Quick Take: Crude oil – a price war amid the coronavirus crisis

March 18, 2020

Oil markets are experiencing an unprecedented combination of supply and demand shocks. As a result, crude oil implied volatilities have exploded, exceeding GFC highs.

Exogenous demand shocks

- On the demand side, COVID-19 and residual weakness from US-China trade disputes threaten to reduce crude demand YOY for the first time since the GFC (IEA base case -90 kb/d).

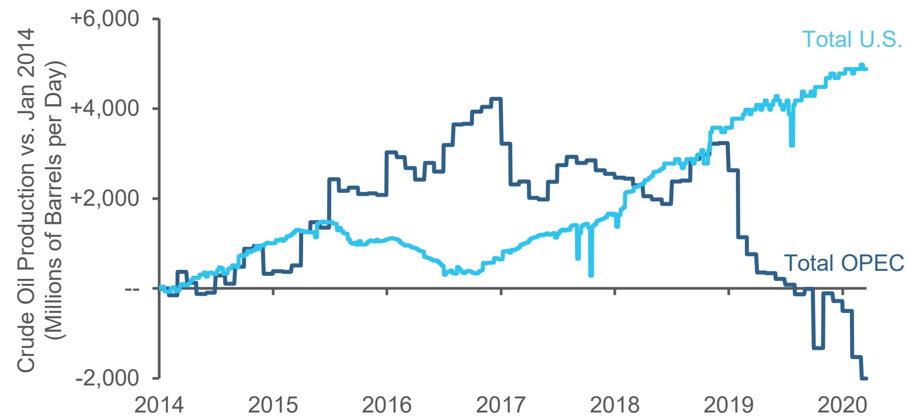
A supply shock with a purpose

- On the supply side, the Russia-Saudi price war threatens all progress that OPEC+ made in recent years to stabilize the market.
- The two countries share the common aim of regaining market share ceded to U.S. shale, whose steadily growing production had almost entirely offset OPEC+ supply cuts since 2016 (top chart).
- But the Russia-Saudi spat over the means to achieve the larger objective all but guarantees that an existing 2.1 mb/d OPEC+ cut will expire at March-end. Moreover, Saudi Arabia slashed its prices by $8/barrel to undercut its export competitors, most notably U.S. shale.

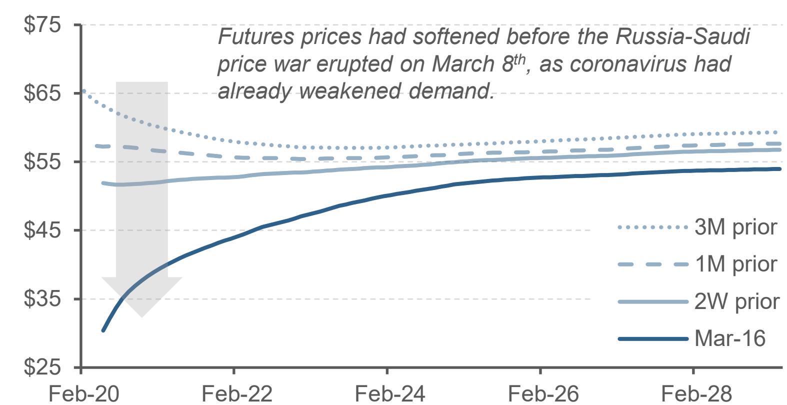
Not a bolt from the blue

- Prices had been softening for a while, well before the violent sell-off. Early in the year, the physical market progressed from a modest deficit to a surplus, following large-scale Chinese industrial shutdowns, and the crude futures curve had flattened (bottom chart). Physical and price-based signals identified these changing dynamics before the dramatic price action of recent weeks.
- Looking forward, the demand shock in oil continues to migrate westward amid signs that Chinese demand is picking up as it weakens in the West. On the supply side, the emergence of shale has fundamentally altered the dynamics of export markets, resulting in less predictability and increased price volatility.

OPEC's supply problem: U.S. shale has offset production cuts



Brent crude oil futures



Sources: for both charts Bloomberg, Acadian Asset Management LLC. For illustrative purposes only.

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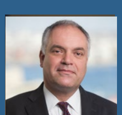

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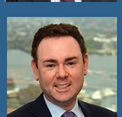

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