FROM UNDERDOG TO CHAMPION? BRENT COULD BE THE FAVOURED OIL BENCHMARK

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In recent weeks as crude oil has fallen to new lows, many investors have positioned for a recovery. But which crude oil benchmark is looking more attractive at this stage? WTI[1] has garnered more interest from the financial community. For example, WisdomTree has seen US$2.7bn inflows into WTI exchange traded products (ETPs) compared to US$0.7bn into Brent ETPs[2]. We believe the somewhat overlooked Brent benchmark could be the better of the two.

In a Tale of two benchmarks we discuss the similarities and differences between those two major oil futures contracts: Brent and WTI. Those two light sweet, crude oil benchmarks are very similar but financially, we favour Brent for the following reasons:

- Over the past month Brent appears to have been more robust in the face of market volatility than WTI.
- The contango[3] in Brent is currently lower than in WTI. Which indicates the roll drag in Brent is less aggressive than in WTI.
- Looking at past oil price recoveries, we observe that Brent generally outperforms WTI.
- In today's oil market crisis, while we have argued that OPEC+'s[4] deal to cut production is insufficient to get oil markets in balance in the short-term, the fact that there is a coordinated cut by large international players may indicate that Brent recovers in a more sustainable fashion than WTI.

In this piece, we will explore these arguments further.

Market volatility and negative prices

We are in a period of unprecedented volatility in oil[5]. So far Brent has dealt with that volatility more gracefully.

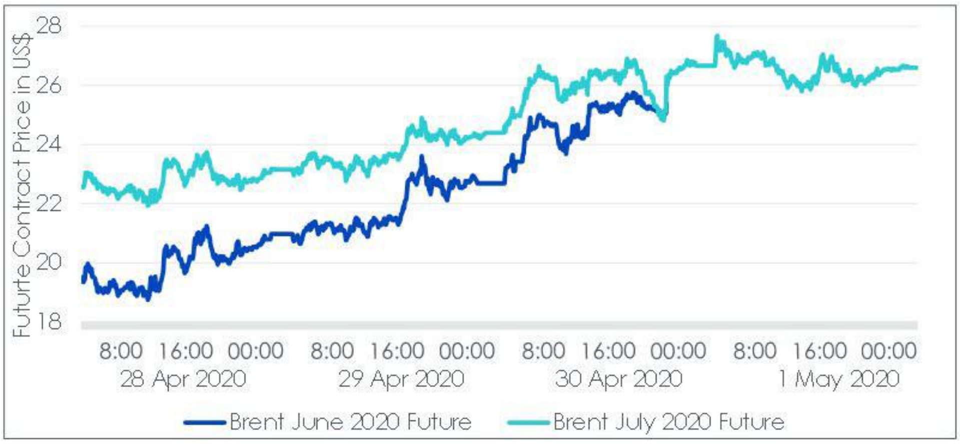
On 20th April 2020, a close-to-expiry Nymex WTI contract traded negative[6]. That was the first time a crude oil futures contract traded negative and took most people by surprise. Looking back, we can identify a key vulnerability in the WTI contract: as a deliverable future, there are certain steps that need to be taken to avoid delivery. A deliverable future means that at expiry, unless the contract is closed (by taking an opposite trade), an investor holding one long futures contract will receive 1000 barrels of oil (contract units are in 1000 barrels). In normal times, the operations are slick and there is an absence of anxiety about accidentally having to take delivery of barrels of oil. In fact, only 1% of contracts go to delivery according to the Energy Information Administration (EIA). But as the May WTI contract came close to expiry, a combination of low liquidity and infrastructure constraints drove the price negative. Those trying to close May WTI contracts on April 20th possibly left it very late and could not find anyone willing to take the other side of the contract in a market with thin liquidity. Of chief concern was the lack of storage at Cushing, Oklahoma where the contracts are settled. EIA data indicates that working storage was anywhere between 76% and 81% full (which is far higher than the below 50% normal rate). Moreover, the remaining capacity was most likely leased out or otherwise committed. In these desperate times, some futures investors closing WTI contracts paid the other party to close out of the contract before expiration and avoid delivery as storage became too difficult and/or costly. That flipped the benchmark into negative territory for several hours.

Brent, traded on the Intercontinental Exchange (ICE), is less likely to suffer from negative prices. To be clear, ICE has not ruled that negative prices are impossible, but as a cash-settled contract, the incentive for negative prices is harder to identify. Cash-settled means that upon expiry of the contract, the futures holders are either credited or debited the difference between the initial price and the final settlement. The scramble for storage or a buyer that has access to available storage does not exist, thus eliminating that cause for negative pricing.

WTI futures catering for two distinct markets – physical delivery and financial market speculators – have hit a snag. Brent, on the other hand, has a forwards market for physical delivery and a futures market for financial markets speculators. There is an off-exchange (bilateral negotiated transaction) mechanism for the Exchange for Physical (EFP), that helps ensure that that physical and futures market don't decouple wildly. In recent weeks, the spread between physical and futures markets has widened, but there has been no sign of Brent futures dropping to zero or beyond.

