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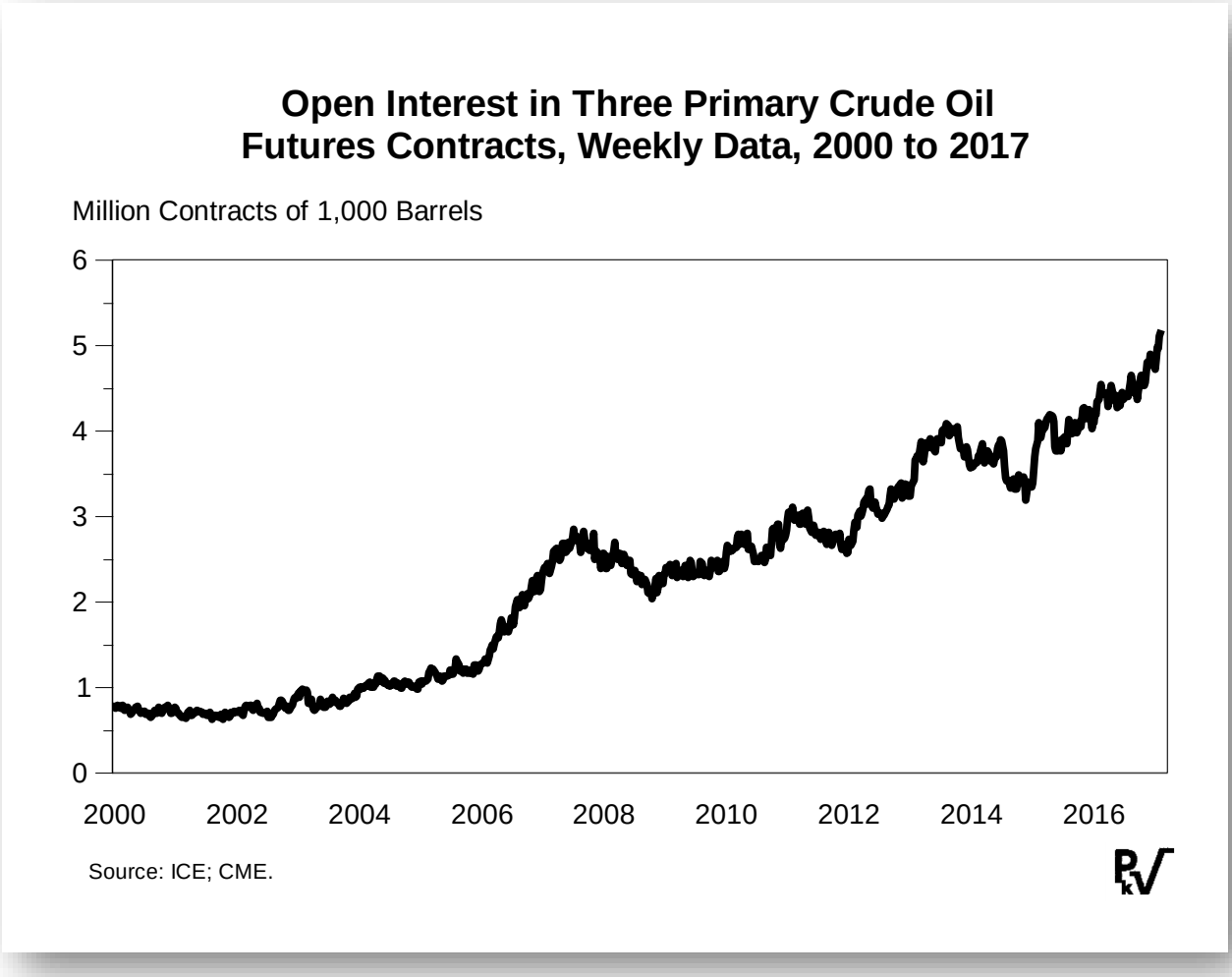
Markets Take Over



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Summary

The title of the January 2017 *Petroleum Economics Monthly*, "Markets Take Over," captures our theme for this report. As an illustration, the cover figure tracks the rise in open interest in the three key futures contracts from 2000. More than six million contracts are now outstanding if one includes options-equivalent positions. Open interest covers more than eighty days of global consumption. Markets have facilitated the accumulation of more than one billion barrels of opportunistic stocks.

Most who follow oil ignore these facts. Indeed, analysts and writers at most publications see the futures market as a sideshow, as do a great many consultants and investment bankers. Admittedly, some sophisticated individuals likely understand the implications of futures markets for oil but have chosen not to discuss them. A few people at one or two major investment banks are likely trading on their knowledge. Yet their institutions publish traditional oil market analyses like nothing has changed, quite probably because they are profiting from their market savvy.

Oil's new world can be summarized in a modified version of a phrase Bill Clinton made famous in 1972: "It's the economy, stupid." We say, "It is the market, stupid." The futures market now dominates the world oil market. Over the last two years, more than one billion barrels in opportunistic inventories have been accumulated. The traders, refiners, and market participants acquiring them have hedged. Global stocks have increased by 1.098 billion barrels. The hedged positions of those owning stocks have risen 1.084 billion barrels. There is a 0.13 percent difference in the two numbers.

Is this an accident? Certainly not. The market is working. Passive investors and speculators have bought futures, expecting prices to increase. They were encouraged by statements by the International Energy Agency's executive director, who warned of shortages in the absence of investment. Their purchases were also encouraged by OPEC ministers promoting a production cut. Today, speculators and others are long more than one billion barrels.

The speculative buying has prompted stock building and hedging. Our analysis shows that prices would have fallen below $20 per barrel had they not done so. What's more, by promoting hedging, the speculators have helped stabilize prices in the mid-50s.

Oil-exporting countries still hope that their output cuts will force sales from inventories. They may get their wish. Part of the excess stocks will be sold. Whether these transactions will boost or depress prices is an open question, though, because it is the volume of unhedged crude relative to consumption that now determines price. Prices will fall if unhedged stocks rise and increase if the unhedged inventories decrease.

Ironically, in this new environment, contango is the friend of those seeking higher prices, not the enemy. Contango promotes storage and leads to smaller unhedged inventories and higher prices. Backwardation, in contrast, leads to stock liquidations, larger unhedged inventories, and lower prices.

Again, few market observers and participants recognize that today "it's the market…." Futures and swaps are carnival attractions that have little impact. The consequence of this ignorance will likely be chaos. Sadly, only time will turn this around.