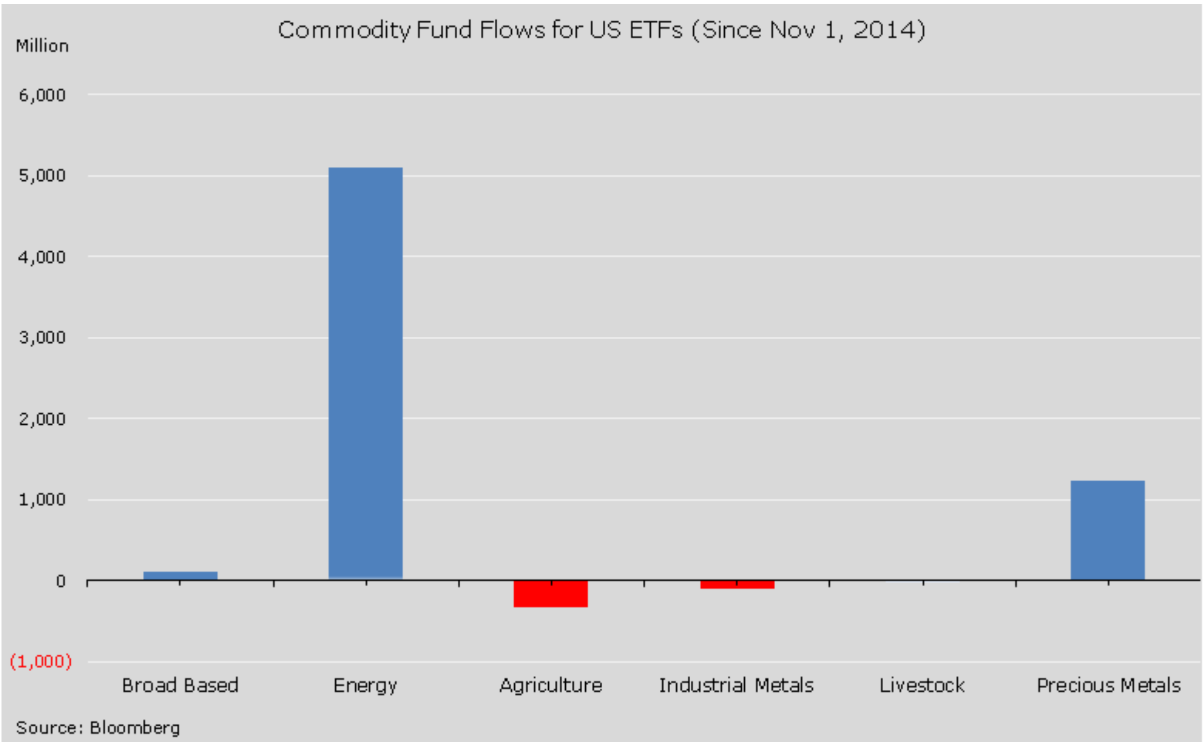
Oil ETFs in demand but beware of the contango trap

