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Oil Prices: Looking Beyond the Headlines

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Snapshot

- Oil made the news with headlines about its price falling into negative territory.
- Despite anticipated near-term volatility, we expect this imbalance to work itself out.
- SEI continues to believe that commodities have an important role to play in strategic asset allocation.

The West Texas Intermediate (WTI) crude oil May futures contract settled below -$37 per barrel on April 20, the first time ever the oil benchmark had fallen negative. While this news may seem dire, the story is far more nuanced and complicated than the headlines suggest.

Perplexing Phenomenon

Oil markets have seen significant volatility since the start of the year, but this was an unprecedented event. Even so, it's important to understand the event in order to put it in perspective.

To sum it up, speculators and investors buy and sell oil futures contracts with the goal of increasing or reducing oil exposure in their portfolios. It's important to note that, unlike other futures contracts with cash settlement options, owners of the NYMEX WTI futures contract at expiration are obligated to take delivery of the physical oil, which can be difficult and costly to store.

Each contract is for 1,000 barrels of oil. Accordingly, most investors ultimately sell the position before the contract expires and, if exposure is still desired, buy a new contract in the next, or some future, expiration date.

It's also important to know that WTI is typically extracted from the Permian Basin in Texas and sent to Cushing Oklahoma via pipeline. Its price is set based on delivery and settlement in Cushing—this is the physical oil market. When Cushing ran out of storage space, the price collapsed. This does not mean the price collapsed everywhere or that gas stations will soon be paying drivers to put gas in their cars.

Bottom Line

On April 20, the May futures contract traded in positive territory for the most of the day, and it wasn't until the trading period neared the close that prices ultimately went negative. The negative price was primarily driven by panicked oil traders who were willing to pay to sell their contracts to avoid having to take physical oil delivery.

The decline (a price drop of more than 300% on April 20) only occurred on futures contracts for May delivery of WTI crude oil; contracts expiring in later months also declined although not to the same extent.

Historic Decline

WTI Futures Settlement Prices ($/bbl)	04/17	04/20	04/21
May Contract	18.27	**-37.63**	10.01
June Contract	25.03	20.43	11.57

Source: Bloomberg.

Given the COVID-19 pandemic-driven collapse in the demand for oil, producers have stockpiled excess oil supply in storage facilities and tankers (not just in Cushing), and this capacity of appropriate storage is nearly full. This combination of abundant supply, weak demand and storage scarcity sets the stage for violent movement in prices. In order words, all is not well in the oil patch.

Our Strategies

The commodity-driven strategies within the SIMT Multi-Asset Accumulation Fund, SIMT Multi-Asset Inflation Managed Fund and SIIT Multi-Asset Real Return Fund did not have exposure to the WTI May contract on April 20. Our managers are actively positioned along varying contract tenors further out on the WTI futures curve. This curve diversification has always been used and is something that differentiates our actively-managed exposures from an indexed approach.

Our View

We anticipate a continuation of volatility in these near-term oil contracts given the finite amount of storage available and weak oil demand. However, we also expect this supply/demand imbalance to work itself out in the months ahead as production is anticipated to continue to decrease in order to correct the imbalance and demand begins recovering as lockdown measures ease.

Long-Term Outlook

Leaving the shorter-term outlook aside, SEI continues to believe that commodities (and not just oil) have an important role to play in a strategic asset allocation. Commodities have historically demonstrated a low correlation to many other asset classes, providing additional portfolio diversification, and the potential to hedge somewhat against unexpected inflation and event risk.

Along with the overarching principles of diversification and having a realistic appreciation for the uncertainty of any outlook or forecast, we believe there is ample justification for maintaining commodity exposure as part of a long-term investment plan.

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