Adding Fuel to the Fire

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Background

Global oil prices declined as much as 30% over the weekend after Saudi Arabia took action to instigate a price war on the commodity. This move came after Russia refused to join production cuts with the Organization of the Petroleum Exporting Countries (OPEC). Russia and the OPEC members have operated in a production alliance since 2016 – often referred to as "OPEC+". Both sides also threatened ramps in production to put further downward pressure on oil prices.

The catalyst for the meeting between Russia and Saudi Arabia was to negotiate production cuts in response to falling demand caused by the spread of the coronavirus. Demand from China (the world's biggest importer of crude oil), has collapsed in the face of factory shutdowns and transportation curtailments. In addition, U.S. shale oil production has been growing consistently since 2010, transforming the country from a large oil consumer to a net oil exporter. The oil industry has now simultaneously experienced a demand shock from the slowdown in the Chinese economy with a potential oversupply shock if production curbs are not enacted.

The plunge in oil prices sent shock waves through markets. Stock markets around the globe declined heavily and U.S. Treasury yields reached all-time lows.

Recently oil prices and equities have been trading in tandem as the commodity is often viewed as an economic activity barometer. Turmoil in the oil market added to spreading fears of Covid-19. Over the past month, the outbreak has spread beyond China to 100 additional countries, as the number of cases approaches the 115,000 mark.

From 2014 to 2016, Saudi Arabia waged a similar price war on oil in an attempt to squeeze out American shale producers. During this time, there were spikes in market volatility and equity market declines as oil prices plummeted by 70%. As the market and businesses adjusted to lower global oil prices, the S&P500 experienced two separate double-digit drawdowns (greater than 10%), and recovered from these losses within a few months. In late 2016, Saudi Arabia ended that oil price war and started the OPEC+ production cut collaboration previously referenced.

How will this impact the global economy?

Countries with heavy dependence on oil production and export, such as the U.S., Canada and OPEC members will suffer the most. In many cases, production costs surpass the current price of oil and thus the declining economics will cause a production curtailment and in turn lower revenue, profitability and GDP growth.

Other areas of impact are more directly connected to financial markets and liquidity conditions. Many oil companies are financed through high yield bonds or equity issuance and are heavily dependent on this source of funding. As long as this price war continues, access to liquidity or additional funding for oil producers will be limited.

Another indirect impact is the negative wealth effect due to lower employment and wages earned in the oil industry – especially in countries like Canada, that rely heavily on the sector for economic growth. This will in turn impact discretionary spending, durable goods purchases and home buying in affected regions.

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What does this mean for the major asset classes?

At the onset, equities and cyclical commodities will be the most negatively impacted. Defensive equities such as utilities and consumer staples will be beneficiaries as investors can typically avoid the uncertainty in the growth outlook with these companies. Gold will also continue to be a sought after asset, as long as the uncertainty persists. Although government-backed bonds have been a stand-out outperforming asset class in recent market turmoil, the current low level of interest rates across the yield curve, leave a diminished amount of room for capital appreciation from current levels.

It is worth noting that some asset classes will be disproportionally affected, given their composition. For example, the high yield market is highly populated with energy companies and if low oil prices persist, the risk in owning debt in high cost producers is high.

Are we adjusting portfolios?

To date, we have not made any adjustments to allocations within client portfolios in response to either the coronavirus or the latest oil price shock. While both events have contributed to a substantial level of uncertainty for investors, the lack of clarity on future risk to the economy remains the issue. In the case of plunging oil prices, given the pain endured by the 30% decline in recent oil prices, it is not out of the question that OPEC members and other large producing countries will return to the negotiating table.

With the coronavirus, we maintain that policy support, fiscal stimulus and containment efforts globally will be required to move past the peak of the crisis. This will then create a more attractive environment for riskier assets such as equities. The best strategy remains to stay the course with appropriately diversified investments that are aligned with your long-term financial goals.

ID3522 (03/20)