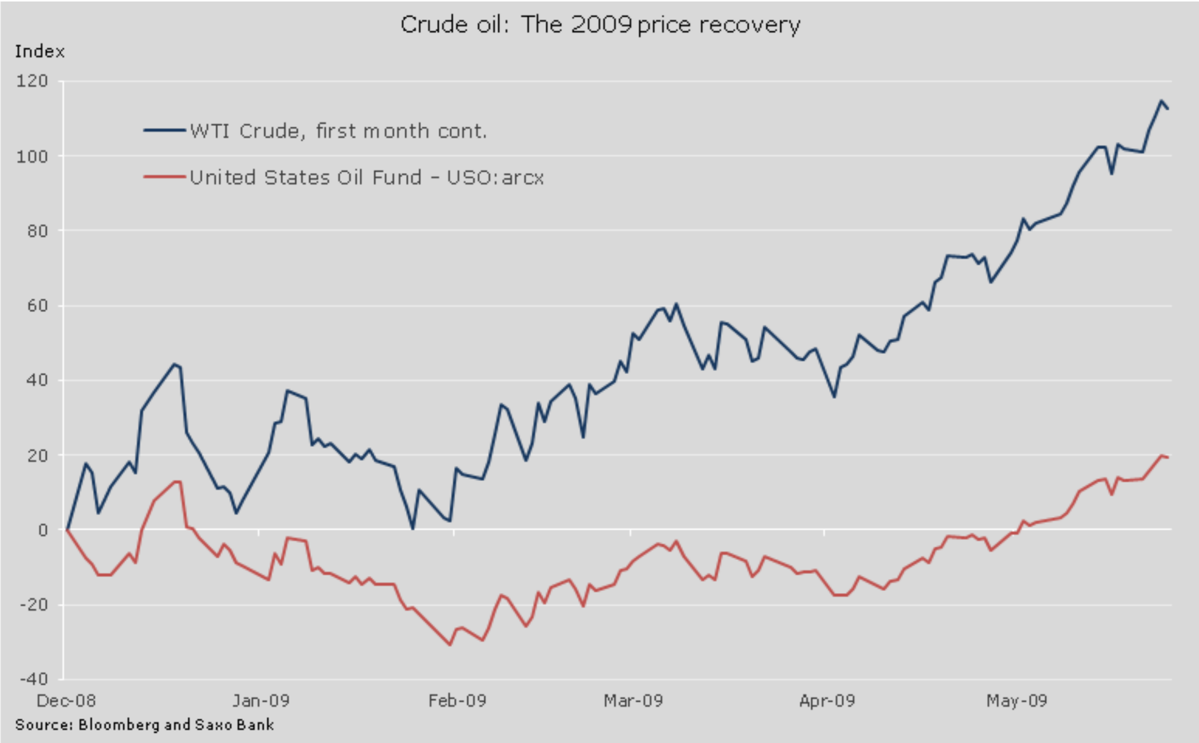
- **Charts often cloudy on true performance of futures contracts**
- **Big rush into oil EFTs at height of global financial crisis**
- **Contango trap has played havoc with crude oil prices for past 6 months**

When looking at the performances of commodities, which are all traded as futures contracts requiring a regular roll, the true performance is often not shown correctly due to the inability of charts to take into account the positive or negative roll yield between an expiring contract and the next. In this we take a closer look at crude oil which has become a hot investment topic during the past few months.

Following the drop of over 50% in the price of crude oil since July, crude oil has increasingly been attracting interest from investors who see the current low prices as unsustainable in the long run. As a result, according to data from Bloomberg, we've seen net flows of more than five billion US dollars into energy ETFs since the beginning of November. The world's largest crude oil ETF, the United States Oil Fund LP, have seen the outstanding amount of shares soar nearly six-fold in just three months, and recently climbed to their highest level since 2009.



A similar rush into oil ETFs was seen following the price collapse back in 2008/09 when many major economies hit the buffer as the global financial crisis raged. As a result of this, demand for crude oil fell off a cliff and the price of WTI crude oil hit a four-year low on December 19 2008 at $32.40. During the following six months the price of WTI crude more than doubled but as an investor in oil ETFs the return during the same time was less than 20%.



A similar situation is now emerging and the argument for higher oil prices in the future is rising, not least due to the amount of future upstream projects currently being cancelled. Whether the selloff is driven by lower demand as in 2009 or by rising supply this time round it has the same impact on the oil curve and this is what we will dig into below.

