

Opinion

Javier Blas

Wall Street Is About to Take Oil Out to a Wild Party

As prices head for \$90 and beyond, the options market will take the lead in making lots of money.



Waiting to hit the jackpot. *Photographer: HAIDAR MOHAMMED ALI/AFP*

By Javier Blas

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Supply and demand fundamentals drive oil prices. Things like OPEC+ production plans and U.S. driving patterns matter the most – until they don't. That's when the wizardry of Wall Street takes over, giving prices a push up or down beyond what the physical fundamentals warrant.

The oil market is on the cusp of one of those moments.

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For the last 18 months or so, bullish oil traders had been accumulating huge numbers of contracts that give them the right to buy crude at a particular price and time – call options, in the industry's jargon. They've bought thousands of those contracts pegged to \$100, \$105, \$110, \$125 and even \$150 a barrel. For many, they were akin to lottery tickets: a cheap way to bet on surging prices in the future.

At the height of the Covid pandemic, the contracts sold for almost nothing. With lockdowns in place and energy demand weak, the likelihood of oil prices surging to triple-digit levels looked freakish. A year ago, one could buy a \$100-a-barrel call option for December 2022 for just 24 cents a barrel. Fast forward to today: That lottery ticket is worth \$4.2 per barrel. There were even cheaper tickets: The December 2022 call option for \$125 a barrel sold for as little as 9 cents a year ago. Today, it's worth nearly 15 times more: \$1.35 a barrel.

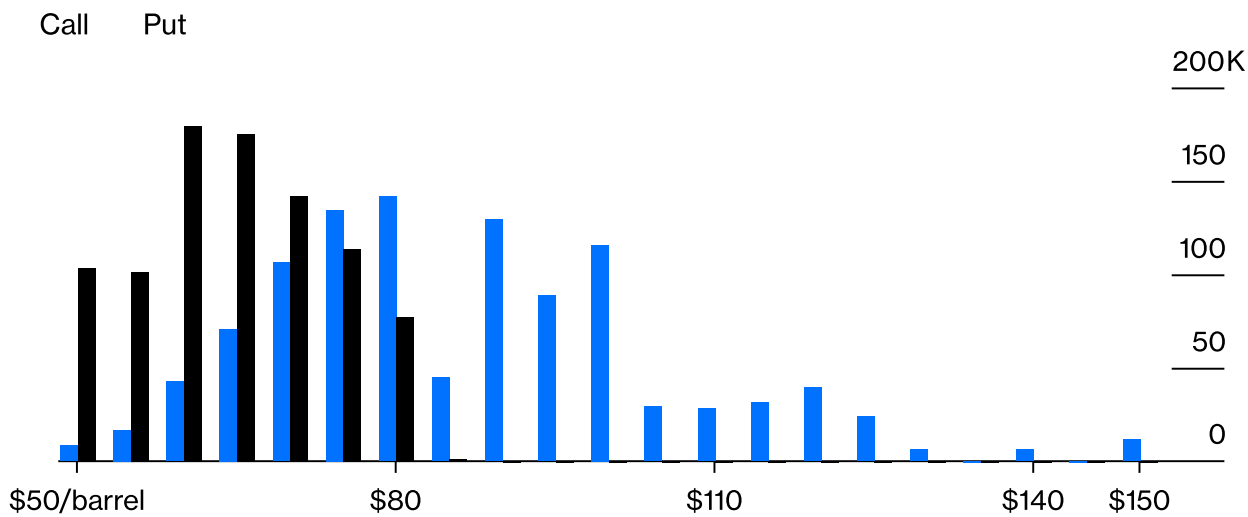
Despite the price surge, few are selling their call options just yet. Instead, many hedge funds and other large investors are patiently awaiting a much bigger prize: for oil prices to rise further so they can exercise their call options in full and enjoy the right to buy crude below its market price.

That's when Wall Street comes to play, with the kind of frenzy that can be deeply addictive or terrifying depending on your tolerance for risk – or how you feel about speculation and commodity prices. It'll also prod the White House, and every other government, already fretting about surging inflation, to panic because higher oil prices mean much higher gasoline prices.

The statistic Wall Street has its eye on is Brent crude, the global benchmark for oil prices. On Wednesday, it hit a seven-year high of \$89.05 a barrel after a key pipeline from Iraq into Turkey was briefly halted following an explosion and fire. That increase has been mainly the result of supply and demand. Omicron hasn't hit consumption as much as feared; meanwhile, OPEC+ is struggling to raise supply, with many countries, including giants like Russia, failing to add extra barrels in December. Oil inventories have continued to shrink throughout mid-January, defying expectations of an oversupplied market.

