OPTIMISING AND CURRENCY HEDGING: TWO USEFUL STRATEGIES WHEN CONSIDERING ENERGY SECTOR EXPOSURE

Nitesh Shah – Head of Commodities and Macroeconomic Research, WisdomTree Europe
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The energy sector outlook looks positive, despite a number of lingering risks. A way of mitigating some of those risks is to use an “optimised” approach where you maintain flexibility in futures contract exposure. If US Dollar depreciation is a source of energy sector returns, European-based investors could be best served with a currency hedge.

Energy market outlook for 2021

Energy prices have rebounded strongly since their April 2020 lows. Brent and West Texas Intermediate (WTI) oil prices are trading above the levels they were a year ago i.e. before the COVID-19 pandemic reached Europe. This is somewhat surprising given that demand has not recovered to pre-pandemic levels. According to International Energy Agency forecasts (IEA), oil demand in 2021 will recover by 5.4 million barrels per day (mb/d), after having fallen 8.8 mb/d in 2020. So, we are likely to fall short of 2019 demand by quite some margin. Indeed, resurgence in COVID-19 cases places downside a risk on these demand forecasts and the IEA, Energy Agency Administration, Organisation for Petroleum Exporting Countries (OPEC) have all been downgrading their demand forecasts in recent months. What has happened is that the OPEC and its partner countries (together OPEC+) have maintained production restraint. The group has collectively cut production close to 10 mb/d relative to a year ago. According to IEA forecasts, if OPEC+ can maintain a hundred percent compliance with their quota, we could see stock withdrawals of 1.1 mb/d or hundred million barrels in Q1 2021. As demand picks up later in the year, if OPEC maintains restraint, we could see even higher stock withdrawals.

Both Brent and WTI futures curves are in backwardation until 2026, highlighting the market expectation for oil market tightness. Indeed speculative positioning in Brent and WTI oil futures is also higher than normal, underscoring investor bullishness. As we indicated above, a lot of this is dependent on OPEC policy. We know the OPEC policy can change abruptly as we saw in March 2020 and November 2014. So we believe that being flexible in contract exposure along the futures curve is very important. Today, being at the front end of the curve will give you maximum exposure to backwardation, but if OPEC policy changes, you would want the flexibility to go out further in the curve depending on changes in the shape of the curve.

Near-term tightness in oil markets should also act as support for petroleum products like gasoline, ultralow sulphur diesel, and gas oil.

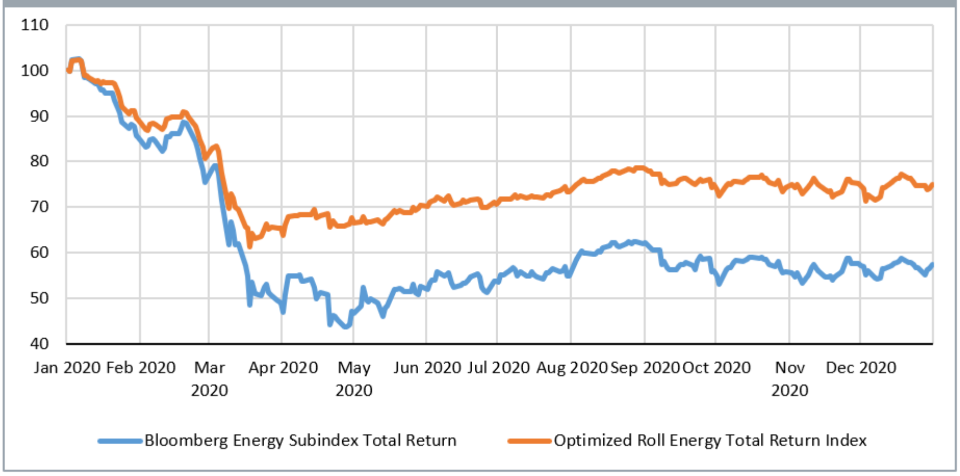
Henry Hub natural gas is a very seasonal commodity, with peaks in demand in winter. Beyond the seasonal patterns, it is somewhat harder to make projections for the price over the course of a year because demand for natural gas is so weather dependent. We are currently in a La Niña weather pattern, which should mean the Northwest of the USA should be cooler than normal. Indeed, the National Oceanic and Atmospheric Association's forecast for February 2021[2] points to much cooler than normal temperatures for the upper half of the US and their three-month forecasts point to a cooler Northwest[3]. That points to higher natural gas demand over the coming month.

Optimised approach for maximum flexibility

If we look across a broad range of commodities, energy commodities often have some of the steepest futures curves[4]. In the oil market, we have seen the futures curve switch from extreme contango last year[5] to backwardation this year. Natural gas, gasoline, diesel, gas oil futures flip from contango to backwardation on a seasonal basis. Bearing in mind that contango markets can act as a very aggressive drag on commodity market returns while backwardation can boost returns , we believe that maintaining flexibility in contract exposure when investing in the energy market is optimal.

