Oil Options Lure Banks on Calmest WTI Since ’96: Energy Markets

By Stephen Voss

Jan. 31 (Bloomberg) -- The lowest oil volatility in 17 years is pushing down options costs, setting up trades that BNP Paribas SA and Commerzbank AG say will profit when Mideast supply disruptions send prices swinging again.

BNP in Paris recommends buying contracts that pay should crude advance and financing them by selling bearish puts. New York-based Goldman Sachs Group Inc. said the drop in oil volatility is “too much too soon.” Commerzbank sees value in bets on Brent climbing toward $130 a barrel.

“It’s a very good time to buy options,” said Hakan Kocayusufpasaoglu, chief investment officer at hedge fund Archbridge Capital AG in Zug, Switzerland. “Risks like geopolitical dangers and potential for supply disruptions remain, and have to be priced in again over time.”

“Major risks have been priced out but the market has overshot,” Archbridge’s Kocayusufpasaoglu said of the drop in implied volatility.

Volatility has subsided as the threat to oil demand from economic collapse in Europe recedes and as booming output in the U.S. provides a safeguard against disruptions to Middle East exports. Algeria’s energy sector suffered its deadliest attack in five years this month, igniting concerns about the vulnerability of North African supplies almost two years after Libyan exports were halted by a national rebellion.

Implied volatility, a measure of expectations for price changes derived from options for the rolling second-month West Texas Intermediate crude, fell to 20.5 percent on Jan. 25, the lowest since a level of 20.4 on Jan. 4, 1996, according to data from the New York Mercantile Exchange compiled by Bloomberg. The second-month options contract can often be a more reliable guide to volatility than the first, which fluctuates as investors roll their positions into the subsequent future at expiration.

BNP Recommendation

WTI oil prices moved on average 1.2 percent per day, up or down, last year, compared with 0.6 percent so far this month, exchange data compiled by Bloomberg show. Spreading those changes over an average of 10 days for a smoother measure of volatility, the level sank to 0.41 percent on Jan. 10, the smallest in at least a decade. WTI was down less than 0.3 percent today at $97.67 a barrel in electronic trading.

“We forecast a steep increase in price over a short period of time,” said Harry Tchilinguirian, head of commodity markets strategy at BNP Paribas in London, who predicts an average of $105 for WTI this quarter and $120 for Brent. “If we are proven correct in this price assessment and time, then we can see a simultaneous rise in volatility and price.”

Fahd Death

The two advanced simultaneously when implied volatility was last at such low readings in Jan. 4, 1996, three days after Saudi Arabia's King Fahd handed over power to his half-brother, Abdullah. WTI oil futures were then at $19.91 a barrel. Six weeks later, on March 19, 1996, volatility had rebounded to 30.8 percent from around 20 and WTI leapt 22 percent to $24.34.

BNP Paribas advises buying calls that give the right to purchase April WTI contracts at $100 a barrel and selling puts that allow the sale of these futures at $95. The strike prices are on either side of the current futures level of about $98 and the strategy makes money should crude rally, not fall. The bank recommends gathering additional funding for the trade by selling $110 April calls.

The position cost about 10 cents a barrel as of 11 a.m. London time yesterday, and would appreciate to $1.25 a barrel if April WTI advanced to $100, according to BNP. As each options contract is for 1,000 barrels, that would equate to a profit of $1,150 per contract.

Political Turmoil

The fall in volatility has been excessive because oil remains prone to unprecedented geopolitical turmoil from Iran and Iraq to Sudan and Venezuela, Jeff Currie, New York-based head of commodities research at Goldman Sachs, wrote in a Jan. 13 report. Fluctuations may diminish over longer periods as U.S. shale output caps rallies, while the cost of those new projects prevents prices collapsing, he said.

"While we have sympathy for the view of a structural decline in long-term commodity price volatility, we believe the recent decline is too much too soon," Currie said. "Risks to both the downside and upside have not completely gone away. In other words, we are not out of the woods yet."

Investors can profit from trading options even if futures don't reach the level at which the contracts can be exercised, known as its strike. BNP Paribas advised June 22 buying $90 calls for December WTI, trading at that time for $3.40, and selling $70 puts, then at $3.03. Two months later, the calls were worth $10.59 and the puts 28 cents.

Equities Volatility

Volatility has dropped in equities and other commodities because stimulus by the U.S. Federal Reserve has improved sentiment, according to Tchilinguirian at BNP Paribas. The Chicago Board Options Exchange Volatility Index, which tracks oscillations in the Standard & Poor’s 500 Index and is known as the VIX, fell to 12.43 on Jan. 22, the lowest since April 2007.

Stability in prices has been sought for years by energy companies such as Total SA and Exxon Mobil Corp. seeking to plan long-term investments, and members of the Organization of Petroleum Exporting Countries as they determine social spending programs. Nigerian oil minister Diezani Alison-Madueke said in an interview in Davos, Switzerland, on Jan. 25 that she welcomed the calm.

“We are very pleased at OPEC that it has managed to hold stability for now,” she said. “It is very difficult to say what is going to happen over the next few months.”

Depressed volatility, combined with rising trading volume and levels of open interest, may signal that prices are on the brink of a decline rather than a rally, said Stephen Schork, president of the Schork Group Inc. in Villanova, Pennsylvania.

One Direction

“The market is moving in one direction with a lack of price variance,” said Schork. “But what happens when the buying stops? If momentum stalls, due to a lack of buying interest, then given that the market is already leaning in one direction, you risk a stampede as bulls look to exit their positions.”

Crude is unlikely to plunge as the nuclear dispute with Iran, attacks in Algeria and conflict in Syria support prices, said Torbjorn Tornqvist, chief executive officer and founder of Gunvor Group Ltd, an energy trading company.

The “geopolitical situation and particularly in the Middle East, Iran, Iraq, Syria, North Africa, is extremely worrisome,” Tornqvist said in an interview in Davos on Jan. 24. “All these factors will create volatility. Given the situation I don’t see a significantly lower oil price. The Iranian situation is the key.”

Iran will meet with officials from the International Atomic Energy Agency in Tehran on Feb. 13 to discuss access to its nuclear facilities, which western governments said are engaged in building an atomic weapon. The Islamic republic denies the charge, saying its nuclear program is for civilian use and that international sanctions on its oil exports are unfair.

Upside Risk

“The risks for oil prices are to the upside,” said Eugen Weinberg, head of commodities research at Commerzbank in Frankfurt. “There may be value in options on Brent crude climbing toward $130 a barrel in case of conflict escalation in the Middle East.”

Algeria’s In Amenas gas-processing plant was attacked by militants linked to al-Qaeda on Jan. 16 in a four-day stand-off that left at least 38 workers dead. Several European governments urged their citizens to leave the Libyan city of Benghazi on Jan. 24, citing a threat to westerners.

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