

# Amadeus Strategy Comment

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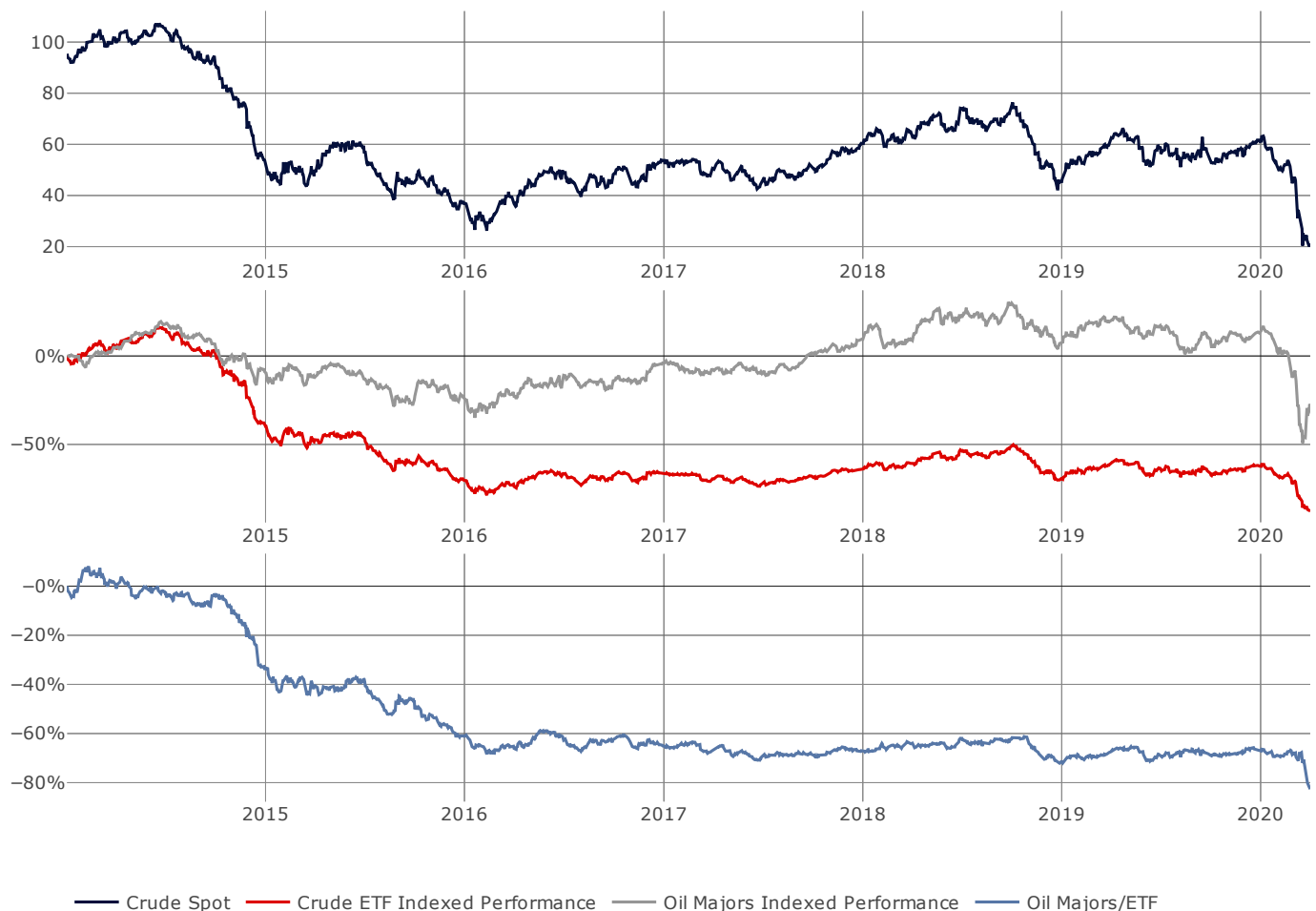
## Why direct investments in crude are an unwise way to play a rebound in oil

In the wake of the Corona crisis, plunging demand quickly sent oil prices to their lowest level since 2003. The disagreement between Russia and OPEC-members further contributed to the crash by adding a veritable supply shock to the initial demand shock. As storage capacity is becoming scarce the price of physical oil has even reached negative territory in some markets. Futures prices followed through with Dec 21 Brent now trading below \$40. Obviously this raises the question how sustainable current price levels are and investors might be tempted to try fishing for the bottom. As weaker players leave the industry while OPEC will eventually pull its leverage to stabilize prices, we believe that oil will in the medium-term bounce back. In the short term however, the lack of an agreement between Russia and the OPEC has changed the dynamics of the market. Furthermore, a serious global recession may lead to subdued demand for years. We therefore believe that getting the timing right in this market is a challenge, investors should not underestimate. This raises the question of how oil bulls should play a recovery.

Some investors might be tempted to take a direct investment through long futures or one of the crude ETFs that have been launched over the past decade. However we consider this a highly dangerous game and prefer exposure to equity as a way to play the rebound. Direct investments in oil suffer from high cost of carry and are therefore a sure way to burn money in the medium-term. This is especially true now with the curve being in strong Contango. Even returns from sharp upwards moves can be eaten up completely by this. On the other hand, large, stable oil majors such as Royal Dutch Shell generate Free Cashflow, thereby providing investors with positive carry while they wait for a normalization of prices. Their diversified business model including up- and downstream exposure makes them relatively resilient even to persistent price shocks - earnings of Royal Dutch for instance stayed positive even during 2015 and 2016. While this situation is partly different as the lockdown is also hitting the downstream business stronger than previous shocks, we believe that the internal diversification will still work to a certain degree. Due to hedging, oil majors tend to feel slumps in crude with some delay. It is therefore likely that the upstream business will only feel the hit once downstream is already recovering.

The chart below compares the performance of a basket of seven oil majors (EXXON, CHEVRO, BP, ROYAL DUTCH, TOTAL, ENI, EQUINOR) with the returns of one of the leading crude ETFs. Interestingly, even during the strong upswing post the 2014/2015 crash, the basket performed in-line with the ETF. In the medium to long-term it outperforms the direct investment massively.

Crude ETF and Stock Basket



The futures curve below illustrates well why a direct investment in crude burns money in the long-term and almost certainly underperforms a basket of major oil producers. During large price crashes, spot prices are generally way more volatile than futures prices resulting in a heavily upwards sloping futures curve (Contango). Aside from reflecting trader's expectations, this results from the high cost of storing oil during a period of massive oversupply. Since the Great Financial Crisis the curve has not been as steep as now, implying that spot prices need to increase significantly in the short-term for long positions to break-even.

Regardless of where prices eventually end up, hoarding physical oil is not a dominant strategy.

### Crude Curve and Cost of Carry

