BLOG POST
The Economics of Capacity
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This month market gawkers witnessed something most never thought we could see: oil trading at -$37/barrel. The historic collapse in the May Nymex contract might also be a foreshadowing of what is still to come. The economic contraction caused by COVID-19 has driven demand for oil to the lowest point in decades at the same time we entered a supply war with Saudi Arabia, and Russia deciding to increase their production of oil. Oil is very short-term inelastic, meaning demand is not dramatically impacted by changes in prices. Gasoline may be the cheapest since we were teenagers, but nobody has anywhere to go. Storage capacity typically provides a buffer on price swings, but as storage neared capacity traders were faced with having to take physical delivery, something they have no ability to do.

- The energy sector is facing debt downgrades at a historic pace, creating Fallen Angels, or companies whose debt moves from investment grade to junk status. Occidental and Apache are two of the most recent victims.
- Even with recently announced production cuts of 10 million barrels per day, the supply of oil remains above the demand for oil by nearly 20 million bpd. With slower travel forecasted, the imbalance between supply and demand is likely to remain.
- The impact of negative capacity is being felt in shipping prices as tankers are being staged off the coast of California with nowhere to unload their cargo, in what amounts to very expensive storage.