RBC Global Asset Management

INVESTOR **INSIGHTS**

# Behind the recent move in oil prices

April 21, 2020

Life in the era of COVID-19 has brought with it some staggering developments. On April 20, financial markets added to their list of unique narratives as the price of oil tumbled into negative territory for the first time in history. As the associated headlines have likely piqued your curiosity, we wanted to take a moment to review the basics with you today.

The decline in oil prices this year is largely a story of supply and demand. In order to understand how prices went negative, we must first review the fundamentals of how oil trades in the market.

### An overview of the commodities market

Commodities (such as oil) trade in standardized contracts known as futures. Originally, they were designed for farmers and businesses to obtain a level of price certainty by entering into a contract to exchange goods for cash at some future date. However, today's futures market is filled with traders that are solely looking to profit from short-term price fluctuations. This has created a disconnect between those trading in the market and those interested in purchasing the underlying commodity.

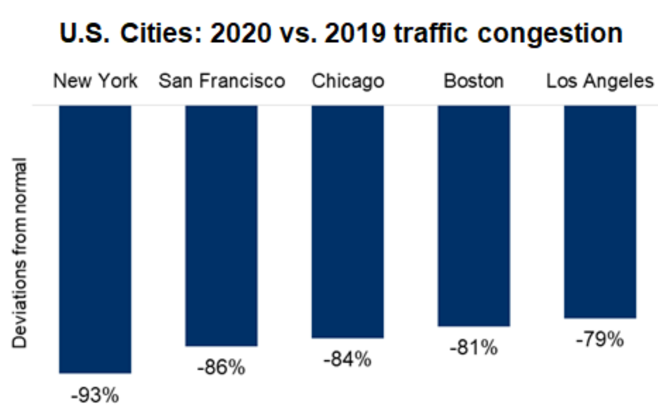
In addition, there are a few distinctive features regarding oil futures that merit highlighting:

- **Oil comes in many different grades.** In Canada, we are perhaps most familiar with Western Canadian Select (WCS) – the heavy oil extracted from the oil sands. Meanwhile, West Texas Intermediate (WTI) is crude from U.S. wells. It's considered light sweet oil and is the easiest to distill into products such as gasoline and jet fuel.
- **Contract expiry.** Occurs the month before the actual delivery of the underlying commodity. On any given day, multiple futures contracts trade simultaneously in the market, reflecting delivery of the various grades of oil for future months.

### An overview of the complexities facing the global oil market

Historically, the global balance of supply and demand is quite tight. However, oil prices have faced severe headwinds thus far in 2020, resulting from the global backdrop:

**Demand has fallen sharply.** As a direct result of COVID-19, the temporary reduction in demand for oil is historic. Demand for upwards of 30 million barrels per day has been removed from the market, representing about 30% of daily demand. Stats from major U.S. cities show vehicular traffic and flight departures down by 80% on average, which has directly impacted the need for oil in the form of gasoline and jet fuel.

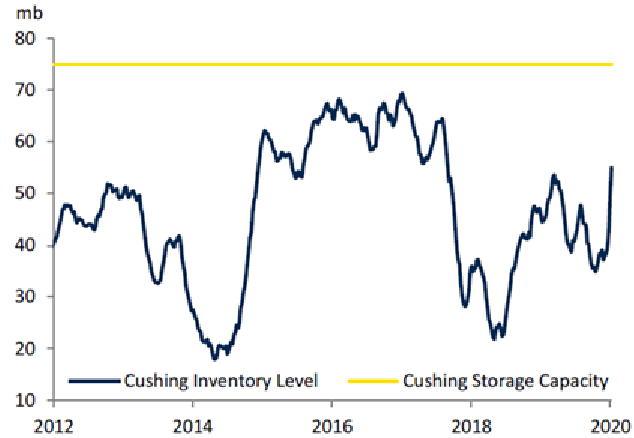



Source: RBC Capital Markets, TomTom. Data as of April 20, 2020

**Oversupply continues to pressure the market.** Recently announced production cuts from Saudi Arabia, Russia and OPEC+ will remove 9.7 million barrels a day from the market. However, the announced cuts don't go halfway towards addressing the gap left by reduced demand. As a result, the oil market is still in incredible imbalance.

**Further compounding the above are concerns over storage levels that are quickly approaching their limits.** Estimates of storage capacity in Cushing, Oklahoma – a vital storage base with many intersecting pipelines and access to refiners and suppliers – suggest there are just weeks of capacity left. The limited capacity increases pressure on drillers from Texas to North Dakota to shut off their wells in what is a remarkably complex and lengthy process. It's important to note, storage congestion is a North American story. On a global scale, we estimate some 1.5 billion barrels remain in onshore storage capacity.

**Storage levels are quickly approaching their limits**




Source: RBC Capital Markets, Bloomberg, Reuters, Refinitiv, EIA, CFTC. Data as of April 20, 2020

## What caused the price to go into negative territory?

The WTI contract for May delivery, the nearest oil futures contract (the spot rate) which expired April 21, was the only contract to turn negative. On April 20, the day before expiry, it detached from the prices of later month contracts, settling at negative $37.63 per barrel. In comparison, the June contract settled that same day at $20.43. This differential is the widest we've ever seen and indicated that someone willing to purchase a barrel of oil for physical delivery in May could get paid nearly $40 to take it off the market.

The severe disconnect was largely a function of limited storage capacity in the U.S. and a lack of demand. Traditionally, the only buyers of expiring futures contracts are entities that want to physically take delivery of the oil (e.g. refineries or airlines). However, as most of the global economy remains closed many of these buyers don't need crude at this point in time, meaning less demand for the expiring contracts. When met with concerns about storage capacity reaching its limits, the market reacted to these two forces by pushing the price of oil for physical delivery on May 1 into negative territory – suggesting a willingness to pay someone to take it off their hands if they have a place to put it. Longer-term contracts are still positive as they reflect time and the expectation that demand will resurface as economies are opened up and oversupply begins to right-size itself.

## Near-term outlook on oil

It remains tough to be positive on oil as the storage capacity fills. In the near term, we expect halts in production to ramp-up and it may take until 2021, or early 2022 until demand recovers to pre-crisis levels. And, once demand recovers, there will still be a large inventory overhang to deal with. In the absence of a creative solution, it will likely take a while for this to work through the market.

Across our portfolios at RBC Global Asset Management, our Portfolio Managers are working diligently to reconcile the long-term investment profile of their Energy investments with a volatile underlying commodity that's suffering from oversupply and a rapid and enormous hit to demand. The teams have focused their investments on companies with large asset bases, strong balance sheets, and the ability to withstand a prolonged period of weakness in commodity prices. While uncertainty may persist until there's clarity around how and when economies will reopen, and it may take considerable time for excess storage to be worked off, the market is forward-looking and will continually look for new information that could help stabilize prices.

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