With the oil futures curve downward sloping and higher prices likely ahead, CIO continues to advise risk-taking investors to add long positions in longer-dated Brent oil contracts. (ddp)

Crude oil: Looking for a tightening market

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When we analyze the oil market, we rely heavily on inventory data to assess market balances. The reason is that the data is released for several locations on a consistent weekly basis. Relying on oil production and demand data instead can be more inaccurate, at least in the short term.

While oil production can be easily tracked in some countries, particularly in oil exporters with low domestic consumption where one can count the oil tankers, other countries like the US only release final production data with a delay. Calculating oil demand is even more cumbersome. Incomplete and inaccurate data from emerging markets, which account for almost 55% of total demand, and the lack of detailed consumption specifics—e.g., whether end users store barrels in tanks to be used for later or immediately consumed—can result in errors. Another challenge comes from historical revisions, where demand is eventually revised years later.

Inventories as “real-time“ indicators

Data on oil inventories is not perfect either, given some emerging markets don't disclose oil inventories. However, on-land inventory data from the developed world, OECD countries, the industry or government controlled sources are very accurate. Further, thanks to satellites, it's possible to track whether oil is being moved or stored on ships (floating storage) or in above ground tanks thanks to floating roof tanks (not possible for underground caverns). Although we can accurately measure only a small portion of all oil inventories around the world, we can make assumptions about the overall market based on visible oil inventories.

One way to think about it is like a bathtub—if the water (oil inventory) level rises, the market is oversupplied, and vice versa if it’s undersupplied. If the visible part is rising or falling, it's very likely the rest of the bathtub (e.g. commercial oil inventories in emerging markets) is too. This is because a shortage or excess in one location triggers an adjustment of the relative prices at that location, which either attracts oil from the rest of the world to that site or sends it elsewhere. The

one exception is if emerging countries like China build up strategic oil reserves, which would send the wrong message; inventories rise not because of an oversupplied market, but due to a government decision.

Oil in transit at high levels

International oil sanctions on Russia have distorted one part of the equation above—oil in transit, which has risen strongly over the last 12 months. In our view, this buildup has been driven by G7 nations with the EU and Australia having stopped importing oil via tankers from Russia. Hence, Russia is diverting larger quantities of its crude to non-EU countries, while Europe is importing its crude from farther locations like North America, South America, Africa, or the Middle East; longer routes mean the shipped oil spends more time on a tanker. We regard this upshift as a structural one, similar to laying out new pipelines that need to be filled.

On-land inventories have been falling

More interesting is the fall in inventories following the strong rise at the start of the year, which was likely driven by the dip in January demand due to mild weather and recovering production from weather disruptions in December. February data suggested a strong increase in demand, resulting in a modestly undersupplied market that month. More recent data shows renewed large on-land inventory drops of more than 30 million barrels over the last three weeks across the US, Europe, Singapore, Japan and Fujairah, suggesting that the market remained undersupplied in March as well. Moreover, exports from Northern Iraq of almost 500,000bpd have been halted since late March and pumping has not yet resumed. While flows may resume in the short term, the interruption and the upcoming voluntary production cuts by nine oil producers should help tighten the oil market further. As a result, we continue to expect oil prices to recover toward USD 100/bbl over the coming quarters.

Different ways to gain exposure

Given our positive price outlook, we reiterate our investment recommendations. With the oil futures curve downward sloping (in backwardation) and higher prices likely ahead, we continue to advise risk-taking investors to add long positions in longer-dated Brent oil contracts. Alternatively, investors can make use of lower spot prices and high option implied volatility by selling Brent's downside price risks over the next six months. Another way to gain exposure is through Brent crude first generation indexes. Such strategies should benefit from solid roll returns on top of the expected spot appreciation, in our view. But considering oil's 30–40% volatility, this strategy does require investors to hold an elevated risk appetite. Our preference remains to gain exposure to oil via Brent and not WTI. With elevated political uncertainty, the US administration could, for example, ban exports of refined products (and eventually crude). While there is a low probability of this event, such a decision could heavily weigh on US prices.

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