OIL PRICING AND VOLATILITY IN A MACRO AND MICRO VIEW

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Worldwide crude oil prices will average $72 a barrel in 2019. That’s according to the Short-term Energy Outlook (STEO) by the U.S. Energy Information Administration.

On September 24, 2018, global oil prices hit a four-year high of $81.20/b (Brent) after OPEC promised to keep production steady. Investors believed that U.S. sanctions against Iran and outages in Venezuela would lead to supply shortages. But by mid-November, prices fell 18 percent, and have continued a decline. By November’s end it appears Global oil prices may have found a bottom (at least until we hear the result of OPEC meeting). Higher U.S. supply has coincided with fears of slowing global growth.

The September spike surpassed the May 10, 2018 record of $80/b (Brent). That spike occurred two days after the United States pulled out of the Iran nuclear agreement and reinstated sanctions. Prices have been supported by the November 30, 2017 OPEC meeting, in which members agreed to keep production cuts through 2018. They may need to cut further at their next meeting to put a floor under prices.

Global oil prices had fallen to a 13-year low of $26.55/b on January 20, 2016. Six months before that, prices had been $60/b. A year earlier in June 2014, they had been $100.26/b. Today’s oil price fluctuates due to constantly changing conditions.

There are two grades of crude oil that are benchmarks for other oil prices. West Texas Intermediate comes from the United States and is the benchmark for U.S. oil prices. Brent North Sea oil comes from Northwest Europe and is the benchmark for global oil prices.

The price of a barrel of WTI oil is approximately $9 per barrel lower than Brent prices due to heightened U.S. supply.

Have U.S. oil prices entered a bear market? The price of a barrel of WTI oil has fallen 20 percent from its four-year high of $76.41 a barrel on October 3, 2018. Inventories rose to a five-month high of 432 million barrels. U.S. oil production increased to a record 11.6 million barrels a day. That meets 58 percent of domestic demand of 19.96 million barrels per day, according to the EIA.

As a result, the United States became the world’s largest crude-oil producer, according to the Energy Information Administration. The U.S. oil industry has found the right balance. It’s increased the supply slowly enough to maintain prices that pay for more exploration. (Remember this)
FOUR REASONS FOR VOLATILE OIL PRICES

Prices have been volatile thanks to swings in oil supply. Oil prices used to have a predictable seasonal swing. They spiked in the spring, as oil traders anticipated high demand for summer vacation driving. Once demand peaked, prices dropped in the fall and winter. So why are oil prices no longer as predictable? The oil industry has changed in four fundamental ways.

First, U.S. production of shale oil and alternative fuels, such as ethanol, began increasing in 2015. The EIA estimated that U.S. fuel production averaged 11.4 million b/d in October 2018. It beat the previous U.S. record of 9.6 million b/d set in 1970. Production averaged 9.4 million b/d in 2017, and 10.9 million b/d in 2018. The average will rise to a record of 12.9 million b/d in 2019 (Forecasted).

Why is the United States producing so much oil despite historically low prices? Many shale oil producers have become more efficient at extracting oil. They’ve found ways to keep wells open, saving them the cost of capping them.

At the same time, massive oil wells in the Gulf began producing in large quantities. They couldn’t stop production regardless of low oil prices. As a result, large traditional oil enterprises stopped exploring new reserves. These companies include Exxon-Mobil, BP, Chevron, and Royal Dutch Shell. It was cheaper for them to buy out the less efficient shale oil companies.

In 2019, production from West Texas will increase by 2 million barrels a day. U.S. companies have drilled 114,000 wells, many of which are profitable at $30 a barrel.

Second, OPEC reduced output to put a floor under prices. On November 30, 2016, its members agreed to cut production by 1.2 million b/d by January 2017. Prices began rising right after the OPEC announcement. On November 30, 2017, OPEC agreed to continue the production cuts through 2018.

OPEC’s cuts lowered production to 32.5 million b/d. The EIA estimates OPEC will produce 32.8 million b/d in 2018. But both figures are still higher than its 2015 average of 32.32 million b/d.

Throughout its history, OPEC controlled production to maintain a $70/b price target. In 2014, it abandoned this policy. Saudi Arabia, OPEC’s biggest contributor, lowered its price to its largest customers in October 2014. It did not want to lose market share to its arch-rival, Iran. These two countries’ rivalry stems from the conflict between the Sunni and Shiite branches of Islam. Iran
promised to double its oil exports to 2.4 million b/d once sanctions were lifted. The 2015 nuclear peace treaty lifted 2010 economic sanctions and allowed Saudi Arabia’s biggest rival to export oil again in 2016.

Saudi Arabia also did not want to lose market share to U.S. shale oil producers. It bet that lower prices would force many U.S. shale producers out of business and reduce its competition. It was right. At first, shale producers found ways to keep the oil pumping. Thanks to increased U.S. supply, demand for OPEC oil fell from 30 million b/d in 2014 to 29 million b/d in 2015. But the strong dollar meant OPEC countries could remain profitable at lower oil prices. Rather than lose market share, OPEC kept its production target at 30 million b/d.

