FORTEM CAPITAL

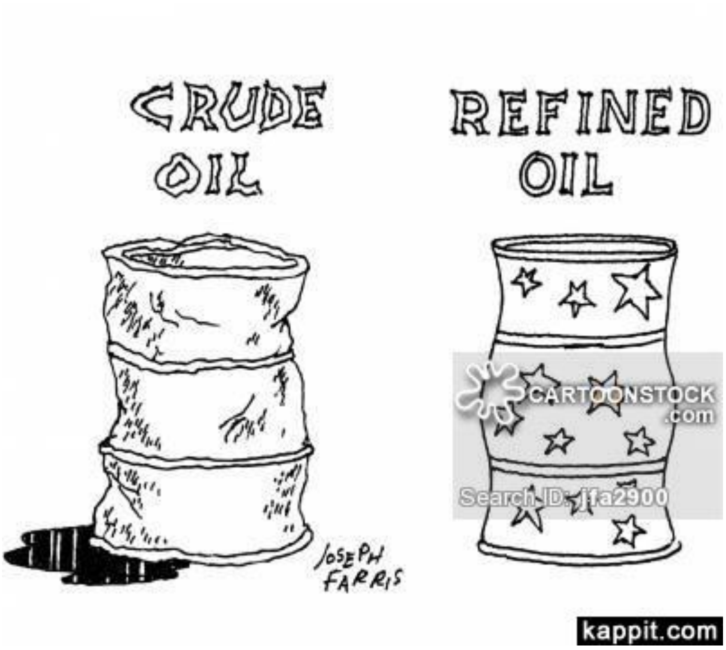
FRIDAY NIGHT 'LIGHTS

24th February 2017

Oil Me up, but don't be crude…

For our clients, there are consistent challenges to investing in commodities – namely that few institutions (or their end clients) have the means to take physical delivery of an asset, nor the desire to pay the storage costs, and perhaps more critically, commodities have no yield, and given the dearth of income in the current market, they aren't hugely appealing unless there's serious capital upside – in the case of oil, that may not be the case. Is there then, a way to be invested in say, oil and to also deliver income? We at Fortem believe there is. But first, let's dive into a little bit of the research to ascertain what people perceive to be the outlook for oil in 2017.

Citigroup strongly believe that **Oil prices remain rangebound (circa $55-60 per barrel).** After burning the midnight oil on behalf of our clients, we found many market participants were of the same view. There are a number of reasons for this, which we shall now attempt to briefly cover.



At the end of January Reuters produced a report highlighting that Oil had been trading within a very narrow range since the start of the year. Moreover, last week oil prices rose, with Reuters suggesting this was strongly correlated to support from an "OPEC-led effort to cut output", but that "rising production elsewhere kept prices within the narrow range that has contained them so far this year." Interestingly, both Brent Crude futures and WTI crude futures have remained within a $5 per barrel trading range since the end of 2016. "The usually fairly volatile oil price has barely budged for two months, the reason being conflicting dynamics in the market," said Dutch bank ABN Amro. OPEC, otherwise known as 'The Organisation of the Petroleum Exporting Countries' (what a mouthful), as well as other producers including Russia, have agreed to cut output by almost 1.8million barrels per day during the first half of 2017 – in a concerted effort to control the obvious global fuel supply overhang.

Product	Coupon
Citi 1yr USD Daily Range Accrual ($40 to $72) on Brent Crude Oil with soft protection at a $40 barrier	7.50%

Rates (bps)		
	Current	Week Chge
GBP 1yr	53.80	0.10
GBP 3yr	65.10	-2.00
GBP 5yr	81.60	-3.80

Equity Indices (%)		
FTSE 100	7250.96	-0.67%
S&P 500	2246.19	-4.46%
Nikkei 225	19283.54	0.25%
Eurostoxx 50	3319.25	0.32%

Currencies (%)		
GBPUSD	1.2544	1.06%

5yr Credit Spreads (bps)		
Citigroup	66.75	0.83
Credit Suisse	117.33	1.10
Deutsche	149.98	-1.11
GS	84.47	1.52
HSBC	65.69	-0.37
JPM	54.32	-1.21
MS	80.08	0.75

Commodities (%)		
Gold	1255.95	1.73%
Oil (CLA)	54.22	0.82%

3m Implied (vol pts)		
FTSE 100	13.01%	2.07%
S&P 500	11.93%	0.59%
Nikkei 225	18.76%	0.15%
Eurostoxx 50	19.01%	3.60%

5yr Implied (vol pts)		
FTSE 100	18.90%	0.05%
S&P 500	20.13%	-0.32%
Nikkei 225	19.38%	-0.36%
Eurostoxx 50	19.80%	0.30%

Source Bloomberg / Partner Banks
Data as at 24th February, 10.30am

Upcoming events	
28th Feb	Annualised US GDP % q/q
01st Mar	Feds release Beige Book
02nd Mar	Eurozone Flash HICP % y/y
03rd Mar	Composite PMI (Final) Index

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However, rising production in the US, has somewhat undermined this effort, where increased drilling activity (especially in shale) has lifted overall output to 8.9million barrels per day – up 6.5% since the middle of last year.

"A floor is being formed by the production reduction agreed by OPEC and several non-OPEC oil producers ... At the other end of the spectrum, a ceiling is being created by the stepped-up shale oil production in the U.S.," ABN said. A lack of trust in the market's willingness to comply (despite the compliance rate being circa 90%) has resulted in skepticism in its ability to achieve its aims. Traders also pointed out that even at an OPEC compliance of 90 percent, and a much lower rate for non-OPEC members, producers would have to accelerate their cuts in the coming months to achieve the average daily reduction target agreed for the first half of the year.

ABN said it had reduced its average Brent oil price forecast for the first half of 2017 "from $55 per barrel to $50 per barrel, while allowing for a possible temporary dip towards $45 per barrel", while Soc Gen forecast an average for 1Q17 of $52.50, and seeing somewhat of an uptick to $60 by 2018. Other institutions, such as the World Bank has it at $55 per barrel, BofA Merrill Lynch predicts $61 per barrel in 2017 and Goldman Sachs predicts the average Brent level to be $57.4 for 2017.

The economic times wrote that "as per **OPEC Monthly Oil Market Report of December 2016**, in 2017, demand for OPEC crude is expected to be at 32.6 mb/pd and Non-OPEC supply is expected to average 56.50 mb/pd. At the 171st Ministerial Conference, OPEC decided to implement a new OPEC-14 production target of 32.5 mb/pd, effective from 1 January 2017. The production rationalization decision of OPEC is intended to address the oversupply and alter prevailing global crude oil prices. However, the real impact on crude prices may be minimal as prices of global crude are dependent on many other factors. Tsvetana Paraskova raises plenty of questions over implementation and sustenance of OPEC production cut. Bloomberg reports that OPEC dynamics are [the] principal driver of global crude fundamentals, therefore close monitoring of administrative and operative decisions of OPEC is critical to understand pricing dynamics."

So, where do we stand and what sort of product might be of interest? Well, given the events of the last 6 months and oil's exposure to global politics, a longer-term trade, when the price is seemingly range bound makes little sense to us, so… how about an income paying structure, producing a coupon of circa 7.5% (accrued daily) if oil remains within a range of $40 and $65, with soft protection at a $40 barrier? Slick pricing? We think so.

For further details, please click the link to the accompanying product factsheet in the email or give us a call. We've got many more oil puns to share…

Disclaimer

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