Lottery Tickets

Bullish oil traders have amassed a large amount of call option contracts above \$90 a barrel, betting on higher prices



Source: Bloomberg

Note: Contract options grouped in \$5 increments. For example, \$50 represents \$50 to \$54.75 a barrel and so on.

At below \$90 a barrel, the oil market has been dominated by the opposite of a call option – a put, which tends to encourage selling from some participants. But once the price hits \$90 and higher, there’s a sea change in the put-to-call ratio because lots of the calls traders accumulated on the cheap will mature – with a concentration around the June and December contracts.

The wizardry of the options market then takes over.

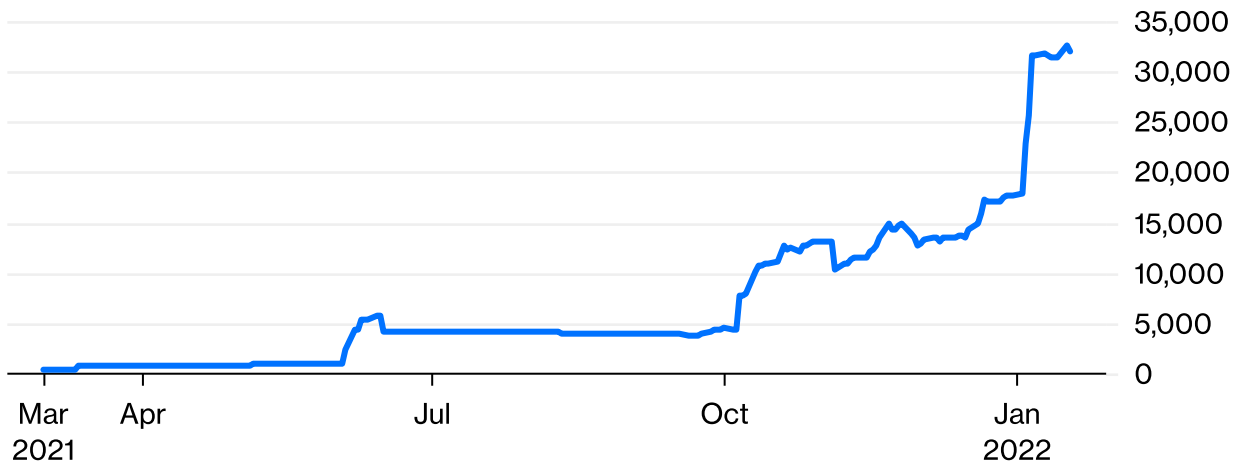
As prices rise toward the value of the call options contracts, the banks that sold the lottery tickets will find themselves on the wrong side of a trade. They are, in all but name, short in a rising market. So they need to protect themselves, and the only way to do so is going long by buying futures. As they do, they risk creating a catch-22 situation: Oil prices rise, banks buy more futures, which trigger further price rises, which commands more buying. It is a situation called gamma, in the jargon of the options market. The oil market has faced similar conditions before, both to the upside and downside.

“If we break above \$90 a barrel, things will probably get spicy,” says Thibaut Remoundos, founder of Commodities Trading Corporation Ltd., which advises oil consumers and producers on options strategies. “As we rise above \$95 and higher, the options market is set up to be a strong tailwind for the bulls.”

Of course, Wall Street alone cannot move the market without strong fundamentals. It’s been the physical market that’s gotten prices this close to \$90. And there may be a bit of a pause in February and March: It’s the time of year when some refiners undergo annual maintenance and crude demand drops. Prices may consolidate.

Triple-Digit Bet

The number of outstanding call options contracts at \$100 a barrel for June 2022 has surged since mid-December as traders bet on higher prices



Source: Bloomberg

But then they'll turn higher. By April, the physical oil market should be stronger while inventories remain very low, particularly when measured by the number of days of forward demand. On Wednesday, the International Energy Agency said that oil inventories in the world's most industrialized countries have fallen to a seven-year low. "If demand continues to grow strongly or supply disappoints, the low level of stocks and shrinking spare capacity mean that oil markets could be in for another volatile year in 2022," the IEA said on its monthly report. With that scenario, oil prices could rise to the level where the options market becomes the place where a lot of money is made.

Over the last month, the number of outstanding contracts, or open interest, for the Brent \$100-a-barrel call option for June 2022 has surged almost 140%, as traders bought more and more lottery tickets. And that's just what's visible on the exchange. In the opaque over-the-counter market, where traders change contracts among themselves directly, volumes could be much higher. If all the stars align, the oil traders, who have held onto their options patiently for months, may finally win the jackpot.

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– *With assistance by Elaine He*

(Updates in 7th paragraph with Iraq-Turkey pipeline disruption; and in 13th with statement from the IEA on oil inventories.)

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To contact the author of this story:
Javier Blas at jblas3@bloomberg.net