In fact, as the June Brent contract expired on 30th April, the transition to the July Brent contract as the active contract appeared seamless. Toward market close on 30th, the July price converged to June contract closing price of US$25.39/bbl and then bounced back next trading day.

Chart 1: Brent July took over Brent June as active contract on April 30th, seamlessly



Source: WisdomTree, Bloomberg. Period 28th April to 1st May 2020 using intraday trade data in USD.

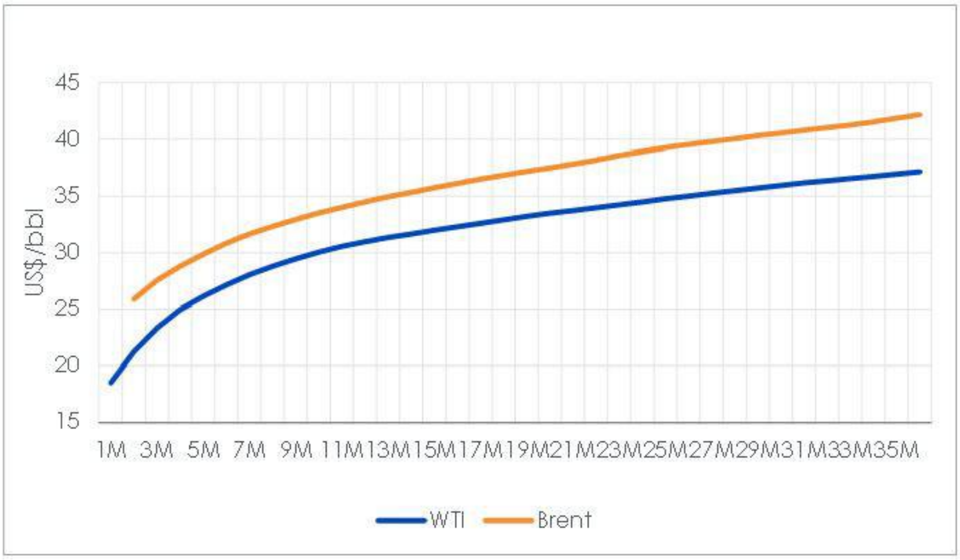
Historical performance is not an indication of future performance and any investments may go down in value.

Even though Brent is more expensive than WTI, it is not abnormally more expensive. That is investors are not paying over-the-odds for a more stable price benchmark. Over the past 10 years, the Brent-WTI spread has been US$7.79/bbl (4th May 2010 to 4th May 2020 using Bloomberg front month data). Today that spread is US$7.36/bbl – completely in line with that historic average.

Roll drag less aggressive in Brent

In Commodity, ETPs are exposed to futures contracts, not the physical spot. Why does it matter?" we describe why the shape of the futures curve can have a material impact on the total return of an oil futures investment. Today we are starting in a position of lower contango in Brent than WTI. That could potentially favour new investors in Brent over new investors in WTI.

Chart 2: Brent futures curve is less steep than the WTI futures curve



Source: WisdomTree, Bloomberg. As of 4/5/2020. Note active contract for WTI is June, while active contract for Brent is July.

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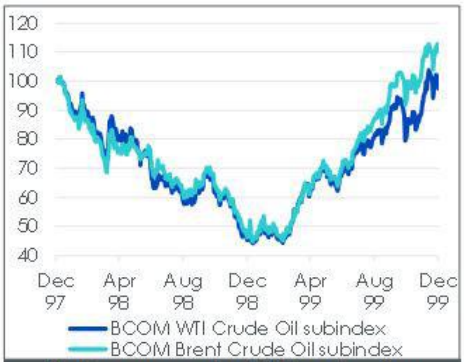
Brent has often outperformed WTI in recoveries

Historically Brent and WTI have had a very strong correlation[7]. So, a recovery in one crude benchmark is very likely to be seen in the other crude benchmark as well. Based on our analysis of four periods of oil price crashes that have been followed by a price recovery, on the upside, we have generally seen Brent outperform WTI (see chart 3). These are all based on Bloomberg Commodity Subindices Excess Return series, which incorporate the effects of rolling contract[8]. That is important as the shape of the futures curve affects the return to an investor, as described above.

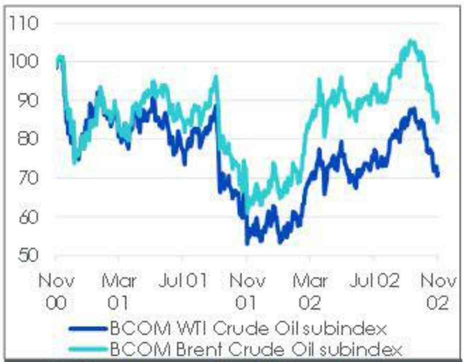
Chart 3: Recoveries have generally favoured Brent over WTI

Note: charts show one-year prior and post price trough. Indexed to 100 at one-year prior to price trough.



