Oil

Futures markets have much to say about oil's direction

On Wall Street

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For a brief, brave moment this year there was a sense the worst was over for the oil sector. This week, that feeling evaporated.

Iran's agreement to curtail its nuclear programme, potentially restoring its place as a leading crude exporter, was just the latest hunk of bearish news thrown at the oil market. Saudi Arabia and Iraq are pumping record volumes. US drillers have again added rigs to probe for oil in shale rocks. China's furious fuel demand growth is easing. For investors pondering exposure to oil through futures, shares or bonds, standing back seems the safest course.

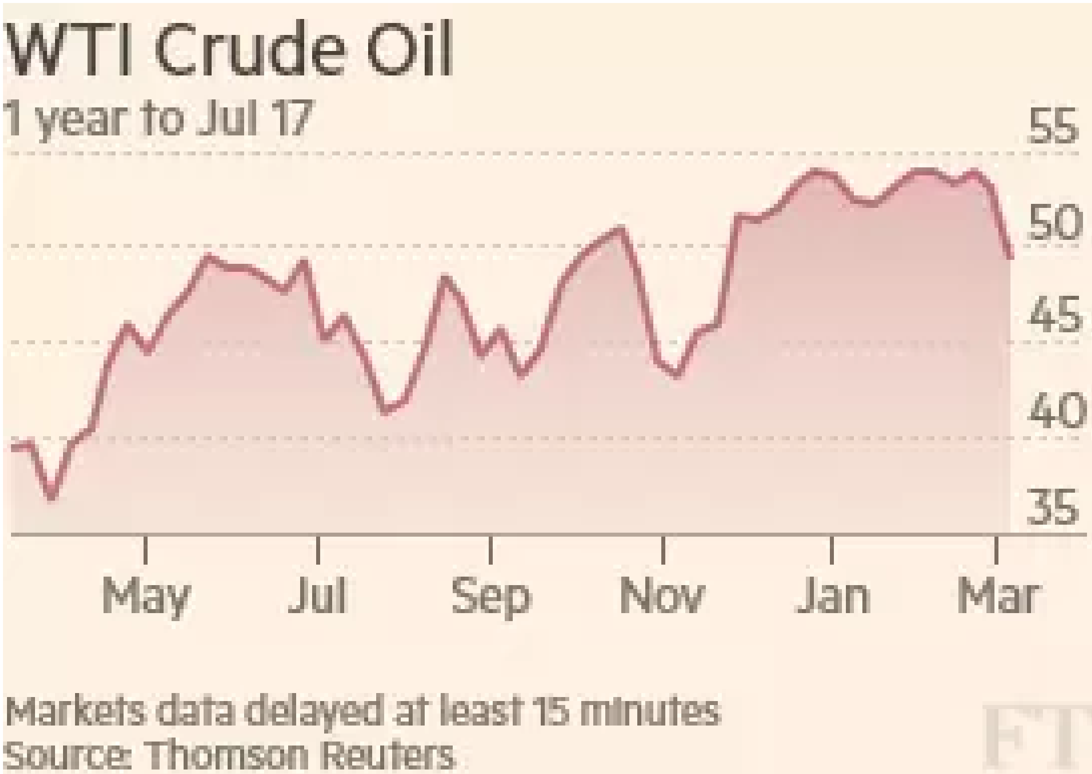
The $50 a barrel plunge in spot oil prices from a year ago has been breathtaking. But to grasp the industry's deepening woes, look at what futures markets are saying.

The price of West Texas Intermediate crude delivered in December 2016 has fallen below $60 a barrel, the lowest since any exchange listed that futures contract. Between the financial crisis and last year, the contract levitated between $80 and $100.

Of course, futures markets are not predictive. But the fall in this and other later-dated oil contracts suggests that an era of higher prices has ended. The number of outstanding contracts for December 2016 crude has increased even as its price has tumbled, indicating producers are holding their noses and selling barrels forward on the cheap.

Collapsing futures prices have stymied long-term investments in additional supply in countries from Canada to Brazil. Unless demand is hit by an electric vehicle revolution, a meaningful tax on carbon or another global recession, the resulting shortfall will force oil prices higher — eventually. For now, as the International Energy Agency said in its monthly oil report, "the bottom of the market may still be ahead".

