Taking Nothing for Granted

- **Brent oil price possibly through $70 and beyond**
- **Persistence of high oil prices dependent on how long Saudi supply outage will continue and the degree to which investors price a higher geopolitical risk**
- **Fed has a dilemma – but may still cut**
- **Bond may have already discounted the bad near-term news**
- **Equities vulnerable**
- **Negative eurozone rates should support yielding eurozone assets**

How much the world can seemingly change in a week. You can never take it for granted that the trend is your friend. Bonds that seemed the inevitable safest asset class saw widespread (panic) profit taking last week as the US and China started a more constructive dialogue on trade talks. In the equity market previous winners became significant losers. And to put literally oil on the fire an attack on Saudi oil fields is putting the risk of inflation back into investors' minds. You can take nothing for granted.

A burst of inflation is not something the markets are prepared for. The potential length of a likely spike in oil prices from the events in Saudi Arabia could be very challenging for the financial markets in the coming weeks.

Oil sharply higher… but for how long?
What a difference a few days make. Brent crude oil prices had ended last week lower by 5.7% from their weekly high at $60.15. The technical analysts will see the July peak of $67.5 as near-term targets for Brent. Beyond that, the April high of $74 looks quite possible.

The initial knee jerk rise in oil prices is likely to be of the order of $10-15 bbl. There are several mitigants to a sharper increase in oil prices. Firstly, OPEC and Russian production cuts are holding supply back from the market. Hence several OPEC countries could just up their oil production. Secondly, Saudi Arabia has said it is prepared to release oil from its strategic reserve. Thirdly the US could release oil from its strategic reserve. Extra production and releases from strategic oil supply all take time.

The market could spend up to a month righting itself from the imbalances in the market as Saudi is unable to fulfil its contracted commitments. At this stage, we don't know the full extent of the damage, although it is reported that Saudi may have lost around 50% of its output. Such a shortfall would amount to approximately 150m barrels of oil per month that would need to be made good in the market.

The geopolitical risk premium for oil must rise, ironically reversing the presumed dip in assumed risk after the resignation of White House hawk John Bolton last week. Given the scale of the attack and the seeming ease with which the oil fields were impacted a $5-10 extra premium for risk appears very possible.

The impact of the rise in oil prices is likely to be felt quite quickly by consumers. US motorists had been enjoying a $2.56 average price at the pumps down substantially from $2.85 a year ago. If the oil price were to just rise to the oil peak that could potentially take the pump price up to $2.80.

The Federal Reserve has a dilemma

The initial reaction of the financial markets may be to hope that the rise in oil prices and the impact on inflation will prove transitory. However, the US Federal Reserve has a headache probably wishing they didn't have a policy meeting this coming week. The FOMC policy-setting committee already had an internal debate underway assessing whether they needed to give the market a further cut this coming week.

Bonds already discount higher oil prices?

Bond markets will be anxiously watching this week's Fed meeting. Before this weekend's turn of events in the oil market, economists were expecting a 25bps cut. However, the market can't be sure the Fed will deliver. The past few days has seen some relenting in the hostility of trade wars and a probable but undefined rise in inflation due to oil prices. Remember that the last print of headline inflation was 2.4%, comfortably ahead of their 2.0% target. US core inflation quarter on quarter is now running at the strongest level since 2011.

On other measures, the Fed should not be easing off their monetary-policy-loosening pedal. Recent major industrial confidence surveys have been weaker than expected; however, one has to assume that good measure of that weakness has been due to the uncertainty around the trade war.

Bottom line the Fed may not want to disturb the market too much after last week's volatility and hence is likely to follow through on a 25bps cut. However, they may also signal to the market that their perceived pace of loosening is slower than that priced by the market.

Bond markets are almost prepared for a spike in inflation risk after the sell-off of the past ten days. Last week the market marked government bond yields higher with a vengeance. 10-year Treasury yields rose 33bps on the week to 1.90% the largest weekly rise since 2016.

Last week's rise in US government bond yields was primarily driven by a more sanguine view about the trade talks after both the US and China signalled some relent in the tit-for-tat rounds of rises in duties. China announced it would buy some agricultural products while the US delayed its tariff increases on $250 billion worth of goods by two weeks. The market may have also taken the better than expected retail sales figures that showed auto-related shopping pushing overall retail sales up 0.4% month-on-month at face value.

Equities vulnerable?

Equities look more vulnerable than bonds in the very near term. Equity markets will be worried that the rise in oil prices will crimp global growth by squeezing real income growth and potentially slowing the pace of interest rate increases. If the Fed were to endorse such a view by indicating that they were in no rush to continue to cut interest rates beyond the presumed cut this week, then equities could see material profit-taking.

The challenges for the equity market come after a tumultuous week in the markets where there was substantial rotation between sectors. Modest rises in the equity markets masked marked reversals of previous winning sectors in favour of sectors that had previously lagged. As one trader put it "it was like a four standard deviation event followed a day later by another four standard deviation event".

The ECB was lucky to have its meeting ahead of events in Saudi Arabia, although we doubt it would have made much difference to their decisions. The ECB cut its primary policy rate to negative 0.5%, and it resumed its bond purchases. The ECB will buy 20 billion euro of eurozone bonds. However, the German and Dutch central banks opposed the decision.

Buy yield in the eurozone

We continue to be surprised at how yield still hangs around in the eurozone asset markets despite the likelihood that the ECB will likely have to maintain negative rates for some time to come. In the equity market, the utility sector performed well in the aftermath of the ECB announcement but still offers a yield of 4.6%. Investors can routinely find 4-6% yields in the commercial real estate market. I recently noted a property in the Netherlands that had a yield of over 4.0% with a single A eurozone based tenant on a long lease. That same tenant has a 10-year bond in the market priced at a yield of just 40 basis points.

Gary Dugan, Johan Jooste, Bill O'Neill (Consultant)

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