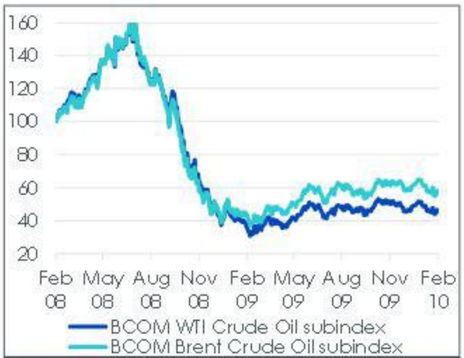
Performance after Oil touches low

	BCOM WTI Oil subindex	BCOM Brent Oil subindex
1M after	13.0%	12.6%
3M after	23.7%	20.5%
6M after	48.8%	49.2%
12M after	115.6%	138.3%



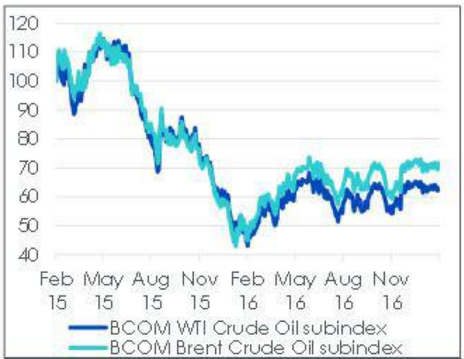
Performance after Oil touches low

	BCOM WTI Oil subindex	BCOM Brent Oil subindex
1M after	6.4%	8.5%
3M after	14.1%	19.4%
6M after	49.7%	57.5%
12M after	34.4%	41.3%



Performance after Oil touches low

	BCOM WTI Oil subindex	BCOM Brent Oil subindex
1M after	2.4%	-3.8%
3M after	16.5%	16.0%
6M after	33.9%	40.0%
12M after	28.5%	31.8%



Performance after Oil touches low

	BCOM WTI Oil subindex	BCOM Brent Oil subindex
1M after	30.3%	31.5%
3M after	45.0%	49.9%
6M after	29.0%	37.1%
12M after	48.0%	59.4%

Source: WisdomTree, Bloomberg. Over four 2-years separate periods: 10th December 1997 to 10th December 1999, 15 November 2000 to 15 November 2002, 12 February 2008 to 12th February 2010 and 11 February 2015 to 11 February 2017.

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OPEC actions may disproportionately favour Brent

While each oil price crash and subsequent recovery have their own causes and paths, one common factor in the recovery period is the efforts of OPEC members who have sought to bring markets into balance. OPEC members are generally benchmarked to Brent and thus Brent often reacts more to OPEC actions than WTI.
Although we believe that OPEC+'s deal has been short of the mark required to bring markets into balance in the short-term[9], the longevity of the deal does offer hope for market balance in the longer-term. Encouragingly Saudi Arabia and Russia started cutting production earlier than the official May 2020 commencement date (one of the concerns was that the cuts start very late). Assuming compliance with the deal is strong, we could see Brent once again outperform WTI.

In the short-term, we may see a wave of bankruptcies in the oil and gas sector in the US, which would grind production in the US lower. Indeed, the US is also one of the nimbler producers in the world and may start to adjust production relatively quickly. However, Federal aid to the struggling oil and gas sector could slow down the production adjustment. In a Presidential election year, we think that is a likely outcome. Recent adjustments by the Federal Reserve also open the doors to more oil and gas sector companies accessing the Main Street loan program[10].

US shale production in land-locked places in the US may face greater hurdles to get to export destinations at a time when the shipping vessels are being booked out months in advance to store oil and the pipelines used to get the oil to coasts are getting very full. The US's adjustment process could be slower today than it has been in the past.

Overall we believe that OPEC+'s actions (which favour Brent) may be a stronger catalyst for global market balance than non-OPEC+'s (including US) actions. The G20 meeting on 10th April 2020, revealed very little willingness of countries outside of OPEC+ to take decisive action.

[1] West Texas Intermediate

[2] Data from 1st Jan 2020 to 1st May 2020

[3] Contango is a situation where the futures price of a commodity is higher than the spot price. Contango usually occurs when an asset price is expected to rise over time. This results in an upward sloping forward curve

[4] Organization of the Petroleum Exporting Countries and their partner countries

[5] An age of unprecedented oil volatility, 27th March 2020

[6] See Nymex WTI front month futures trade negative, 21st April 2020

[7] 0.95 from March 1990 to March 2020 based on monthly data using Bloomberg Commodity Subindices

[8] See Commodity ETPs are exposed to futures contracts not the physical spot. Why does it matter?, May 2020

[9] See OPEC+ reaches a historic deal: but is it enough?, 14th April 2020

[10] Larger and more indebted companies now qualify for the programme as of 30th April 2020, in a move that was widely interpreted as to accommodate small oil companies.

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+ WisdomTree Brent Crude Oil Pre-roll
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