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A Holiday Rout

Oil Market Outlook

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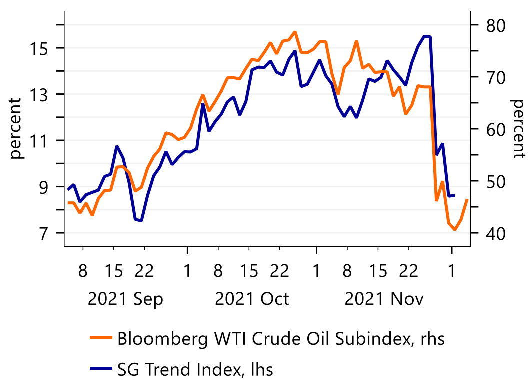
Summary

- Oil prices collapsed last Friday amid low liquidity and volatility-driven fund liquidation
- OPEC+ surprised the market by following through on their plan to increase production by 400kb/d in January, potentially leading to a modestly oversupplied oil market early next year
- Commodity indices are on pace to post the largest annual gains since the early 2000s

Volatility-driven liquidation

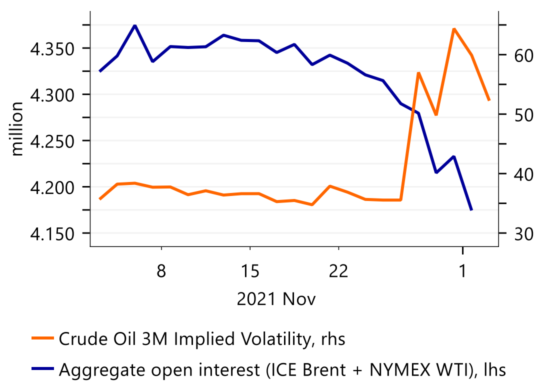
Oil markets ended November with a bang as prices fell close to 15% in the final days of the month. In fact, just last Friday, oil prices tumbled more than $10 per barrel in one trading session, causing a massive spike in implied volatility. For reference, the three month at-the-money implied volatility for crude oil options was trading in the low to mid 30s in early November before spiking to more than 60 in the wake of Friday's selloff. In dollars per barrel terms, average trading ranges have doubled, spiking up to more than $4 per barrel after averaging just over $2 per barrel in recent months. As for the drivers behind last Friday's oil rout, the market was extremely vulnerable leading up to the event as news of a coordinated SPR release, a new highly contagious virus strain, and a much stronger US dollar, all came face to face with poor liquidity due to the US Thanksgiving holiday. Unsurprisingly, the selloff resulted in deep losses for trend followers who were forced to deleverage into thin markets. This dynamic is part of the new norm for oil markets, and volatility-driven liquidation events have become a common occurrence thanks to the rise of risk-parity type strategies and other volatility-targeted funds. As can happen, this recent spike in volatility snowballed into a significant liquidation event, as trading algorithms mechanically sold oil futures to reduce position sizes in response to the increased market risk (volatility). This idea of systematic liquidation has also been supported by the drop in aggregate open interest for the two benchmark crude oil contracts in the days following the event. In addition to the fallout from the holiday rout, the oil market got more bearish news on Thursday when OPEC+ decided to follow through on their plan to increase production by 400kb/d in January, potentially leading to a modestly oversupplied oil market next year. Nonetheless, the oil market rallied following the bearish announcement which could be an important signal that oil prices are putting in a bottom.

Figure 1: Trend followers suffered big losses last Friday as oil prices fell in a classic holiday rout....



Source: Bloomberg, Rabobank

Figure 2: The volatility spike triggered fund liquidation as can be seen in open interest data...

