COMMENTARY

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Increase in Oil Production Makes for Manic Monday

- An oil price war between Russia and Saudi Arabia is sending crude oil prices plummeting.
- The oil shock comes at a time when investors were gauging the impacts of COVID-19.
- We expect more market volatility and recommend diversification and working with your financial professional to stay on track with your financial goals and objectives.

Over the weekend, Saudi Arabia's state-owned oil company decided to cut oil prices by ramping up production. This seems to be part of a plan to steal market share from Russia after the two countries failed to reach an agreement on oil prices. As a result of this new price war, U.S. crude oil prices fell over 20% to around $30/barrel. This also impacts U.S. shale producers. Aided by new technology, the breakeven cost for drilling shale has been coming down, but U.S. shale producers generally can't make money with oil prices under $50 a barrel.

The price war sent stocks and high yield bonds sharply lower. The oil and gas sectors make up over 10% of the high yield bond market and equity investors were already jittery over the new COVID-19 virus so the news of a price war only amplified investor worries. U.S. equity futures markets fell over 5% before the market open, triggering circuit breakers which halted trading. After markets opened, the S&P 500 fell over 7% triggering circuit breakers on the New York Stock Exchange. This halted trading for 15 minutes at the open. At the point of this circuit breaker, the S&P 500 was down roughly 19% off its all-time high in February. A decline of 20% off its highs at the market close, would signal a technical end to the current equity bull market. The slide in equities has investors fleeing to high-quality government bonds and safety. Government bond yields, which move in the opposite direction to bond prices, fell to all-time lows. The benchmark 10-year Treasury yield fell below 0.43% for the first time ever.

The oil price war has exacerbated the global market weakness that was already suffering from the fallout of COVID-19. We do believe that the current market situation will worsen before it gets better for many reasons. The biggest worry relates to the timing of this oil price war and COVID-19. Unlike most prior market shocks, COVID-19 has affected both the supply and demand sides of the economy. Potential travel limits, factory closings, and school closures impact the supply side – the ability of economies to produce goods and services is reduced. On the other hand, fewer trips to malls, restaurants, and sporting events impact the demand side and result in lower consumer spending. Furthermore, sharp stock market drops also contribute to lower consumer demand as household wealth is impacted. These supply and demand impacts can also be linked as factory shutdowns which can reduce the income of consumers, which consequently reduces their spending. Using China as a proxy for potentially how bad the economic fallout could be due to COVID-19, some examples include the 80% drop in February car sales and the 17.2% overall drop in Chinese exports during January and February.

Turning to oil, with oil prices down over 20%, the profitability and incentive to drill for oil in the U.S. is reduced. Since the oil and natural gas industry supports 10.3 million U.S. jobs and nearly 8% of U.S. GDP (API.org), less drilling will likely impact the U.S. labor market and overall economy, especially as you factor in related jobs and reduced consumer and business spending. Furthermore, with less oil drilling, we may also see an increase in bankruptcies for smaller oil drillers. This risk and concern have been reflected in the recent jump in high yield bond spreads as most small oil drillers have borrowed in this part of the financing market. Investors are concerned that many of the companies may go bankrupt, therefore reducing the likelihood of getting paid back.

While the market impact will be decidedly negative for the foreseeable future, we do have some causes for optimism beyond this near-term pain. First, as seen by the plateauing number of cases and deaths inside its borders, China has provided the world with a game plan on how to deal with the virus including reduced social contact and monetary stimulus. With some signs of economic normalcy emerging in its borders, as people have returned to work and started to spend money, China has shown the world that there is a potential light at the end of the tunnel. Also, the sharp drop in oil prices is an economic boon for their economy. For example, in 2019, China imported a record 506 million tons of crude oil (10.12 million barrels per day), according to data from the General Administration of Customs. Lower oil prices will help their economy. Investors have taken notice of signs of economic improvement and lower oil prices as the Chinese stock market is not hitting new market lows as seen in other countries.

Another case for optimism is global central banks and, in particular, the Federal Reserve (Fed). While the Fed has already cut interest rates by one-half of one percent, there are signs that further rate cuts are extremely likely. While there is likely more economic pain as COVID-19 spreads in the U.S., once cases plateau like they did in China, the combination of lower interest rates and oil hovering around $30/barrel has provided consumers with essentially a tax cut.

Lastly, the sharp decline in stock prices has led to more reasonable market valuations. At the high on February 19, the S&P 500 had a price-earnings ratio of 19.5X on forward earnings. Today, it hovers around a much more attractive 16X earnings.

Markets are moving fast as investors digest new information. We remind you that markets can move quickly in both directions though. Last week is a good example of that. It is widely known in behavioral finance that the pain of losses hurts more than the reward of gains. That's why we tend to remember the losses more. Last week, the S&P 500 actually posted a gain of 0.60%. After some pretty rough days, it was easy to forget the S&P 500 was up 4.22% last Wednesday. This is an extremely volatile market and being diversified is very important by not having too much risk exposure to one asset class or security. Focusing on long-term risk and return objectives is important. Your financial professional can help you stay on course and focus on the things you can control in your portfolio.

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