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Q&A-Crude to hit capacity constraints by mid-year, expect aid for U.S. shale: Konstantinos Venetis, TS Lombard

Global crude stockpiles are likely to hit capacity constraints by the middle of 2020, making a repeat of May's carnage in the WTI futures market a possibility, **Konstantinos Venetis, TS Lombard senior economist,** told the Reuters Global Markets Forum on Tuesday, May 5.

He also added that the U.S. government is likely to roll out some amount of financial support for major U.S. shale players.

Following are edited excerpts from the conversation:

Q: As the coronavirus lockdowns get lifted, how soon do you see demand coming back, and what quantum?

A: I think the market is gradually moving past the peak of the demand-supply imbalance. This is on the back of the combination of a gradual easing of economic lockdown measures in a number of major economies with a broadening of the supply response.

Global inventories should continue building over the coming quarters as the economic activity resumes only gradually and the transportation industry – a major driver of global crude consumption – remains in shackles. This should weigh on prices along the curve even as the magnitude of the contango at the front end diminishes.

Q: What is the status of storage capacities now, including strategic reserves?

A: It is always hard to tell with storage capacity. The IEA puts its high-level estimate for total global crude storage capacity at 6.7 billion barrels. So, assuming a maximum operational cap of around 75%-85%, global crude stockpiles should hit capacity constraints by mid-year.

The degree of super- contango in the futures market witnessed in April suggests we are probably already in that critical range.

Q: So do you see WTI futures for June, and may be even July, going negative as well closer to expiry?

A: On June WTI, it is possible that we see a mini-repeat of May, with downward price pressure picking up leading to the contract's expiry. Interestingly, we are seeing soaring retail participation in oil ETFs that, in effect, absorbs shale producers' forward sales.

The problem is ETFs cannot take delivery, so the May dislocations could resurface.

Q: Interesting, so the dislocations could be driven by factors other than storage, strictly speaking.

A: Storage constraints are the root of the problem, but the solution remains elusive as there is not enough physical (or, real) demand.

Q: At what point do you see a possible US government bailout of shale producers? If we see a shale recovery, what magnitude is likely to come back and will it make a material difference to the oil markets?

A: On US government support, I fully expect some supportive measures to be rolled out, but we cannot avoid the fact that the oil price collapse is catalysing the transition of the US shale industry to its next stage.

This will be characterised by pockets of credit distress and a wave of consolidation that sees the strong hands take over, with Big Oil expanding its presence further.

Q: What supportive measures do you expect to be rolled out for the shale industry by the US govt?

A: These will be there for the big players, I think, once the world economy starts returning to some sort of normalcy and the oil market comes back from the brink. These will have to be financial in nature, as the SPR can only absorb around a week's supply.

Q: So some form of direct lending facility or equity stakes?
A: Yes, would not be surprised to see such measures, along with banks offering state-backed favourable loan extension terms.

Q: Konstantinos, you addressed the demand side (with lockdowns easing), do you feel we'll see supply cuts which will be meaningful enough? How much deeper do you see OPEC+ going beyond the combined 9.7 mbd for May-June?
A: US shale operators will try to achieve output cuts via natural declines before resorting to shut-ins. But April's extreme price action on the May WTI contract has rang the alarm bell catalysing involuntary shut-ins.

These could take total supply down to around 10-11mbd by year-end, depending on the pace of the slowdown in the number of new wells put on production.

OPEC+ has pledged to take further action if needed. Additional cuts will be tailored to the evolution of demand. I think the bulk of the cuts is behind us, unless we see a second Covid-19 wave that deals another heavy blow to demand.

Q: Any parting thoughts for us, Konstantinos?
A: It all depends on the market's conviction on the global recovery. We first need to see the contango evaporate, this should pave the way for the whole of the forwards curve to shift higher.

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