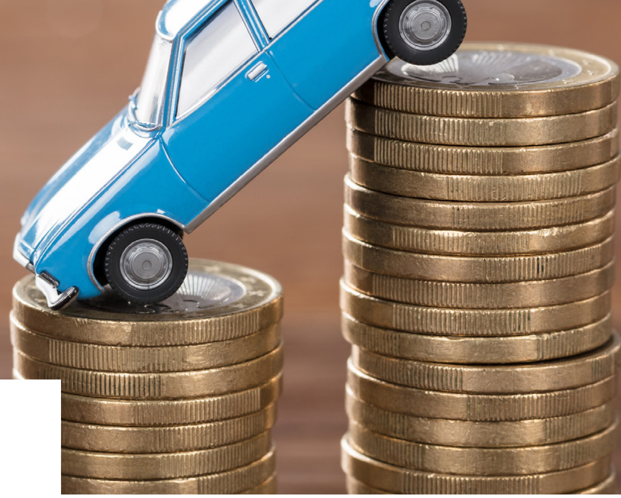

Weekly Digest

| 27 April 2020 |

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Forty Below Zero

Even as I was writing last week's Weekly Digest, there was a torpedo in the water heading towards the oil market, and it duly hit its target on Monday afternoon. The outcome was that the price of a barrel of oil in the United States fell below zero, leading to a joke doing the rounds that criminals had been spotted syphoning petrol into cars! Oil joined interest rates and bond yields in the strange "through the looking glass" world of negative values. How on earth can this be?

In the case of oil we need to look into the futures market, which is where the damage occurred. The ownership of one futures contract for benchmark West Texas Intermediate (WTI) crude oil confers not only the right but also, crucially, the obligation to take delivery of 1,000 barrels of the black stuff on expiry. In normal circumstances, this would not pose a problem, but, as we are increasingly discovering, we live in far from normal times.

As is often the case in commodities markets, the underlying problem currently is one of supply and demand. The global production of oil is as high as it has ever been, running at around 100 million barrels per day. It was boosted to these levels by the sharp increase in recent years from US shale fields (partly thanks to the availability of cheap and plentiful debt to support the drilling), and, more recently, a breakdown in relations between Saudi Arabia and Russia which led to both countries increasing production.

Unfortunately, this abundance of supply materialised just as demand dropped off a cliff thanks to the coronavirus. Current global demand is estimated to be around 70-75 million barrels per day. In normal times a supply/demand imbalance of as little as a couple of million barrels can move the oil price by as much as $10, so you can imagine that a 25-30 million barrel imbalance is going to cause havoc.

When far more oil is being produced than consumed, there are three options available. The first, to increase demand, is not currently viable. The second is to reduce supply. As simple a solution as that might seem, it is not exactly practical. Turning off an oil well is more technically challenging than just turning off a tap, and there are more challenges ahead when it comes to turning supply back on again. Then there are the political difficulties of agreeing cuts when producing countries don't wish to cede market share and revenue. Much of the world's oil is produced by nationally controlled oil companies. On top of that are private sector producers who have to service liabilities such as bank loans and interest payments on bonds, and so need any cash flow they can generate. The pragmatic solution is to carry on producing and to store the oil in anticipation of higher future demand and recovering prices.

The latter route is the one the industry has taken during this downturn. The futures market has consistently suggested that the oil price will recover strongly in the months ahead as demand eventually recovers and marginally profitable producers fail.

Therefore there has been a surge in demand for storage capacity, from huge seaborne tankers to rusty old trucks, to take advantage of this arbitrage: buy cheap oil today, store it for a few months, and sell it on at a guaranteed higher price in the summer. But this storage capacity is finite, and now close to brimful.

Enter the "mug punter". The experience of the last two big oil price declines in 2008/09 and 2015/16 suggested that if you dive into the oil market when the price falls much below $40 a barrel and hold your nose for long enough there is a profit to be made. As the price recently fell well below that level, the temptation to bet on some sort of mean reversion increased, and the United States Oil Exchange Traded Fund alone drew $1.5 billion of new flows two weeks ago. The fund itself accounted for a quarter of all open futures contracts.

