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## Daily Note

# OIL - STORAGE WARS

Konstantinos Venetis

- **Yawning demand-supply imbalance keeps oil market under pressure**
- **'Storage squeeze' sends spot WTI to negative territory for first time**
- **US output to decline sharply as shale players face production shut-ins**

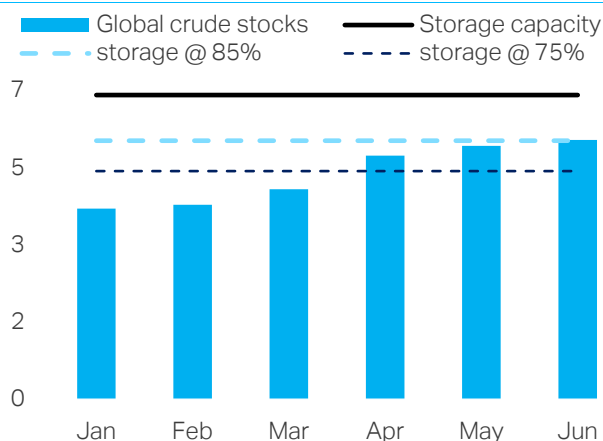
**The pressure is on.** The latest OPEC+ agreement ended the month-long price war triggered by what was, in the words of Saudi Arabia's oil minister, an "[unwelcome departure](#)" from Riyadh's preferred strategy of collective production cuts. Yet it would be premature to deem this deal as anything more than a damage-control exercise. The IEA is penciling in a record 9.3mbd annual drop in global oil demand in 2020, marked by a 23.1mbd decline in the second quarter – more than twice the combined size of the announced OPEC+ cuts (9.7mbd for May-June) and "natural" output reductions by other producers. The extent of the fundamental demand-supply imbalance should keep prices on the back foot for the foreseeable future, rubbing salt into oil producers' open wounds.

**Desperate times call for desperate measures.** It is telling that part of the coordinated response to the supply glut has involved encouraging IEA member-states to [increase their strategic reserves](#) with a view to taking some crude off the market. The financial pain from depressed prices is so acute that tackling the global inventory overhang – the original *raison d'être* of OPEC+ alliance – has taken a back seat to putting a floor under prices. But just as policymakers' response to the economic aftershocks from Covid-19 will not be enough to stave off a global recession, so oil supply reductions will not lead to higher prices unless demand starts to pick up. The message is that the OPEC+ deal is, in effect, simply buying time, dampening the inevitable increase in crude storage utilization rates.

**Capacity is scarce.** In its April [Oil Market Report](#), the IEA puts its high-level estimate for total global crude storage capacity at 6.7 billion barrels and assumes a maximum operational cap at around 75%-85% (there are various practical limitations pertaining to availability, quality, etc.). With the storage utilization rate already at 63% in January, the IEA expects global crude stockpiles to hit

## IEA warns oil storage could dry up by June

Crude stocks vs operational storage capacity\* (billion bbl)



Source: IEA, TS Lombard. \*IEA estimates (Oil Market Report, 4/2020)

## Super-contango redefined

 WTI crude: 1<sup>st</sup>/12<sup>th</sup> month contract price differential (US\$)


Source: Bloomberg, TS Lombard.

 Data up to April 20<sup>th</sup>

operational capacity constraints by mid-year. The wide contango in the futures market (i.e. spot prices lower than forwards) suggests we must be fairly close to, if not already in, that critical range.