The lower prices caused 2016 U.S. oil production to fall to 8.9 million b/d. Less efficient shale producers either cut back or were bought out. That reduced supply by around 10 percent, creating a boom and bust in U.S. shale oil.

Third, foreign exchange traders drove up the value of the dollar by 25 percent in 2014 and 2015. All oil transactions are paid in U.S. dollars. The strong dollar helped cause some of the 70 percent decline in the price of petroleum for exporting countries. Most oil-exporting countries peg their currencies to the dollar. Therefore, a 25 percent rise in the dollar offsets a 25 percent drop in oil prices. Global uncertainty keeps the U.S. dollar strong.

Since December 2016, the dollar’s value has been falling, according to the DXY interactive chart. On December 11, 2016, the USDX was 102.95. In early 2017, hedge funds began shorting the dollar as Europe’s economy improved. As the euro rose, the dollar fell. By April 11, 2018, it had fallen to 89.53.

Fourth, global demand grew more slowly than anticipated. It only rose to 93.3 million b/d in 2015, from 92.4 million b/d in 2014, according to the IEA. Most of the increase was from China, which now consumes 12 percent of global oil production. China’s economic reforms were slowing its growth. President Trump’s trade war has further slowed China’s growth. As a result, global demand for oil has dropped.

While the above reveal the macro view of volatility in global oil prices. Let us take a look at a micro view for the past six to ten weeks of the drop in oil prices and heightened volatility.
MANAGED MONEY NET LENGTH AND PRODUCER HEDGES (THE SNOWBALL)

Hedge fund managers have exited from all the bullish positions in crude oil and fuels they accumulated in the second half of 2017 as the bull market has unwound.

Upside price potential from Iran sanctions and prospective production cuts by OPEC is matched by downside risks from rapidly rising U.S. shale production and a deteriorating economic outlook. (Above stated Macro view)

Portfolio managers have sold the equivalent of 553 million barrels of crude and fuels in the last seven weeks, the largest reduction over a comparable period since at least 2013.

Funds now hold a net long position of just 547 million barrels, less than half the recent peak of 1.1 billion at the end of September, and down from a record 1.484 billion in January.

Net length has been reduced to the lowest level since July 2017 essentially unwinding the petroleum bull market of 2017/18.

Bullishness towards oil prices has evaporated and hedge funds now have the fewest outright long positions in crude and fuels since January 2016, when oil prices were hitting the bottom of the last slump.

By contrast, short positions have climbed to 261 million barrels, the highest for a year, and up from a recent low of just 96 million barrels at the end of September.

In the last five weeks, funds have sold 47 million barrels of U.S. gasoline, 31 million barrels of U.S. heating oil(ULSD) and 29 million barrels of European gasoil.

But the heaviest selling has been in crude, where fund managers have sold 282 million barrels of Brent in the last seven weeks and 221 million barrels of WTI in the last 10 weeks.

Fund managers still have a residual net long position of 380 million barrels in Brent and WTI, according to an analysis of exchange and regulatory data. But most of the remaining positions appear to be long-term, passive and structural in nature rather than expressing an active view on prices.
Producers have been hedging their portfolio against a significant drop in price throughout 2018, according to exchange and government data. One particular producing country has always been known for their large hedge in the financial markets. Mexico purchases puts in structured terms for 2018, the right to sell at a particular price for a premium paid, to hedge their production for a drop in prices below the stated strike price. The puts purchased were at the 65, 60, and 55 dollar strike price. (Strike price equals the level at which they can sell oil). As with all trades there must be a seller and buyer for every transaction. So, all those that sold the puts would be long if the market fell below the levels of the puts, and where the hedging producer is now short.

As the markets move lower those that sold the puts hold a position that becomes longer the further the market drops, which in turn would make those getting longer a need to sell into a falling market. Can you see the snowball forming?

In quick conclusion, managed money positions (long oil and refined products) are being covered due to macro views of oil which state a possible decline in oil price. As the positions are unwound the market drops to levels which large producers had hedged production. The puts are converted to futures by exercising through the exchange and making those that sold the puts now long futures at levels above current price levels (when $65 puts are exercised (converted to futures) the market will be below that level so that the owner of stated put is short at levels which are in the money, and so on) creating further selling to cover unwanted length, which in turn pushes the market below the next strike price and so on. It appears that much of the unwanted length has been covered and managed funds have covered their length and now hold a mostly neutral position in oil and refined products.

Managed money had significant profits from long positions accumulated since late 2017 and would not sit around and watch them disappear as data, geopolitical, and other news showed the possibility of a price decline. Hedge funds start to cover which ignited further selling pressure by those that sold puts to producers and you have snowball moving downhill in a technical move. Fundamentals will again take hold of the market and return some normalcy to volatility and price movement. The snowball has little impotence now.