

Why OPEC's supply cut extension is structurally bullish for oil

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Investors holding a 3x leveraged oil ETP would have gained over 15% in the first week of November—more than 3x the return of front-month oil futures over the same period. Underpinning this is an easing supply glut and a potential OPEC supply cut extension—both of which, we believe, reaffirm the structural bull case for oil.

Ahead of the Vienna OPEC meeting on 30 November, we highlight how oil investors can express their views on oil using short and leveraged oil ETPs, and/or unleveraged oil ETCs.

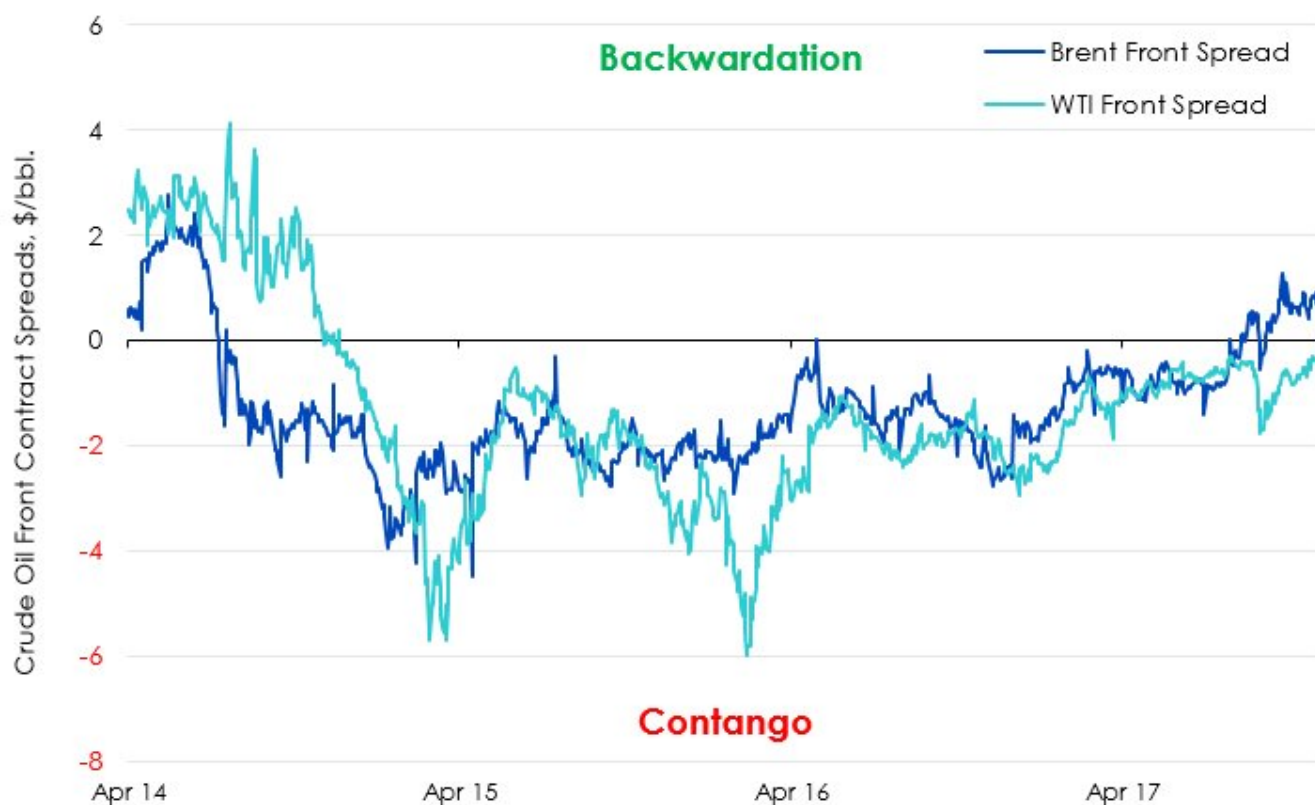
Tightening fundamentals underpin oil's backwardation

Oil is in backwardation for the first time since 2014. This is showcased by positive and near positive front future contract spreads for Brent and WTI respectively, as shown in Figure 1.

Since the spread reflects the price differential between first and fourth month contracts, a positive spread indicates a backwardated futures curve, with further-out contracts **less** expensive than near-month contracts. Conversely, a negative spread implies a market in contango, with further-out contracts **more** expensive than near-month contracts.

Oil in Backwardation for the time since 2014

Price differential between 1st and 4th month futures for WTI and Brent



Source: WisdomTree, Bloomberg. Data from 01/04/14 to 06/11/17.

Past performance is not indicative of future returns.

Since 2014, WTI has exhibited deeper contango relative to Brent. This is because WTI is the primary benchmark for US oil and it's more sensitive to US shale production which has been in persistent oversupply in recent years. This oversupply created wider front contract spreads relative to Brent, and at 31st October 2017, also widened the Brent-WTI price spread to \$7—the highest it's been since 2015.

Despite this, Brent's and WTI's improving fundamentals, evident by a 15% fall in US oil inventories since their peak in mid-March, are driving both Brent and WTI to revert to backwardation. This is likely due to Russia and OPEC meeting production targets, with combined supply cuts of over 1.5 million barrels a day (bpd) easily offsetting the 1.1 million increase in daily non-OPEC production. Global oil production has contracted by 400,000 bpd year to date and continues to fall.

Oil's increasingly backwardated futures curve and recent price appreciation have not only vindicated OPEC's decision to curb supply, but is now encouraging other oil producing nations to participate in supply cuts. Take Nigeria, for example. Having been exempt from the initial OPEC deal, it has offered its support to contribute to future cuts, potentially alongside non-OPEC members, Turkmenistan and Uzbekistan.

On a standalone basis, their contribution will do little to dampen global oil supply. However, this highlights oil producing nations' increased willingness to tighten supply collectively to stave off the threat of shale and potentially drive oil prices higher. As such, the Vienna OPEC meeting on 30 November seems to be about not if cuts will be extended, but how long to extend cuts for. This presents oil trading opportunities.

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