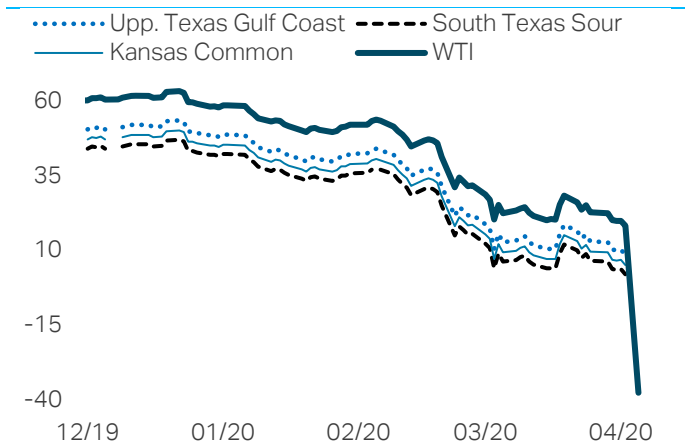
**US shale in focus.** Looking ahead, the evolution of storage capacity dictates the roadmap for supply that recent oil price moves have already started to discount. As the tanks fill up, rising storage costs coupled with falling crude prices will ultimately lead to involuntary production shut-ins. This is particularly relevant for operators in land-locked regions with limited access to international markets, which means most players in the US shale industry. At some point, these producers will have to weigh the cost of suspending output, which also results in reservoir damage that threatens future output revival, against paying to have the oil taken off their hands, which raises the possibility of negative prices.

**Storage squeeze.** Until now, negative oil prices had been seen only in obscure corners of the US physical market. Yesterday was the first time this happened with WTI crude, the main US benchmark. In extreme market action, the May 2020 contract settled at *negative* US\$37.63 on its penultimate day of trading as, to put it simply, there is too much oil with too little space to store it. WTI futures contracts settle in Cushing, Oklahoma, where stockpiles have already risen to more than three-quarters of working storage capacity, taking total US crude inventories back up to mid-2017 levels. With available storage in short supply, nobody wanted to hold a contract about to come due. Add a speculative/self-fulfilling element and this explains how we got these historic price moves. Meanwhile, demand for crude from refineries is drying up, exacerbating the supply glut. All this means that US shale producers are fast approaching the point where they will be forced to shut down operations. Exports are set to suffer in 2020, with the US on course to become a net oil importer again come Q3, according to the EIA. By then, we will probably have already started to see accelerated job losses in the energy sector.

**In the eye of the storm.** From a trading perspective, it feels like we are in the eye of the storm. Just as the market was preoccupied with OPEC spare production capacity in mid-2018, so it is now driven by concerns over US crude storage capacity. With demand expectations depressed and macro visibility restricted, it is hard even for contrarians to turn bullish on oil right now. That said, it is also hard to see prices staying so low (and the contango so wide) for long, even as further downside volatility cannot be ruled out. Near term, one or more of the following would need to happen for the market to find a firmer footing: 1) OPEC+ follows up on its pledge to “take further action if needed”; 2) non-OPEC+ producers announce large voluntary cuts; 3) production shut-ins from US shale kick in; 4) the transportation industry gradually comes back; and 5) there is a medical breakthrough on Covid-19. But by this time next year, do not be surprised if the market’s focus has shifted to upside oil price risks on the back of lower shale output, well productivity challenges, deficient capex and increasing M&A activity. The playbook might be different, but the cycle will still play out.

**Storage squeeze takes WTI crude negative**

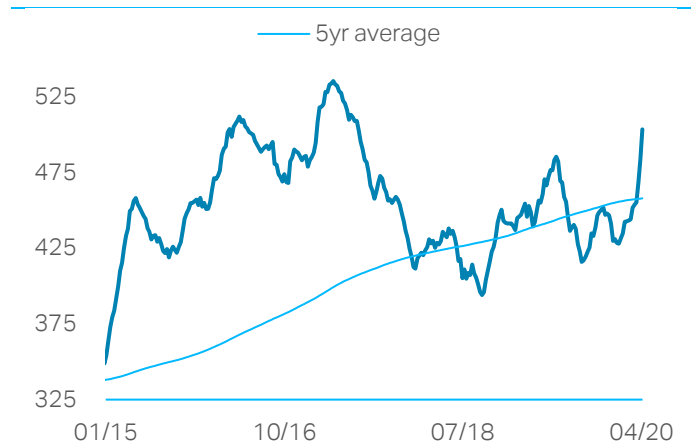
Physical US crude oil prices (\$/bbl)



Sources: Bloomberg, TS Lombard. Data up to April 20<sup>th</sup>

**US stockpiles back up to mid-2017 levels**

US crude oil inventories ex strategic reserve (mb)



Sources: DOE, Bloomberg, TS Lombard.