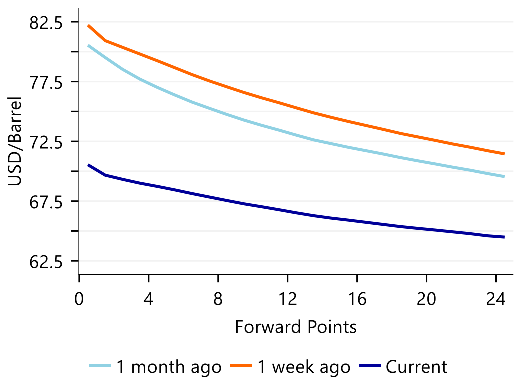


Source: Bloomberg, Rabobank

The coming year

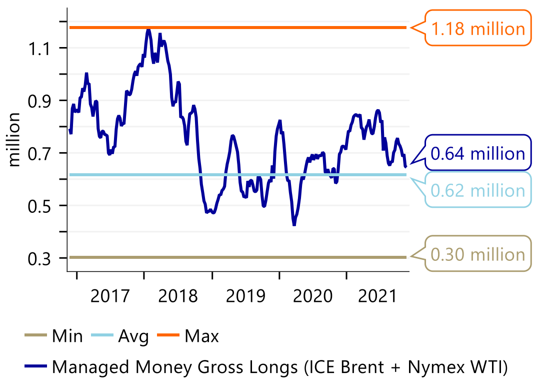
The past two years have been nothing short of remarkable for oil markets and we suspect only more of the same for this coming year. In fact, soaring inflation as a result of the global pandemic has sparked huge interest in oil and the broader commodities markets this year and we see that continuing well into 2022 and beyond. As we noted last week, commodities are set to post very strong results for 2021, currently with gains of more than 23% for the diversified Bloomberg Commodity Index (BCOM) and an even more impressive 30% gain for the energy heavy S&P GSCI Commodity Index. As it stands, these would be the biggest annual gains since 2003 for the BCOM and all the way back to 2000 for the GSCI. It is worth remembering that those returns were registered during the last commodity super-cycle of the early 2000s. Additionally, that super-cycle was further supported by institutional money flows as investors poured into commodity index products to gain exposure to the alternative asset class. In fact, this year echoes that investment period in a number of ways, especially the record commodity index ETF inflows recorded this year on the back of mounting inflation fears. This investment momentum could well continue to impress in 2022 as institutional investors chase this year's strong risk-adjusted returns and as portfolio managers look to diversify holdings away from stocks and bonds. Moreover, with crude oil now back into the low 70s and even high 60s, prices are looking more attractive from a value perspective, and especially in light of the high inflation backdrop that is increasing the cost of production for oil. In addition, trend and momentum signals are also still bullish on a weighted basis, despite some short-term signals turning bearish on the selloff. Notably, the oil futures curves are still offering attractive roll-yields even with the curves weakening during the recent rout. Further to that end, the one year implied yield for ICE Brent and Nymex WTI is over 5%, providing a nice entry edge from the "long" side of the market for long-term investors. As such, we expect that CTAs and systematic funds will begin rebuilding "long" positions in the coming months given the mostly favourable conditions for oil futures. Furthermore, the speculative positioning in oil markets is far from "crowded" and there is plenty of dry power on hand as we head into the new year. Undoubtedly, the US Dollar will also be a key oil market driver in 2022.

Figure 3: The implied positive roll-yield for ICE Brent is attractive for long-term investors...



Source: Bloomberg, Rabobank

Figure 4: Oil speculators have plenty of dry power on hand as we head into the new year...



Source: Bloomberg, Rabobank

Looking forward

Looking forward, not much has changed in our views despite the sharp correction in prices and we still expect sideways and choppy markets through year-end as we said last week, before the oil rally begins in earnest again early next year. While the OPEC+ supply decision was a surprise to us, it does signal that the group is expecting robust demand next year. That's not to say we expect oil prices to rally straight up from here, but perhaps the lows are in the rear view mirror. As for market volatility, we expect it to remain elevated, as these bigger trading ranges become the new normal and with that there is both more risk and more trading opportunities ahead.

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