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Stoxx 600 383.52 -0.63% ▼ Nikkei 22694.50 -0.56% ▼ U.S. 10 Yr 4/32 Yield 2.907% ▲ Crude Oil 65.66 -0.44% ▼ Euro 1.1768 -0.26% ▼

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MARKETS

How OPEC and Shale Have Squeezed Out Volatility in the Oil Market

Even threats of war, sanctions and an economic crisis fail to rouse market moves

By Sarah McFarlane

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Volatility in the oil market is being squeezed out by two giant forces: U.S. shale and OPEC.

Even threats of war, sanctions and an economic crisis can't rouse the sort of market movements that drive profits for traders and hedge funds.

The volatility of Brent crude, the international benchmark, has fallen to around 22%, measured by the standard deviation of daily price moves over the past year. Since 1995, the average has been 32%. A lower figure indicates less volatility.

The oil price tends to move around more when global inventories shift between being very high, prompting prices to fall because of extra supply, and very low, which pushes up the price.

Currently, when inventories fall, nimble U.S. shale producers respond quickly to price rises by producing more oil, meaning their tanks don't empty too much. On the other side, supply cuts from the Organization of Petroleum Exporting Countries and other major producers mean inventories don't rise too high.

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"It's a combination of shale becoming a bigger force and then you have this more cyclical story of inventories coming down helped by OPEC cuts, Venezuela and strong demand," said Francisco Blanch, head of commodities research at Bank of America Merrill Lynch.

An economic crisis has crimped production in Venezuela, one of several geopolitical factors that would typically stir volatility.

Tensions are high in the Middle East, with Yemeni rebels targeting Saudi Arabian oil facilities and Israel hitting Iranian targets in Syria. Meanwhile, the U.S. is reinstating sanctions against Iran, which analysts say will likely curb supply from the country.

"Even with the events in the Middle East and the geopolitical price premium, the market volatility is not screaming panic," said Thibaut Remoundos, chief executive of consultancy Commodities Trading Corporation.

Volatility has fallen across most markets in recent years, but stocks are now whipsawing more as central banks withdraw stimulus and political risk rises.

Brent was up 0.1% at $77.66 on Friday, having fallen from over $80 a barrel last month. It may feel like oil is swinging about a lot, but it isn't.

Swings in prices are currently at the lower end of a historical range that stretches back over 20 years.

OPEC and its ability to move prices isn't a new factor. But the addition of U.S. oil exports has added another large supply stream that can respond to price signals. Shale producers can react to price moves within months, whereas other sources of crude—such as deep water oil fields—can take years.

This faster response time has muted swings in prices. When the oil price rises shale producers turn on the taps, when it falls they ease off, capping big moves in either direction.

"Shale is contributing a lot in the sense that it's giving people comfort that even if inventories fall a lot or build, production is going to adjust," said Bank of America Merrill Lynch's Mr. Blanch.

A facility in the Bakken Formation near Dickinson, North Dakota. **PHOTO:** DANIEL ACKER/BLOOMBERG NEWS

The supply cuts agreed in 2016 by OPEC and its allies puts a cap on supply from about half of global production, affecting just how high those inventories can rise.

It was Washington's decision to reinstate sanctions on Iran that sent Brent above $80 a barrel. But that led Saudi Arabia and Russia to step in, saying they are working to boost production soon, pushing oil lower again.

Analysts say that when oil inventories are neither particularly high nor low, price volatility tends to diminish.

Oil inventories brimmed after U.S. shale technology unleashed vast reserves of oil after 2010 and OPEC reacted by turning on its taps in a battle for market share.

But now inventories are low again, hitting their lowest level in three years in March, and back in line with their five-year average, according to the Organization for Economic Cooperation and Development.

"The possibility of inventories becoming extremely high or low should diminish which reduces the likelihood of extreme spikes or drops in price," said Sebastian Barrack, head of commodities, at Chicago-based hedge fund Citadel.

Less volatility is a good thing for oil producers and consumers, who find it easier to plan ahead if prices aren't whipsawing around. But it isn't so great for traders and hedge funds.

Lower volatility is putting pressure on the razor-thin margins of the giant trade houses that ship millions of barrels of oil around the world in a high volume.

"We work on margins which are less than half a percent of turnover which means you don't have a lot of margin for error," said Marco Dunand, chief executive of Switzerland-based trader Mercuria Energy Group.

Amid such trading conditions hedge funds are bowing out. Oil trader Andy Hall's main fund at Astenbeck Capital Management LLC closed down last August, while Madava Asset

Management led by veteran energy trader George Taylor and New York-based Jamison Capital Partners LP have also shut down funds.

—Jon Sindreu and Patricia Minczeski contributed to this article

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Corrections & Amplifications

The Organization of the Petroleum Exporting Countries is an oil cartel. An earlier version of this article incorrectly stated the name as the Organization of Petroleum Producing Countries. June 1, 2018.

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