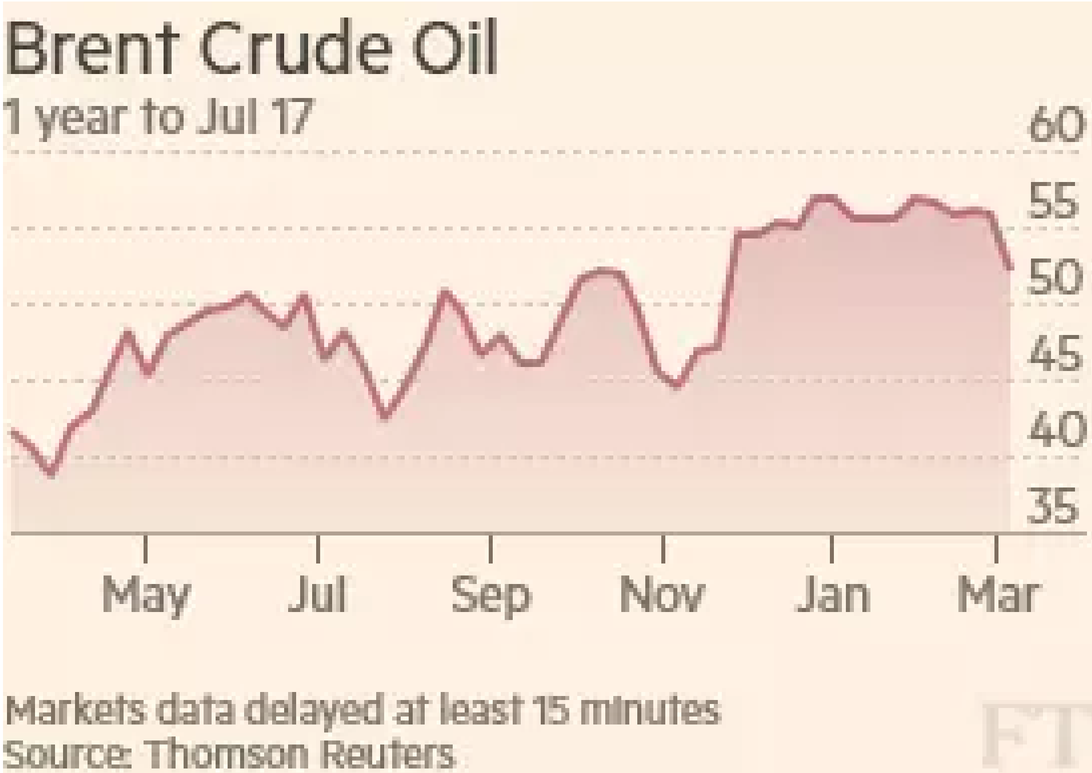
Investors searching for that bottom would do well to avoid buying commodity futures and similar instruments. The upward slope of the futures market erodes returns as investors must constantly replace expiring contracts with new ones that cost more per barrel. Dealers catering to large commodity futures investors are bearish, with Goldman Sachs forecasting the price of WTI to be $45 in October. Pimco, which manages about $20bn in commodity assets, says peace with Iran will put a cap on long-term oil prices.



As for securities, the choices are not much easier. Oil and gas exploration and development companies issued $21.8bn in equity and $55.7bn in bonds in the first half of 2015, according to Dealogic, to investors eagerly betting on a rebound. For a few heady days in April, energy stocks were beating the broad S&P 500 index.

That optimism has soured.

"As recently as a month ago the building consensus was for a V-shaped recovery for oil prices," Bill Herbert, co-head of securities at Simmons & Co, the energy investment bank, told me. "Now the script has been completely rewritten. We're in this purgatory again of oil prices flatter for longer."



Such gloom arguably presents an opportunity, but for many energy stocks it still comes down to the oil market. Moves in the S&P oil and gas exploration and production (E&P) index, which includes upstream companies such as ConocoPhillips, EOG Resources and Anadarko Petroleum, have a 90 per cent annual correlation with oil prices. Paul Sankey of Wolfe Research calls E&Ps a "hope trade".

Integrated energy companies such as ExxonMobil and Chevron are more appealing given generally stronger balance sheets, higher dividend yields and hedges against low crude prices in the form of refinery assets. But as Mr Sankey writes, their share prices as a multiple of earnings are "extremely stretched" — ie, not cheap.

Pure refiners seem attractive, especially companies such as Valero and Tesoro able to mop up the US crude surfeit. But at some point they risk turning the glut of crude into a glut of refined fuel. US refiners also live in fear of Washington lifting its ban on crude exports, erasing their cost advantage in the world market.

In fixed income securities, Scott Minerd of Guggenheim Partners made a case this week for energy junk bonds, which offer 8.8 per cent yields on the secondary market and are priced well below par.

"The key will be to distinguish between good and bad credits," Mr Minerd wrote in a note. To his point, Sabine Oil & Gas, a Houston-based E&P, filed for bankruptcy the day he published it.

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