Oil Price War Fuels Another Market Sell-Off

March 9, 2020

Ben Pace, Chief Investment Officer

The breakout of an oil price war between OPEC and Russia further roiled the financial markets over the weekend and today, increasing the anxiety of investors already concerned about the global economic impact of the coronavirus.

It all began when Russia refused to cut an additional 1.5 million barrels per day (bpd) on top of the 1.7 million bpd to which they initially agreed. Russia ostensibly did not want to help U.S. shale producers by artificially supporting oil prices. In retaliation, the Saudis surprised everyone by offering crude oil at steep discounts and announcing they would increase production when the current production agreement ends on April 1. Oil prices fell roughly 20% overnight.

Lower oil prices are negative for energy producers, but a net positive for global economic growth as consumers ultimately benefit from lower gasoline and heating oil prices. High-energy consuming industries such as airlines will also likely benefit. However, they will likely suffer more in the near term from lower demand and passenger cancellations. Consumers may hold off spending any cost savings until the crisis passes. If oil prices remain at these lower levels, capital spending in the energy sector will drop. The high-yield debt sector, of which nearly 15% of outstanding debt has been issued by energy companies, has come under pressure today with prices off approximately 5% for the average issue.

Regarding the coronavirus, several U.S. states have declared emergencies, events have been canceled, and some schools and universities have been closed. People who can work from home are being encouraged to do so, especially in the more heavily impacted western states. Outside the U.S., Italy has locked down the northern provinces, including Milan and Lombardy. Unfortunately, these are important industrial sectors, which puts even more pressure on the country's struggling economy.

While the general population rightly fears the spread of this new virus, financial markets fear the reaction, and the potentially draconian attempts to contain it. Various federal, state, and local authorities, as well as businesses, are feeling intense pressure from the population and the media to take some action. Quarantines, travel bans, and plant closings have been ordered or are being contemplated. Should these potential steps be implemented, the period of lost production will have a direct impact on the global and U.S. economies. As it will take time for these measures to have an effect, we are anticipating a U-shaped recovery. Historically, we have experienced a V-shaped recovery after natural disasters, where the production lost in one quarter is made up rather quickly in subsequent quarters.

We are now awaiting policy responses as well as the seasonal dissipation of flu viruses to better assess the near-term economic damage. Looking at China, the epicenter of the outbreak, gives us some information. In addition to taking the rather harsh steps of mandatory quarantines and travel bans, China has aggressively expanded both monetary and fiscal policy to combat the economic impact of effectively shutting down the economy for the month of February. These combined responses appear to have slowed the spread of the virus. Additionally, China's markets and currency have shown strong relative performance over the last week. The virus also seems to be slowing down in South Korea.

The monetary policy response in the U.S. was even more aggressive than China. The Federal Reserve cut its benchmark rate 0.50% (50 basis points) last week to a range of 1.00%-1.25%. Another rate reduction is highly probable at the bank's March 18 meeting. With the bond market calling for a 0.75% (75 basis points) cut to a range of 0.25%-0.50%, it would not be surprising for the Fed to act sooner. Additionally, look for quantitative easing to resume, which involves the purchase of longer-term securities. The Bank of Canada and the Reserve Bank of Australia joined the Fed in cutting rates last week. There will be intense pressure on the European Central Bank to also provide support. A 0.10% (10 basis point) cut in its deposit rate to -0.60% is likely, so is an announcement of a higher rate of corporate bond purchases, and a reinforcement of their targeted liquidity provisioning program.

As some believe monetary policy is not very effective in resolving supply shock slowdowns and with some central banks having exhausted traditional easing methods, many are calling for a more aggressive fiscal policy response. Several countries, including the U.S., have appropriated emergency funding for dealing with the virus. Expansion of paid sick leave and help for companies facing immediate disruptions are natural and rather easy policy prescriptions. However, this could also be a good time to have various global parliaments, especially the U.S. Congress, pass more sweeping spending and tax policies to help cushion the ultimate economic blow from lost production.

The condition of the U.S. economy before the outbreak gives us the most confidence in our forecast of no recession and a recovery in the second half of the year. In another time, without the threat of a global viral infection, we would be singing the praises of a U.S. economy continuing to grow jobs at a historically high rate and sitting at 3.5% unemployment with no inflationary pressures. Businesses were also spending on capital projects, particularly on software and technology. While it would be nice to see bond yields stabilize and stay out of negative territory, the consumer and housing industry will benefit from the lower rate environment as long as employment remains stable.

The enactment of stock market circuit breakers due to the sharp fall in equity prices on the open is admittedly disconcerting to the investment community. The spread of the coronavirus and its ultimate impact on human health and the economy remains highly uncertain. The pressure on the high-yield bond market could exacerbate the wealth effect of equity market weakness and slow consumer spending a bit more. However, with the Fed providing ample liquidity to prevent any kind of freeze, the lack of any inventory excesses, and the inherent strength of the U.S. economy, we remain confident the economy will recover most of the lost production and return to our expected 2% growth trend. Equity markets are currently in the process of retesting the lows reached last week. Finding a bottom may take weeks as opposed to days. Therefore, we are not compelled to implement any tactical moves at this time even though we remain bullish with 95% of S&P 500 stocks currently yielding more than the 10-year Treasury note.

Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, he was Chief Investment Officer, and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.

Cerity Partners LLC ("Cerity Partners") is an SEC-registered investment adviser with offices in California, Colorado, Illinois, Ohio, Michigan, New York and Texas. This commentary is limited to general information about Cerity Partners' services and its financial market outlook, which may not be suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this piece will come to pass. Investing in the financial markets involves risk, including the risk of loss of the principal amount invested; and may not be appropriate for everyone. The information presented is subject to change without notice and should not be considered as an offer to sell or a solicitation of an offer to buy any security. All information is deemed reliable but is not guaranteed. For information pertaining to the registration status of Cerity Partners, please contact us or refer to the Investment Adviser Public Disclosure website (www.adviserinfo.sec.gov). For additional information about Cerity Partners, including fees and services, send for our disclosure statement as set forth on Form ADV Part 2A using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

©2020 Cerity Partners LLC, an SEC-registered investment adviser. All Rights Reserved. (03/20)