WHAT IS THE OUTLOOK FOR OIL? WHAT DO THE STOCK MARKETS EXPECT?

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What's the outlook for oil? What to expect from stock markets?

The tumbling of crude oil prices does not give us any indication of the economic outlook for the coming months; it basically reflects the situation of supply and demand, and storage capacities in today's context of widespread lockdown.

Stock markets have entered a phase of digestion of the price rally seen over the past 30 days. We recommend capitalising on the expected volatility to increase exposure to equity markets, which we expect to be close to the 200-day moving average by year-end.

Tuesday was the last trading day for the May WTI (West Texas Intermediate) futures contract. This due date revealed a completely unimaginable situation, namely that none wants to take delivery of this oil for lack of sufficient storage capacity in Cushing, Oklahoma. This explains why the last remaining May contracts traded at negative prices (at -$37.6/barrel vs. $17.85% at Monday morning's opening), in other words sellers had to pay buyers to get rid of their oil!

On Tuesday, the June contract continued to fall, losing a further 43% to $11.69/b. The Brent (North Sea oil) plunged 20.7% to $19/b, an unprecedented low. Lockdown measures and travel restrictions led to a collapse in demand at a time when there was already an excess in supply. With storage capacities almost all used, the US oil market is reaching physical limits of storage and transportation.

When will prices rise again?

There is no doubt that prices will rise because the situation is untenable for all producers, whether American, Russian or Saudi. While there is no further cooperation between producer countries and/or temporary support measures, supply will automatically decline because the least profitable producers will disappear at the cost of an impressive rise in unemployment and considerable financial damage.

In the United States, the profitability threshold for shale oil is estimated at $45 per barrel on average. The big difference with conventional oilfields is that the lifespan of wells is relatively short and continuous investment is necessary to dig new ones. And yet this industry is dominated by a large number of small- and medium-sized producers which already had difficulty generating enough cashflow before the coronavirus crisis. With prices so low, it is now impossible for them to obtain the necessary capital.

The number of active wells has already fallen sharply in recent weeks (to 438 from 831 in early April 2019). US production is therefore expected to decline in the coming months.

Saudi Arabia has much lower cost prices but its problem is that it needs to balance its budget with oil at $70 per barrel. Prior to the coronavirus crisis, it was already running a budget deficit of more than 6% of its GDP. Falling oil prices could lead to social movements that would be dangerous to the authorities in power. Russia is in a more comfortable situation but its economy is also very dependent on oil.

What about OPEC +?

OPEC countries, Russia and allied producer countries ('OPEC +') agreed at the G20 summit to stop the price war and cut supply by 9.7 million barrels per day in May and June, and by 7.5 mbd thereafter. But in April the fall in demand outpaced supply by 20 mbd or even more. OPEC + efforts should therefore only have the effect when demand resumes with the lifting of lockdown measures.

Record contango

In normal circumstances, commodity futures contracts are 'backwardated', meaning that futures contracts become increasingly cheap as maturity dates become more distant. It is normal to pay more for a raw material that is rapidly available because there is no need to store it, so there is less risk, etc.

When there is a surplus, futures are in 'contango', and prices are increasingly expensive depending on the maturity. Now the oil contango is at an all-time high.

On Tuesday the Brent June 2020 contract was $20.2, December 2020 at $32.6 (61% dearer) and the June 2021 at $36.1 (+78%).

Why investing in oil ETFs is not a good idea

Exchange traded funds (ETFs) on oil invest in futures contracts. On a regular basis, the fund sells contracts that are about to mature and buys the following month's contracts. In a very strong contango situation, as at present, the renewal of contracts costs a great deal because the contracts purchased are systematically more expensive than the contracts sold. To be a winner with this type of instrument, oil prices need to rise very quickly or more strongly than contango.

