ANALYSIS

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Oil prices have collapsed – and some argue that they could even turn negative

With an excess of supply and a drastic cut in demand, the oil price has been hammered this year. John Stepek looks at what that means for oil producers, the economy, and your money.

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American shale oil producers face an uncertain future © Getty

The oil price has collapsed this year. It's all about coronavirus and price wars.

Oil on both sides of the Atlantic is now trading at levels not seen since 2002.

And yet some argue that oil could go even lower. Eventually, producers might be paying consumers to take it off their hands.

Oil is being hammered by both supply and demand issues

Oil is being battered at both ends. On the supply side, Saudi Arabia and Russia initiated an oil price war just as the coronavirus was turning into a global emergency. As a result, the market is being flooded with more oil than ever before.

The motivations of the parties involved are not necessarily clear, but one side effect is to make life very difficult for oil producers in the US. As the FT reports, US energy producers last week made "the biggest cut to the number of drilling rigs operating in five years", according to the latest Baker Hughes figures.

The US is currently the world's top oil producer, ahead of Saudi Arabia. But that might not last if the country is forced to slash production as low oil prices continue.

The other massive problem is on the demand side. Coronavirus means that people have virtually stopped flying. Budget airline EasyJet this morning announced that it has grounded its entire fleet and furloughed (the jargon word for temporary redundancy) most of its crew as a result.

People have stopped driving too. Apparently global petrol demand could halve in certain markets, according to analysts quoted in the FT.

(Also note that – while it has nothing to do with oil demand – electricity demand in the UK fell by about 10% last week, and a whopping 30% year-on-year, as the lockdown keeps most people at home. That saw wholesale prices fall too, which naturally might take a while to feed into your domestic electricity bill).

Overall, says the FT, analysts reckon that as much as a quarter of normal global consumption could be lost.

Another problem is that we are running out of storage space for the spare oil. Analysts suggest that at current storage capacity we have months or perhaps weeks before storage space is full. That leads to the idea that we could even at some point see a negative oil price – where people are literally paying others to take it off their hands. That seems nuts – that would be nuts – but the fact that this is even being floated as a possibility gives you some idea of how much oversupply we're currently looking at.

What does this all mean for investors?

What are the implications?

In a more normal world, prices would fall. Demand would rise as a result (when petrol prices fall in the US, for example, people drive more and buy bigger cars), and so prices would rise again as supply and demand balanced out.

That can't happen this time. Demand can't react because it is shut in, and supply isn't reacting because the dominant producers want to put the shale upstarts out of business.

So on the oversupply side, it looks to me that the shale industry will be the big casualty. With the market less keen to invest in risky debt it seems hard to believe that at least some of them won't go to the wall. As Francisco Blanch of Merrill Lynch tells the FT, "capital markets are now shut to the shale sector".

On top of that, investors were already becoming wary of the oil sector given the whole rush for ESG (environmental, social and governance) investing, and fears about stranded assets. The current rout will just make them even queasier. And while oil might be a strategic asset for the US, can the government really go in and bail out the whole sector? It seems unlikely. The US is open to topping up its strategic reserve but that can only suck up so much excess oil.

So I'd expect shale to give way first. The Russians are being described as the most capable of enduring a long, low oil price, while the Saudis need much higher prices to fund their public spending. But if they both think that they might get rid of the competition from the US, then they may both feel it's worth hanging on.

What about the demand side? In terms of what the problem is and what the solution is, it's very clear. Once lockdown measures end and as coronavirus recedes as a threat, oil demand will return. It may bounce back, or we may be a little more circumspect. Some may not travel as much (maybe we'll realise we don't need to be in the office every day) and some might change their habits on an ecological basis.

But I think these behavioural shifts will be relatively minor factors. The majority of people aren't lucky enough to be able to work from home on a permanent basis. And once this is all done I think people will want to go on holiday again. So I can see demand recovering to something approaching normal in the longer run.

OK. So on the supply side, Russia and Saudi Arabia may or may not keep pumping. The quicker US shale producers give up the ghost, the more likely they are to pull back production. On the demand side, meanwhile, it's all about coronavirus and the containment measures.

So what does all of that imply for investors?

If you're going to buy oil, I'd stick with the oil majors. They should have the firepower to survive this downturn, but don't be surprised to see dividend cuts. The oil price itself could go yet lower, although there does come a point where even Russia and Saudi Arabia might think twice (like, when oil prices genuinely look as though they might go negative).

In terms of a recovery – as with many other things at the moment, the key variable is the coronavirus. If it goes away quickly, demand will go up and prices should follow (because even if supply remains ample, the market will start to be less oversupplied, if nothing else). If we're sitting on minimal demand for months and months though, oil prices could be stuck here or even below for some time.

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