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First Negative Yields – Now Negative Oil Prices

Oil falls below zero for the first time

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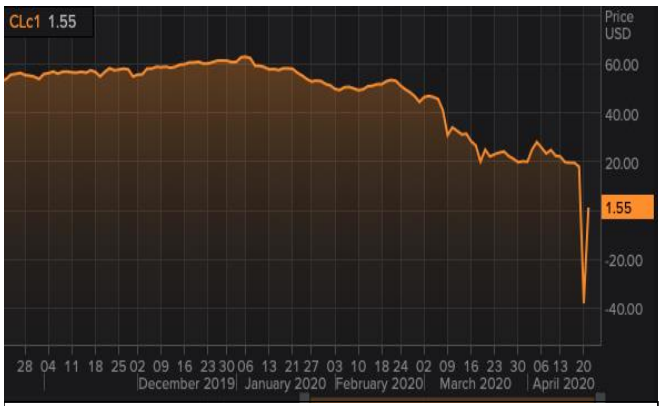
Oil took time to catch up with other asset classes in the recent sell off of assets, and it was caused mostly by the gloomy economic environment from the COVID-19 pandemic. On April 20th however, oil, to be precise West Texas Intermediate Oil Futures first contract, went into a nosedive that some may find hard to understand. How can you have a negative oil price? But when you look closely, it makes sense. We have seen negative interest rates in many countries for years, with some people even having been paid to take out loans and mortgages, but does this mean that when the price filters through we will be paid to buy and use oil and petrol?

Not in this instance. This is the result of a technical effect on prices brought about by the current economic situation effecting supply and demand, and futures price moves being pressurized into a wild panic move by the factors of time and supply. This extreme situation highlights the need to fully understand futures and derivatives. It is not enough to know a little about futures. You need to know and understand the mechanics of the futures market and the specifics of each contract, in particular, the difference in cash settled futures and deliverable futures.

This move was caused by the onset of expiry of the current first contract in the West Texas Future, on April 21st. Everyone involved has known for years when this contract would expire, and the key thing about this contract is it is deliverable. Some futures are cash settled (contracts for difference) and a compensating amount is paid or deducted from those holding a position when the futures contract expires. But, as with all deliverable futures contracts, if you have an open position at expiry, you must deliver or receive the underlying. In contracts like these, demand and supply can have a huge impact on prices running into the expiry.



5d West Texas Crude chart contract exp 21apr

In many cases of deliverable futures, the danger is in being short of the underlying (bonds, equities, etc.) at expiry because if you don't own the underlying, you have to buy the underlying, and that may be in

short supply at that time, whereas if you are long you just take delivery of the underlying and put it in your account. However, with oil and other commodities in these depressed price conditions where supply is abundant, the danger can be in being long at expiry of the contract.

Many factors can affect the price into expiry such as shipping costs, but in this instance the key price triggers were time and storage availability. Long traders of the contract held their stock hoping for a correction, but realised demand was unlikely to increase in the short-term as storage for black gold coming from the vast U.S. fields had filled to the brim. Usually, investors who want to continue to invest in oil would simply sell their soon-to-expire contract to buyers that want it right now, and then buy the next (June) contract, with a minimal price difference between the two. But with plummeting demand driven by the global economic malaise caused largely by the COVID19 driving economic shutdown, this time there was no demand to buy the first contract. There is little demand for oil, especially in the US, compounded by concerns of where you would store it when you take delivery. This also caused the spread between first and second contracts to reach historic levels.

The issue here was a technical one in deliverable futures compounded by overall market conditions. The unwillingness for traders to cut their positions at a loss in the first contract, at already extreme levels in spread to the second contract, led to eventual panic-forced selling as the contract came to expiry with storage seen as a problem. It is also interesting to note the influence of behavioural finance around the price movement at expiry in this situation, and that it should remain a key consideration in current times.

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