette and Treasury Secretary Steven Mnuchin begin work immediately on a plan to support U.S. energy companies. Brouillette has reportedly approached House leaders for funding required to add 77 million barrels to the U.S. Strategic Petroleum Reserve, effectively topping off capacity.

Whatever fixes the administration can come up with are likely to be short-lived. The U.S. shale oil industry has a $40 per barrel breakeven point according to the International Business Times, and many smaller U.S. fracking companies were already nearing bankruptcy. The solution for the oil industry would be a sharp rise in demand, and that won't happen until the slumbering global economy wakes up.

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Please see disclosure on page 2.

Market Indications as of 4:35 P.M. Central Time

DOW	Down 631 to 23,018 (HIGH: 29,551)
NASDAQ	Down 297 to 8,263 (HIGH: 9,817)
S&P 500	Down 87 to 2,736 (HIGH: 3,386)
1-Yr T-bill	current yield 0.11%; opening yield 0.12%
2-Yr T-note	current yield 0.20%; opening yield 0.20%
5-Yr T-note	current yield 0.34%; opening yield 0.34%
10-Yr T-note	current yield 0.57%; opening yield 0.61%
30-Yr T-bond	current yield 1.16%; opening yield 1.22%