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Oil: The bottom fell out…again. Is there a silver lining?

Just when we thought we had seen everything in energy in 2020, the bottom fell out of the West Texas Intermediate (WTI) crude oil futures on Monday April 20th. The May contract closed at a price of -$37.60 (yes, you read that correctly), an astounding $55.90 below where it had opened the very same day, and most troubling, in negative territory for the first time in its history. While the dramatic price movement was really driven by technical factors around the contract roll, the June contract closed Monday at a more respectable $21.29, the price movement is symptomatic of the broken oil market. The combination of the demand shock caused by COVID-19 and the temporary supply shock caused by the Saudi-Russian price war has left the world awash of crude oil. Despite the recently announced OPEC+ production cuts, global storage is likely to be filled by early June, with U.S. storage potentially reaching tank tops by the end of April. With storage filled and demand still weak, physical prices will need to remain very low in order to force producers to shut in production.

While we doubt we will see futures prices at levels like we saw today, oil prices are likely to stay weak for at least the next few months. At that point, assuming the world starts to go back to some normalcy and the OPEC+ cuts hold, oil prices should go back to more sane levels. Nevertheless, there will still be a lot of storage to work off, and it is unlikely that the world will bounce back to previous worldwide global demand levels of roughly 100mm b/d.

Investors looking for a silver lining in all this might look in two places. First, depending on the length of the downturn and the well damage that may come from shutting in so much production, the world could actually find itself short of oil supply as we get into late 2021 and beyond. Second, and this point is more certain, the breakdown in the oil markets is proving to be a boon for U.S. natural gas. For years, natural gas prices have struggled, hurt by rising oil production and the big increases of associated gas that are a by-product of shale production. Associated gas from the big U.S. basins like Permian, Bakken and Eagle Ford makes up roughly one-third of U.S. production and was expected to continue to squeeze the dry gas producers in the Marcellus and Haynesville. Suddenly, with U.S. shale oil production looking like it could fall by 2-3mm b/d over the next year or so, the U.S. natural gas supply is looking tighter. The 12-month strip NYMEX Henry Hub gas price has jumped from $2.06/mmbtu at the end of February to close at $2.52/mmbtu on Monday, and for the first time in a long while, natural gas levered E&P and midstream stocks are dramatically outperforming their oil-levered counterparts. Volatility of this magnitude allows active managers to reposition portfolios to take advantage of these shifts, and from our vantage point, we do not see the silver lining of stronger natural gas prices going away any time soon.

Sources: Bloomberg Finance L.P.

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David Grumhaus, Jr. is Co-Chief Investment Officer for all Duff & Phelps Investment Management Co. investment strategies, including the Global Listed Infrastructure, Global Real Estate Securities and Portfolio Solutions strategies. Mr. Grumhaus is also a Senior Portfolio Manager for the firm's Master Limited Partnership and Energy Infrastructure strategies.

Mr. Grumhaus has over two decades of experience working in the investment management industry. Prior to joining Duff & Phelps in February 2014, Mr. Grumhaus served as a portfolio manager and director of research for Copia Capital, LLC. He previously worked as an investment banker for Goldman, Sachs & Co. and William Blair & Company, LLC.

Mr. Grumhaus holds a BA in History, cum laude, from Princeton University and an MBA from Harvard Graduate School of Business Administration, where he was a George F. Baker scholar. In addition, he was an Alderman and finance chair for City of Lake Forest, IL (2005 - 2011), and is currently the Treasurer of PADS Lake County, Board President of the Beyond Sports Foundation as well as a member of the Investment Committee and Board of Directors at the Ann and Robert H. Lurie Children's Hospital of Chicago.