The catalyst for the carnage was the expiry of the April contract in the middle of last week. Holders of the contract, who were already facing losses on paper, had to choose between either rolling forward to the next month (which would incur higher costs owing to the higher forward price), or taking delivery of the oil. The former option might not be possible owing to existing mark-to-market losses and the requirement for more margin to fund the trade; the latter option is not practical for a purely financial trader, especially with storage costs already soaring. Thus, the path of least resistance became to pay someone to take the liability off your hands, with the contract price at one point falling as low as minus $40 per barrel. Mad as all of this might sound, it is perfectly logical, and the price immediately reverted to positive territory once the expiry was complete.

Theoretically, this should be a short-term phenomenon. Oil remains, after all, a valuable commodity that we will need for some time to come. However, as long as supply continues to overwhelm demand and storage capacity remains limited, we could witness more such price movements. Much will depend on the speed at which demand recovers relative to supply, and, given that many producers have incentives to continue producing beyond short-term profitability, the outlook is hardly encouraging.

We do not normally invest in oil price futures contracts, and we don't intend to start now. However, within our portfolios we do have exposure to oil through the companies that produce, refine and market it, notably BP and Royal Dutch Shell. These two alone provided 18% of the pre-virus forecast total dividend payments for the UK market in 2020.

Our analysts are doing their best to assess what probability there is of dividends being paid this year. Currently we ascribe a 75% probability to BP and Shell's dividends being the same as in 2019. The free-cash flow break even oil price for big oil companies (accounting for operating expenses and capital expenditure) is in the range of $25-30 per barrel. The dividends for the majors currently cost around $20 per barrel. Today's nearest contract price for Brent Crude is $24, and below $15 for WTI. Both companies have recently committed to maintaining their dividend payments, but you can see that the maths doesn't work today. Both have paid dividends by assuming more debt in the past, and this is sustainable for a while owing to the usually strong underlying cash-generating nature of the business. But not in perpetuity.

This has big implications for investors relying on dividends for income. We currently estimate that the UK market's dividend payments will be cut by 50% this year. If we assume that BP and Shell are forced to cut their dividends entirely, the shortfall would rise to 63%. Historical dividend yield data such as you might find in the Financial Times is of no use currently. The quoted yield of 5.3% for the FTSE 100 Index will be well below 3% on a forward looking basis. We will get more of a steer this week with the publication of first quarter results from BP (Tuesday) and Shell (Thursday), as well as from other international majors such as Total (also Thursday), Exxon and Chevron (both on Friday).

I am certainly not trying to induce panic on the income front, as much of the dividend shortfall should prove temporary. However, the news on dividends as we progress through the company reporting season will ensure that everyone needs to reassess their current income requirements and to cut their coat accordingly. It might also be a mistake to try to reach for higher income in portfolios to plug the gap. Higher income now almost certainly entails taking higher risks at a time of elevated uncertainty.

Finally, for those wondering why petrol stations are not giving petrol away (or at least why the price of

a litre is still around 110p hereabouts), remember that the government gets most of what you pay. Fuel duty is currently 57.95p per litre, on top which (sneakily) is added VAT, so that's 69.54p for starters! Unless the Chancellor is overtaken by a sudden bout of generosity, this is one price I can't see falling below zero

Last week's Economic Highlights

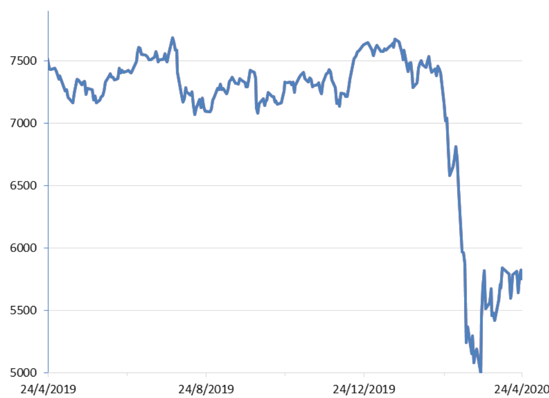
FTSE 100 Weekly Winners

Taylor Wimpey	11.1%
Persimmon	9.8%
Berkeley Group	7.6%
Barratt Developments	6.6%
Royal Mail	6.1%
Reckitt Benckiser	4.6%
Admiral Group	4.6%

FTSE 100 Weekly Losers

NMC Health	-99.5%
TUI AG	-17.0%
Burberry Group	-12.3%
Pearson	-11.3%
easyJet	-10.3%
John Wood Group	-10.2%
Legal & General Group	-9.6%

FTSE 100 Index, Past 12 Months



Source:FactSet

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