Conclusion

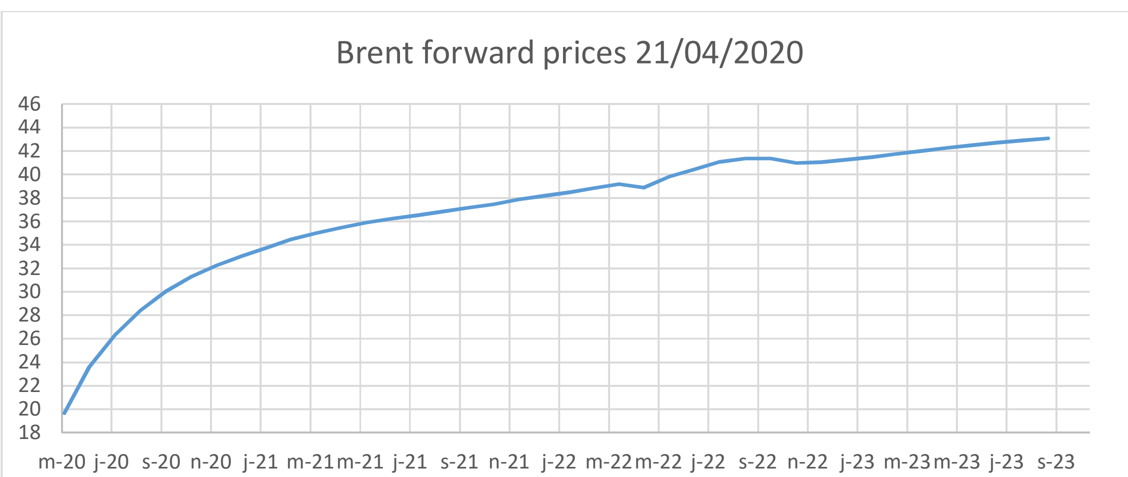
We do not expect a sustained recovery in prices until demand is unleashed through the lifting of lockdown measures and travel restrictions worldwide. The combination of a rebound in global demand as early as the summer and a fall in supply later this year should help the price of Brent recover towards $45-55/b in the second half of 2020.

The more prices fall in the short term (and the greater the damage suffered by the industry) the more prices will rise later this year.

The long-term outlook for oil is positive given the small number of investment decisions made during the period of tumbling prices in 2014-2017 and again this year. Without investment, the production of traditional oilfields declines by an average of 6-7% per year. As for the negative impact of the energy transition, it should only be felt from 2025.

Given the strong contango that flows into oil ETFs, the best way to capture the expected rise in oil prices is to invest in the shares of the oil 'majors' which have the additional advantage to keep paying big dividends.

Chart: Forward WTI price curve on April (source: Reuters)



What to expect from stock markets?

A consolidation of stock markets is taking place

Since the low of 23 March, stock markets have gained 25%, recouping half of the 34% loss since mid-February. It is a classic recovery. In terms of Fibonacci, we have a 50% retracement. This could have been as much as 61.8% but the news from the oil sector (among other) prevents it from doing so. The S&P500 index shed 3% yesterday, the Euro Stoxx, 3.5% and the Topix less than 1%.

An interesting novelty during yesterday's trading session was the pullback in the technology sector, with the Nasdaq closing down 3.5%. Until then the rebound in equity markets from the 23 March low had been characterised by a limited participation from sectors and securities, as well as a disappointing performance by small- and medium-sized companies; same story for "Value" stocks. Volumes had also tended to dwindle.

All these factors support the scenario of a retest of the lows. As a reminder, except once, bear markets have always retested their lows before recovering. Some observers believe that this time, thanks to an unprecedented mobilisation of the monetary authorities and elected authorities, a return to the previous low may not occur. We are open to this possibility by reminding ourselves that the four most dangerous words in finance are 'this time is different'.

There are too many unknowns to judge what form this period of digestion of the rise will take (When will we exit lock-down? At what rate will economic activity return to normal? How many companies will go bankrupt? What about consumer behaviour? etc.). The magnitude of the uncertainties is reflected in the current reporting season: numerous companies are suspending any guidance on future activity.

Take advantage of volatility to accumulate

Our base-case scenario integrates a willingness to capitalise on weaknesses in stock markets to accumulate new positions. This strategy aims to participate in the stock market rally that we expect to extend beyond the short-term phase of formation of a solid bottom. Stock markets should exceed current levels by year-end. However, it would be unreasonable to anticipate a return towards peak levels because sharp profit declines have left valuations stretched. A return to the 200-day moving average is the best we can expect, or an increase of no more than 13%. For more details on the oil sector and our sector preferences, please refer to the sector focus released on 21 April.

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