From an economics perspective, the oil market is oversupplied because of the coronavirus related collapse in demand. Logistically, the severity of the oversupply is making it difficult to move oil around the world and find storage. Recently this logistical monster reared its head in the U.S., and domestic oil prices moved into negative territory. Lastly, several countries sell oil as their primary economic means and are willing to sell at very depressed prices to generate revenues and take market share. These factors have coalesced to put severe downward pressure on oil prices. Below we answer some key questions.

**What is happening to oil prices?**

The collapse in oil prices to below $20 per barrel for both West Texas Intermediate (WTI) crude and Brent crude is primarily a story of collapsing demand due to the COVID-19 virus, but there are a number of other near-term technical factors at play. Global economic growth is the driver of global demand for commodities, and the global economy is shut down to prevent the spread of coronavirus. The physical oil market is very oversupplied.

**Domestic oil prices briefly traded below zero. How does that happen?**

There are physical (commodity) and financial (paper) reasons for this phenomenon. The short answer is that domestic producers and refiners are running out of storage and ended up paying their counterparties (negative prices) to avoid taking physical delivery of oil as monthly contracts matured. This was a logistical problem. This was also happening in financial markets (paper), with energy traders paying to avoid taking delivery of physical oil.

Further, the rapid decline in prices put pressure on hedging positions and for technical reasons (negative roll yields) also threatened the solvency of major oil trading exchange-traded funds (ETFs), which saw large inflows the previous few weeks on speculators trying to time a rebound in oil prices.

**Why didn’t the Organization of the Petroleum Exporting Countries (OPEC)+ supply cuts succeed in rebalancing the oil market?**

The “biggest production cut ever” by OPEC+ probably provided some support to Brent crude prices, but the cuts have less impact domestically. The recent cut and future cuts is expected to have a limited impact as long as demand is nonexistent. In essence, oil market players are just passing around barrels of oil until demand comes back.
A number of countries rely primarily on oil revenues for economic growth, have very low costs of production, and may have limited storage capacity. This sets up a situation of desperation. In an oversupplied market, there is incentive to violate production quotas and/or to offer discounts to take market share and earn revenues. This will be a theme that will likely stick around even after demand returns.

**When could demand come back?**

This depends on the evolution of the COVID-19 virus and related health care solutions that would allow us to “turn the global economy back on.” If the virus allows for a gradual reopening, oil demand is expected to creep higher in the second half of the year as global growth picks up. But demand may also come back in an uneven nature if air travel and jet fuel demand takes longer to recover either because restrictions remain in place or consumer behaviors change. Looking further out, it’s possible that oil demand may not reach its previous peak for years.

**What are the geopolitical issues at play?**

The shale revolution in the U.S. and the surge in production changed the market dynamics in terms of the interplay of geopolitics and oil markets. In the past, oil prices were very sensitive to geopolitical risk given the potential for supply shocks in regions and countries with major oil producers. That was true when oil markets were tight. When oil markets are oversupplied, geopolitical risk sits on the backburner absent a major conflict that brings the biggest producers offline. There are also likely some global players who would welcome a tighter market with fewer players.

**What does all of this mean for oil prices? What does the post-Coronavirus oil environment look like?**

BofA Global Research expects oil prices to remain under pressure in the next month or two as demand remains severely depressed. They would not rule out additional volatility around near-month contract maturities. They project Brent and WTI will average $37 per barrel and $32 per barrel, respectively, for this year.

As stated, oil prices should recover when global growth picks up, and that depends heavily on the evolution of coronavirus. The speed of the rebound will be reflected in oil prices.

**What’s the damage for the U.S. economy and financial markets?**

The U.S. energy sector will be a drag on U.S. economic growth, but there are much bigger factors at play that can swamp the energy impact on growth in both directions. The U.S consumer plus business investment in technology make up the bulk of growth in the U.S. economy, and they are not negatively affected from lower energy prices. While consumers would typically benefit from lower energy prices, the benefit is muted because they are neither flying nor driving in the current environment.

That said, we expect deleveraging to continue and a wave of bankruptcies and consolidation in the U.S. energy sector as the price of oil remains well below the break-even prices. Jobs related to oil and gas production have been in a multiyear decline following the 2014–2015 oil price collapse. This is expected to continue. From an economy-wide perspective, they represent a small percentage of the overall labor market.

**How will policymakers likely respond to the collapse in energy prices?**

Importantly, the collapse in energy prices is driving inflation and inflation expectations lower, which will encourage the Federal Reserve (Fed) to maintain its reflationary stance. On the fiscal side, a government rescue of at-risk U.S. energy producers would likely
just push oil prices even lower as it would perpetuate the state of oversupply. Firms that cannot compete at lower prices will need to figure out a way to lower production costs, merge or close up shop.

**What are the key takeaways for investors to consider?**

In the U.S., even with a recovery in demand and prices, it will likely take a long time for higher-cost shale producers in the U.S. to repair their balance sheets, and it still remains to be seen if prices will move above the price necessary for some to compete in the global arena. This is reflected in the High Yield Energy Option Adjusted Spreads. We are cautious of energy ETFs designed to gain long exposure to oil prices as they are structurally vulnerable in this environment because of the shape of the oil futures curve and the potential for storage issues to continue to disrupt near-month domestic oil prices.

We remain underweight the energy equity sector overall.

---

**DUE DILIGENCE VIEW ON OIL COLLAPSE**

**Traditional managers fall into two camps.** 1) They are all over natural gas thematically and avoiding oil by pointing out the transition fuel story and the decline in gas production that is associated with drilling that targets oil; and, 2) bullish on oil, which is predicated on the idea that the collapse of U.S. oil production is imminent.

- Whether they are bullish or bearish oil, long-only active managers all have the option to be further out of the curve away from these destructive front-end dynamics.

**Passive* managers are straining under their mandate** with the exception of those designed to mitigate the impact of negative roll yield, which is achieved by positioning further out on the futures curve where negative pressure has been much less pronounced.

- Energy equities that are sensitive to oil prices like exploration and production may be a way to participate in an upturn in oil prices, though there may be extensive volatility—including bankruptcies—if low prices persist.

**Commodity Trading Advisors (CTAs)** seem to be looking to take advantage of the sharp downward trend in many oil and oil product markets, potentially benefiting from the slide in the oil price as they have been positioned net short in the aggregate since January.

- Exposures are modest as volatility in oil markets is currently very high.

- Typically investors should consider avoiding having exposure to specific futures close to expiry by rolling their positions to further out months at least 1-2 weeks in advance before liquidity in front month contracts diminishes.

---

* Passive management seeks to outperform benchmarks by making tactical allocation decisions. Will mirror the returns of asset classes within the portfolio.
Important Disclosures

This material was prepared by the Chief Investment Office (CIO) and is not a publication of BofA Global Research. The views expressed are those of the CIO only and are subject to change. This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be either a specific offer by any Merrill or Bank of America entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

Global Wealth & Investment Management (GWIM) is a division of Bank of America Corporation. The Chief Investment Office, which provides investment strategies, due diligence, portfolio construction guidance and wealth management solutions for GWIM clients, is part of the Investment Solutions Group (ISG) of GWIM.

Bank of America, Merrill, their affiliates and advisors do not provide legal, tax or accounting advice. Clients should consult their legal and/or tax advisors before making any financial decisions.

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities (including ADRs) involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

© 2020 Bank of America Corporation. All rights reserved.