A futile attempt

Oil Market Outlook

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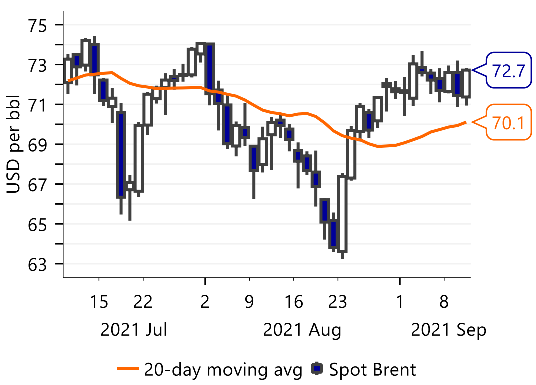
Summary

- China, the world's biggest oil importer, attempted to pressure oil prices lower this week by announcing a release of crude oil from its Strategic Petroleum Reserve (SPR)
- The move signalled political vulnerability to rising commodity price inflation, but even more so, it is not enough physical supply to move the dial
- The powerful herd of systematic funds have begun rebuilding "long" oil futures positions after deleveraging in August, as is evident in the latest market positioning and open interest data

A not so strategic release

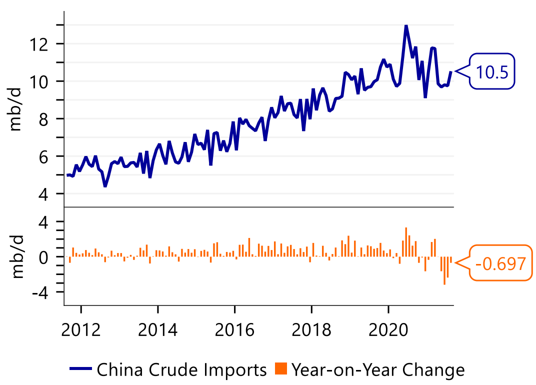
Oil prices were choppy this week, but as of this writing, have so far failed to break out of last week's trading range. Further to that end, the oil market was strong in the early part of the week, but came under selling pressure on Thursday as news of China releasing oil from its strategic reserve (SPR) hit the wires. Ironically, the move comes on the heels of President Biden indicating he was also considering releasing crude oil from the US strategic reserve in the wake of Hurricane Ida in addition to pleading with OPEC+ to pump more oil in the weeks before the storm. In the end, a US release made no sense as a significant portion of refining capacity was also knocked offline along with crude production. Nonetheless, the move by China, the world's biggest crude oil and commodity importer, was no doubt designed to ease upward price pressures on rising oil import costs, however, it is unlikely to have the desired effect, as we see it. For starters, it signals political vulnerability to commodity inflation just as Biden's earlier plea to OPEC+ did, and even more so, it is not enough physical supply to move the dial and only partially offsets the drop in US production since the storm hit. Initial reports are suggesting that about 22mb will be released which is roughly two days' worth of oil imports for China or just a couple hours' worth of daily global demand. On top of that, the release reduces the amount of oil available for a true supply-side emergency and, as such, will have to be refilled in the not too distant future and potentially at higher prices. Finally, large systematic traders have begun rebuilding "long" oil positions as can be seen in the latest market positioning and open interest data and these funds only react to quantitative signals for the most part, so the SPR release is unlikely to slow their buying programs.

Figure 1: Oil prices have been choppy recently, but momentum is back in the bulls camp...



Source: Bloomberg, Rabobank

Figure 2: Chinese crude oil imports rebounded above 10mb/d in August...

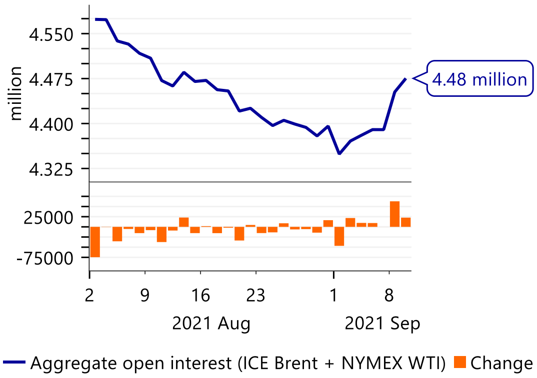


Source: Bloomberg, Rabobank

The herd is on the move

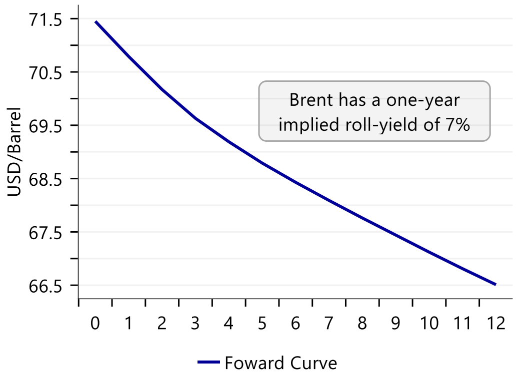
As we just noted, the powerful herd of systematic funds have begun rebuilding "long" oil futures positions in recent data after significantly deleveraging in August. In fact, large money managers have a lot of dry powder at hand, as we see it, and are looking rather underinvested in oil futures given the strong "backwardation" along the forward curves and bullish long-term trend and momentum signals, not to mention the widespread inflation risks to stock and bond portfolios at play. As such, we fully expect to see a sharp uptick in the managed money net position across petroleum contracts into year end, which if we are correct, should continue to drive oil prices higher thereby squeezing large commodity consumers and keeping upward pressure on inflation metrics. As we highlighted in our last oil note, the implied one-year roll-yield for the two benchmark crude oil contracts currently stands at about 7%, which compares to just a 1.3% yield for the 10-year US Treasury note. While not apples to apples, fund managers seeking out yield opportunities in this low rate environment should surely be increasing "long" oil futures positions in the current setting. This is especially true as oil curve structure tends to be somewhat persistent while tight fundamental balances and global crude stock draws are likely to continue to support the curve structure in the coming months. Importantly, the roll-down effect of "backwardation" also amplifies and supports the already strong longer-term bullish trend and momentum signals, as each monthly roll reduces the cost basis of the position further. As such, the combination of bullish roll-yield and long term trend and momentum is hard to overstate when it comes to commodity futures markets returns. If that were not enough, institutional commodity index allocations remain historically low despite the big ramp up in exposure in the first half of the year. As such, we expect to see another commodity index buying spree occur in the not too distant future, as global portfolio managers seek out the well-known inflation hedging benefits that commodities and oil futures have historically provided. In fact, on Wednesday we saw the largest one-day increase to aggregate open interest (+63mb) for ICE Brent and Nymex WTI futures since April in a strong sign that speculators are ramping up crude oil exposure again.

Figure 3: Open interest is increasing in recent data as speculators rebuild "long" positions



Source: Bloomberg, Rabobank

Figure 4: The implied roll-yield for oil looks very attractive in the current low rate environment…



Source: Bloomberg, Rabobank

Looking Forward

Looking forward, we see China's recent attempt at pressuring oil prices lower as futile and likely to be overwhelmed by financial futures flows given the bullish quantitative market signals and global inflation risks at play. Furthermore, the recent increases in aggregate futures open interest data is encouraging and signals to us that the herd movement of systematic funds is already underway, That being said, we see scope for significantly more speculative buying to occur in the months ahead given the current underinvestment in oil futures, especially in light of all the money that has been pumped into financial markets over the past 18 months. As such, we see more upside risks to oil prices than downside, particularly in the deferred contracts as inflation takes hold.

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