By the point of reference, we compare two energy commodity indices in 2020: the Bloomberg Energy subindex total return (which maintains an exposure close to the front end of the futures curve) versus the Optimized Roll Energy Total Return Index (which maintains a flexible contract exposure, dependent on the shape of the futures curve). We can see that in 2020 while the former fell by 43%, the latter only fell by 24%, an out-performance of 18%. The key thing to note is that at the time of the oil price crash in March and April 2020, the optimised approach was exposed to oil futures contracts deeper into the futures curve where the contango was considerably lower than in the front month approach. Moreover, as oil markets moved back into backwardation towards the end of the year, the optimised approach shifted contract exposure towards the front end of the curve thus enabling it to participate in some of the stronger price appreciation at the front end of the curve. The optimised approach, having avoided as deep a drawdown as the front month approach, has been better placed to recover losses during the recovery.

Figure 1: Bloomberg Energy Subindex Total Return vs. Optimized Roll Energy Total Return Index in 2020 (USD), Indexed to 100 on 1st January 2020



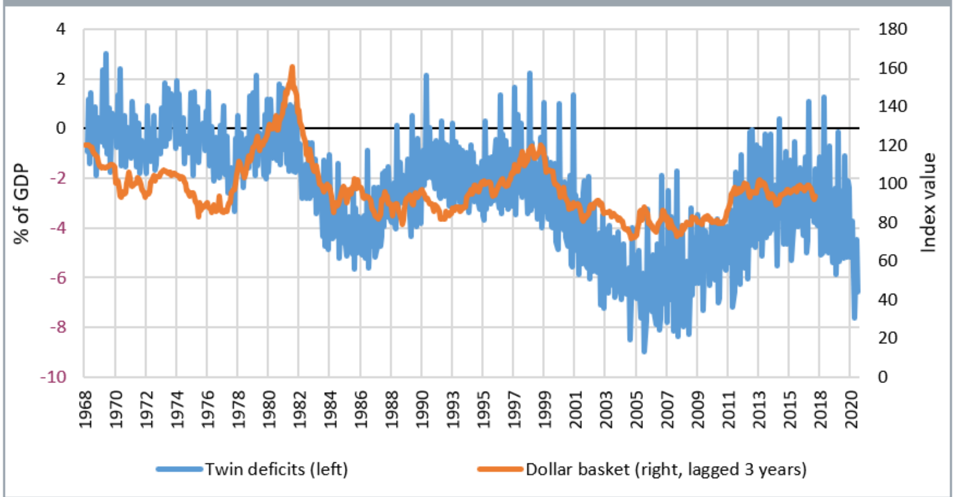
Source: WisdomTree, Bloomberg, data from 1 January 2020 to 31 December 2020.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Currency hedging

Figure 2 below highlights the US dollar basket goes through long cycles of strength and weakness and historically big movements in the twin deficit have been a trigger for the turning point in the cycle. The chart plots the twin deficit against the US dollar basket with a three a lag. So, if history is any guide to the future, a period of dollar weakness may have already been set in motion. The twin deficits have potential to rise further as the combination of Biden in the Whitehouse and Democrats controlling both chambers of Congress may unblock obstacles to higher spending that the Democrats have advocated. Obviously, these relationships aren't identity equations and there are many other influences on currency direction, but currently, many investors are worried about history repeating itself and hence investor speculative positioning on the dollar is very negative.[7]

Figure 2: US Dollar and US Twin deficits



Source: WisdomTree, Bloomberg, data from January 1968 to January 2021

Twin deficit is defined as a current account deficit and a government budget deficit. The wider the deficit, the more negative the number. Dollar basket is the US Dollar against a basket of six currencies. Index value increases with Dollar appreciation. You cannot invest directly in an index.

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If we are in for a period of structural weakness for the US dollar, a European investor in energy may miss out on potential gains if their energy exposure is unhedged. Energy prices in US dollar terms tend to gain from US dollar weakness, but holders in other currencies (unhedged) don't benefit. Hedging could give a European investor a similar return to a US investor.

Conclusions

Energy prices have made a strong recovery from April 2020 lows. In the oil market, that is supported by OPEC+ supply restraint. If that's maintained, it can offer the energy complex strong support. We believe an optimised approach to investing in energy commodities is preferable given seasonality in the futures curves of natural gas, gasoline, diesel and gas oil and the fact that crude oil futures curves have shifted from backwardation to contango frequently in the past. Maintaining flexibility is highly valuable in the energy markets. For European investors exposed to futures contract prices in US dollar terms, currency hedging exposure could help them unlock the full potential of energy in a US Dollar depreciating environment.

[1] For more information on contango and backwardation please see Commodity ETPs Are Exposed To Futures Contracts Not The Physical Spot. Why Does It Matter?, May 2020

[2] https://www.cpc.ncep.noaa.gov/products/predictions/long_range/lead14/

[3] https://www.cpc.ncep.noaa.gov/products/predictions/long_range/seasonal.php?lead=1

[4] Especially after supply shocks like in April 2020

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

[6] For more information on contango and backwardation please see Commodity ETPs Are Exposed To Futures Contracts Not The Physical Spot. Why Does It Matter?, May 2020

[7] In January 2020, net speculative positioning on the US Dollar were the most short since 2007 (The Commitments of Traders report by the Commodity Futures Trading Commission).

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