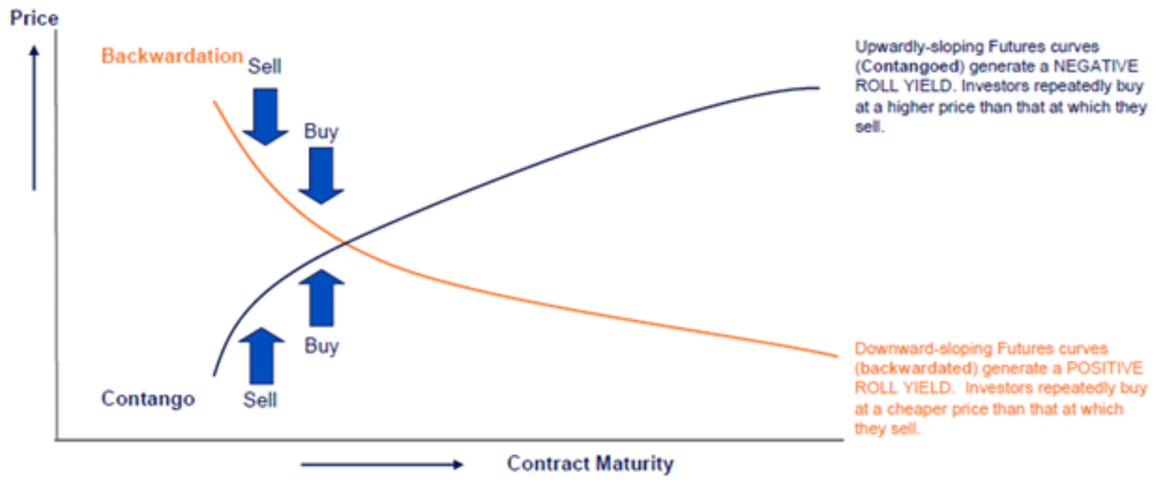
Contango and backwardation

In a situation where the forward oil price is higher than the current price the ETF will accrue a loss on each of the monthly expiries as the ETF provider will be buying the next contract at a higher price than the one it is selling. This shape of the futures curve is called contango and it occurs in a situation like the present one where ample supplies keep the spot price under pressure.

The opposite scenario is backwardation where tightness in the physical market raises the spot price above the forward price. This situation, which had become more frequent over the last few years, especially following the Arab Spring which raised the number of supply disruptions. Despite seeing the price of crude oil trading mostly sideways for three years this nevertheless created a positive roll environment for oil ETFs and investors where making a handsome return.

Contango trap

The impact on performance from the shape of the forward curve



The contango trap mentioned above has been playing havoc with crude oil during the past six months not least in Brent crude but also more recently in WTI crude. The current oversupply, estimated at between 1.5 and 2 million barrels per day, could rise yet further during the coming weeks so investors looking for the recovery will have to be patient and in the meantime not get frustrated about not seeing the return that the crude oil future eventually may indicate.

The biggest oil ETFs measured in net flows since November 1, 2014 are:

United States Oil Fund LP (USO:arcx) seeks an investment result that reflects the changes of the price of the WTI Crude oil futures contract.

ProShares Ultra Bloomberg Crude (UCO:arcx) seeks an investment result that corresponds to twice the daily performance of the Bloomberg Crude Oil Sub-Index.

iPath Goldman Sachs Crude oil (OIL:arcx) seeks an investment result that corresponds to the performance of the S&P GSCI Crude oil total return index.

PowerShares DB Oil Fund (DBO:arcx) The Fund’s objective is to track the DVIQ Optimum Yield Crude Oil Index Excess Return.

Head of Commodity Strategy at Saxo Bank **Ole Sloth Hansen**

Email: olh@saxobank.com

Phone: +45 3977 4810

Twitter: @ole_s_hansen

Ole Sloth Hansen is a specialist in all traded Futures, with over 20 years' experience both on the buy and sell side. Hansen joined Saxo Bank in 2008 and is today Head of Commodity Strategy focusing on a diversified range of products from fixed income to commodities. He previously worked for 15 years in London, most recently for a multi-asset Futures and Forex Hedge fund, where he was in charge of the trade execution team. He is available for comments on most commodities, especially energies and precious metals.