

Extraordinary times... winners and losers in the oil game

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We are living and investing in extraordinary times. Investors face a 'perfect storm' of risks which are correlating and affecting markets. The largest headlines are being generated by the movements in energy markets as Brent crude oil has fallen by 45% so far this year in US dollar terms. The implications of this dramatic fall are many and varied; the most obvious are the benefits for the US consumer and the developed world more broadly. The impact at US gasoline pumps is material and immediate, and should boost consumer spending in due course. A falling oil price also reduces inflationary pressures, and is one of the reasons US bond yields refuse to rise, despite the prospect of stronger growth and higher short-term interest rates next year.

The reduction in inflationary pressure also applies to Europe and Japan, as they rely on energy imports. Both should see benefits in input costs and inflation at the current level of the oil price. For Europe, however, where the ECB is grappling with deflation and its potential consequences, and with borrowing still high, this deflationary shock has come at the wrong time. We shall have to see if this is the catalyst for the introduction of sovereign quantitative easing (QE) in the first quarter of 2015, as the consensus now suggests.

For the emerging markets (EMs), the movement in energy prices is a major challenge, although there are exceptions. The accompanying dollar strength has historically been a headwind for EMs, and the current experience looks no different. The fall in the oil price, whilst of benefit to India, Turkey and other EM energy importers, is a catastrophe for EM oil producers. For Venezuela, where oil comprises 90% of the budget, the market response has been brutal. For Russia, which is also grappling with Western sanctions, the impact on the currency has been extreme and it appears there is no level of interest rates that would steady the rouble. The risk of a financial accident somewhere must be rising, as must the risk of an outbreak in geopolitical tensions. Whether the result is a run on the banking system, or armed response to food shortages, parts of the world are currently under acute pressure. What happens next is very unpredictable.

The fall in the oil price is difficult to fathom. Whilst US shale production has boosted supply, and weaker global growth has moderated demand, the fall in the price has been much greater than might have been expected. Initial theories suggested it was a Saudi Arabian response to increased US production, and an attempt to force the closure of the more expensive and only marginally profitable US wells, thus restoring Saudi Arabia's position as the largest 'swing' producer (i.e. the producer that seeks to balance supply and demand). OPEC is a shadow of its former self, unable or unwilling to reduce production to restore some equilibrium to the oil market. Pressures on producers' budgets are acute at current prices, and the risk must be that they increase production to boost cash revenues even at the current reduced level of the oil price. For resource companies, capital expenditure (capex) programmes have long lead times, so cash flow will start to deteriorate quickly (even for the large firms), and balance sheets and shareholder returns will come under pressure.

Many investors have already felt the impact of the falling oil price. In US high yield, for example, investors have seen the asset class underperform European high yield by over 300bps this year and year-to-date returns are flat whilst other bond markets have been rampant. This is because energy comprises 15% of the US high yield universe and energy companies have been the largest issuers over the last few years. Defaults in this sector will increase sharply if the current oil price persists. Stock-specific risk will also increase.

Returning to the US, it is worth considering whether the weaker oil price is unequivocally good news. Analysis would suggest that oil exploration and production have been big drivers of US capex and employment growth over the last few years, and both are set to fall as oil companies react to a new economic reality. Much has been made of corporate America's competitive advantage derived from the assured supply of cheap energy; this is an investment thesis we may need to reconsider. Let us hope that US consumers continue to spend their gas pump windfall to help keep the economy moving forward.

Where does this leave us from an asset allocation perspective? With powerful deflationary forces at work in the global economy, real yields have started to rise, reflecting falling inflation. Core government bond yields are likely to stay at the lower levels, reflecting lower growth and lower inflation, although they will have to contend with the first rise in US short-term interest rates at some point next year. This anchoring of the yield curve will continue to support higher-yielding assets, although both equity and credit valuations are much less attractive than they were, despite an encouraging corporate environment.

Within equities, we need to reflect on the strong outperformance of the S&P 500, and consider whether the story has now moved on, particularly if we are on the verge of sovereign QE in Europe. EMs remain challenged, both by dollar strength and weak commodity prices, although as ever there will be both winners and losers. Whatever the outcome, it is not an environment in which investors should be too exposed to risk, as events are conspiring to challenge the global economy and financial system. It is going to be a very interesting 2015!