



Understanding the Oil Market

The recent oil market plunge has caused many investors to wonder whether getting into oil now is a possible investment option. We would however argue that it is not – it is a speculative option, one that should be handled with extreme care given that the oil market is a very finely balanced market place of demand and supply.

Holding oil is not a simple investment option – unlike most other investments it does not provide an income stream. Moreover, there is a direct cost to holding any commodity – this is primarily the cost of storage and is quite significant when looking at something like gold. To bypass the storage cost most Exchange Traded Funds (ETFs) and particularly those dealing in oil exposure, do not actually buy physical oil but rather the financial derivative that is freely traded on various exchanges that references oil. These contracts on the price of oil is set for a particular date – known as the close out date. At the close out date an investor has no choice but to sell the contract at the prevailing market price and buy a new – future dated contract. This works well enough if the oil market is at or near equilibrium. However recent developments in the oil market has shown that equilibrium is no guarantee and the resulting losses from forced selling can have dire consequences for investors in oil ETFs.

Below is the graph of the largest Oil ETF showing a loss of more than 80% in a matter of 4 months.



Oil Market Demand and Supply Dynamics

Demand factors:

- The actual demand for oil products is driven by the consumption of oil related products which is underpinned by economic activity. Given the outbreak of COVID-19, global demand for petrol, diesel and Avgas has dropped off a cliff.
- Storage capacity from refineries. Refineries have contracts to buy oil on an ongoing bases to satisfy the demand listed above – many of these contracts have been concluded long before the outbreak of COVID-19. Temporary supply and demand fluctuations are managed by refineries by storing either the oil (to be processed later) or the finished product (to be sold later). In the normal course of business inventories are low – so when prices drop, refineries would buy more and store for later. These storage capacities have however filled up fast with most nearing capacity. Thus, refineries are no longer demanding oil – irrespective of the price.
- Transporting oil is not cheap. This is why the oil price is different in various areas of the world – thus for a Texan producer to start supplying to a new market – say India, it is unlikely to be profitable as the cost factored to transport the oil to the new market may simply not be feasible. This is even further exacerbated due to the fact that some oil producers are storing oil on ships at the moment due to decreasing storage capacity which is also driving up the transport costs of oil.
- Europe is a major consumer of heating oils and natural gas – which is part of the larger oil production supply chain – and going into the summer months this demand will further drop off.

Supply Factors:

- To most oil exporting nations, oil revenue makes up the majority or at least a very significant portion of the total government revenue. Thus, a nation might not be able to afford simply cutting back on production and risk fiscal ruin. Therefore selling at a lower price is still better than not selling at all.
- Oil producing companies are generally heavily indebted as the costs of setting up wells are expensive with long payback periods – the debt still needs to be serviced and as a result even private companies face much the same dilemma as oil nations – selling at a lower price is still better than selling at nothing.
- The structure of oil wells are also a consideration – in short, a well cannot simply be switched off without exposing the well and the equipment to significant risks. Even just slowing production may have unintended consequences such as the unexpected release of formation fluids and natural gas. This is why the pumps continue to run even as the companies are making losses from them.
- The low growth economic environment that has started to emerge pre the COVID-19 crises has caused non-OPEC countries to increase production in order to balance their budgets and which led to increased supply (in a time where demand is falling) since 1 April. Couple this with political considerations, where Trump wants to keep oil prices relatively low to keep Russia weak, and this introduces other supply side dynamics that are not easy to model.

ETF Structures

All oil ETFs are based on derivative futures. All futures have an expiry date or contracted end date. Thus it is irrelevant to what the view of the manager is – the contract needs to be closed and the next contract is to be purchased. Each ETF has its own rules on what contract may be purchased and this causes divergence between oil ETFs.

Below is the graph of the second largest oil ETF, showing a loss of more than 50% in 4 months – which is significantly less than that of the 80% of the largest above and is solely as a result of the differing rules of the ETF.



Oil Companies

Oil exposed companies' share prices have plummeted in many instances faster than the oil price and looks attractive considering the historical levels. Here too extreme caution is required. Considering the above dynamics and the impact on the revenue line dropping whilst many of the expenses remain constant – coupled with debt servicing costs and the related cash flows, can quickly spell disaster to any business operation. This has already been witnessed with many of the small, less resilient, oil producers in the US.

When overlaying capital market requirements – such as credit and bond covenants requiring certain metrics such as free cash flow, debt to equity ratio and other profitability metrics - this may cause many of these companies to be technically in default. Such as the case with Sasol currently. This will require these companies to either drastically restructure their business (which may cause the future profile of the company to deviate from what is known from the past) or to issue more equity (which is dilutive to existing shareholders).

Investment Decision

Thus, the choice is not an investment choice as much as it is a potential for speculation. And as should be clear from the risks highlighted above – a decision based on a mean reversion strategy only without considering the other dynamics at play in the oil and related markets may be detrimental to your wealth.