MARKET INSIGHTS

On the Minds of Investors

April 2020

The Great Glut: A historic supply and demand shock in the oil market

Rising production and collapsing demand due to the COVID-19 pandemic is causing an unprecedented glut in the oil market. As a result, we are currently witnessing a pronounced supply and demand shock that has sent oil prices to a multi-year low.

At the current pace of production, global oil storage capacity will be filled by the end of the second quarter. This situation is already causing price pressures at oil wells, where oil producers are finding it increasingly difficult to sell their inventories. As a consequence, energy stocks have been the worst performing year-to-date in global equity markets, while credit spreads of sub-investment grade energy companies have widened dramatically, signaling increasing concerns about the solvency of the sector.

The major oil producing countries have now agreed to cut production to try to avert the crisis. But will their action be enough to balance the oil market? And what are the implications for investors?

An unprecedented drop in oil demand

The COVID-19 pandemic has led to the implementation of rigorous measures globally to contain the spread of the virus. Travel restrictions, social distancing and stay-at-home orders have reduced global oil demand by an estimated 5.6 million barrels per day (mb/d) in the first quarter of 2020 relative to the first quarter of 2019. This situation is expected to worsen in the second quarter.

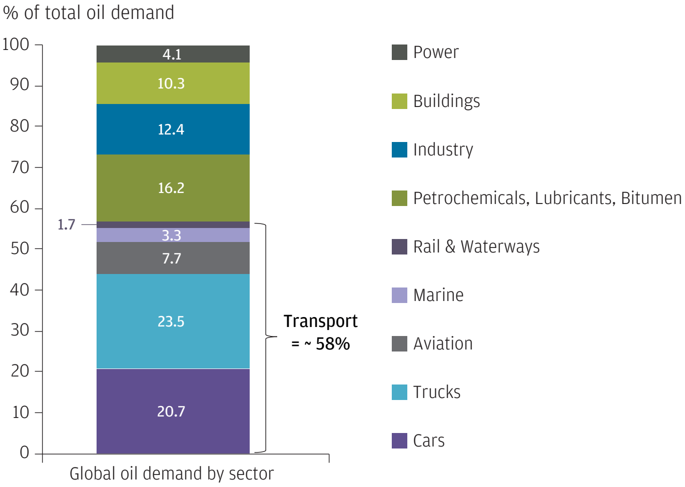
Peak oil demand destruction is expected in April and May, with an average decrease of 20mb/d. Even in a scenario where global COVID-19 containment policies are gradually lifted by the end of May, the US Energy Information Agency (EIA) is estimating a loss of oil demand in 2020 between 5.2mb/d to 9.3mb/d. To put this number into perspective, in 2009 – the year of the last global recession – oil demand decreased by 0.8mb/d.

Exhibit 1 shows that almost 58% of global oil demand is derived from fuel for transportation. The impact on demand, and thus the oil market, is significantly worse than in normal recessions because of the widespread implementation of travel restrictions, which has reduced global air traffic by 30%. Quarantine measures have also caused a significant drop in road traffic, by roughly 40%, leading to a large drop in demand for petrol and diesel.

AUTHOR

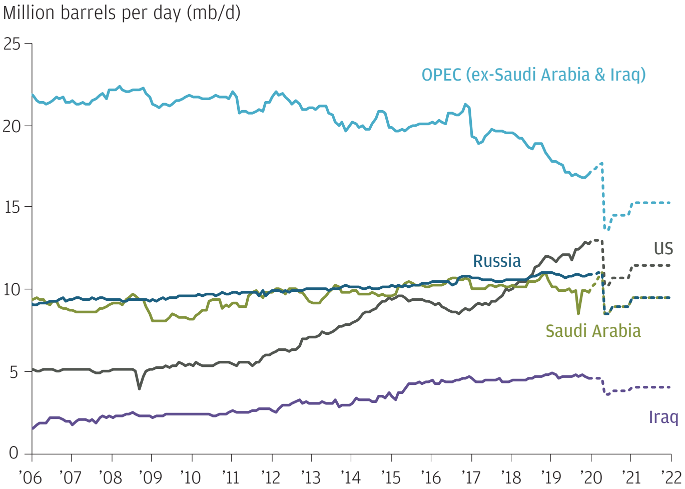
Tilmann Galler
Global Market Strategist

EXHIBIT 1: GLOBAL OIL CONSUMPTION BY SECTOR



Source: British Petroleum, J.P. Morgan Asset Management. Data shows an estimate of global oil consumption by sector for 2020 from the BP Energy Outlook 2019. Data as of 31 March 2020.

EXHIBIT 2: CRUDE OIL PRODUCTION BY COUNTRY



Source: EIA, Refinitiv Datastream, J.P. Morgan Asset Management. 2020 and 2021 data using dotted lines are J.P. Morgan Asset Management estimates based on announced cuts. Data as of 15 April 2020.

Record deal to cut production

The imbalance in oil markets was exacerbated in early March, when Russia and Saudi Arabia couldn't agree on production cuts. In fact, quite the opposite took place as Saudi Arabia, in retaliation, started a price war by giving rebates on their crude oil exports and announced an increase in production starting in April. However, the steep fall in oil demand and rapidly rising inventories have now convinced the world's top producers to reverse course.

On Easter Sunday, the members of the Organization of the Petroleum Exporting Countries (OPEC) and the main non-OPEC oil producing countries (known as OPEC+) agreed to a historic cut in production to contain the oil glut. Oil production will be cut by 9.7mb/d beginning on 1 May. After that, the group will taper the cuts in July by 2.1mb/d and in January 2021 by another 2.0mb/d. The remaining 5.6mb/d cut will be in place until the agreement expires in April 2022. To put the cuts into perspective, **Exhibit 2** shows the main oil producers and their level of current production.

Despite the historic size of the announcement, the agreed production cuts do not appear to be steep enough to balance the large drop in demand for oil that is expected over the next couple of months. However, achieving an immediate balance in the oil market was never a realistic outcome since it would have relieved the higher cost non-OPEC producers from sharing the burden of production cuts. Oil inventories will therefore continue to rise in the short term, likely putting further pressure on oil prices over the next couple of months.

However, if producers stay compliant to the agreement, and if the major global economies have begun to lift their COVID-19 shutdown measures by the beginning of June, then fuel and oil demand should start to slowly normalise and oil market fundamentals could improve in the second half of the year. In this constructive scenario the oil market could be in balance again by September 2020.

What does this mean for investors?

Equity and credit investors in energy can expect a couple more difficult months ahead, with fundamental headwinds and challenging newsflow. Corporate earnings will likely have further to fall and preserving liquidity will remain a main task for the time being.

However, it is often in challenging times like these when the foundations of the next upswing are laid. The weak players are dropping out and exploration companies are significantly reducing their capital expenditure. Today's cancelled projects will be missed in three years' time. So, companies that survive the "Great Glut" may be able to look forward to a more balanced oil market in the next five years than they have experienced in the previous five.

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