Macro Monthly

UBS Asset Management
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- Rising geopolitical concerns, disciplined supply from OPEC countries and lower-than-forecast production in the US have driven Brent Oil to USD 75.
- The negative potential impact of higher oil prices on US consumption growth is cushioned by the larger role of oil production in the US economy and by tax cuts that are boosting disposable incomes.
- Oil prices boost headline inflation and breakevens, but not real yields. Thus the higher oil price supports our underweight in global duration but has not shifted our positive view on global demand growth and global equities.
- Exposure to commodity-linked assets may provide useful diversification benefits late in the economic cycle.

What do higher oil prices mean for markets?

Last month, the price of Brent oil reached USD 75, its highest level since 2014. Just over two years ago, the dollar cost of a barrel of oil was as low as USD 28. And just as the USD 85 drop in oil prices from 2014 to 2016 was central to the global economic and market environment then, the recent rise in oil has implications for investing today. In this Macro Monthly we examine why oil prices have been rising, what it means for the global economy, and implications for asset allocation.

As with any asset price, oil is driven by supply and demand. On the demand side, oil was impacted by a slowdown of global growth, driven in particular by China and other emerging markets, from 2014 to early 2016. On the supply side, Saudi Arabia made a strategic decision to flood the market in an attempt to regain market share—lowering the price via increased supply to make higher cost US shale oil companies sufficiently unprofitable to cease production. Finally, the 25% gain in the trade-weighted dollar over this period also weighed on the commodity. The rebound in oil over the last two years largely reflects an unwinding of these conditions. The global economy rebounded sharply over the course of 2016, supported by Chinese stimulus and extraordinarily easy monetary policy from developed market central banks. Meanwhile, domestic considerations led Saudi Arabia to not only reverse its own policy of oversupply, but spearhead an OPEC+Russia agreement to cut production sharply. Dollar strength has partially unwound, which has also boosted oil.

Last year, most energy analysts originally forecast oil prices to remain in the USD 40 to 60 range, anticipating that any significant rise in oil prices would be met with a sharp increase in US shale oil production. However, US production has disappointed as many energy companies have either focused on repairing balance sheets damaged by the 2014-2016 oil collapse or faced production bottlenecks including congested pipelines and input shortages. While US production is missing estimates, OPEC+Russia adherence to agreed supply cuts has been remarkably disciplined compared to prior agreements. As such, demand has outstripped supply and inventories declined (Exhibit 1). Tighter balances have left the oil market more vulnerable to supply shocks such as in Venezuela and to the possibility of a re-imposition of export sanctions on Iran, a major oil producing country. Moreover, with Saudi Arabia keen to sell a stake in its USD 2 trillion-valued national oil company Aramco, the Saudi leadership has a strong incentive to continue supporting oil prices. While US shale production is still projected to ramp up further, tighter balances and geopolitical developments have skewed risks to the oil price to the upside in the near-term.

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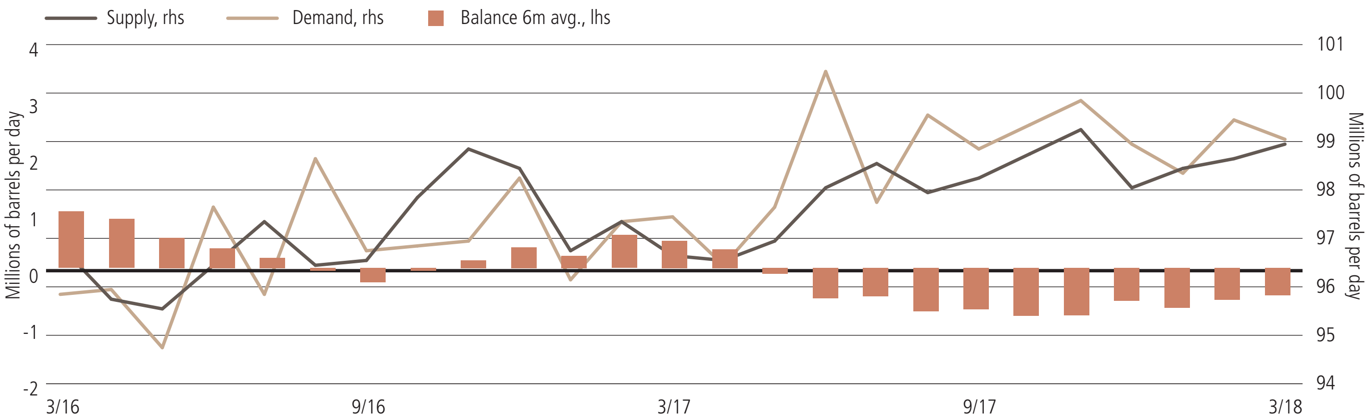
Exhibit 1: Global oil demand has exceeded supply since 2017, bringing balances into deficit



Source: Energy Intelligence Group, Bloomberg, UBS Asset Management

Implications for the economy and markets

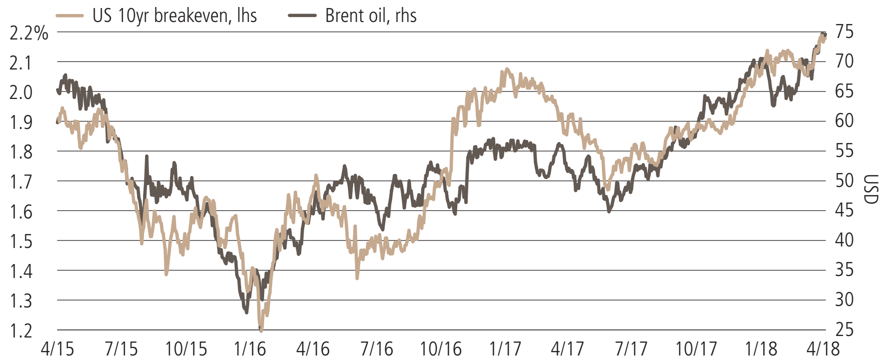
An oil price rise is a tax on consumers in oil importing developed economies and a windfall for major oil producing countries, many of which are emerging markets. Prices of 'at the pump' gasoline have risen steadily in the US, which was part of the reason for softer consumption in US Q1 GDP. But as the shale revolution has made the US one of the world's largest oil producers, energy has become an increasingly important part of the US economy, driving employment and capital expenditure (Exhibit 2). Moreover, tax cuts are starting to boost disposable incomes, which should cushion the negative impact from higher energy costs. And while the oil price rise is filtering through to higher headline inflation, it is excluded from the Fed's preferred Core Personal Consumption Expenditures index. As an input cost across industries, there will almost certainly be some pass-through of higher oil prices to core measures, but the Fed is likely to look past higher energy costs and focus on the trend in less volatile underlying inflation. As such, we do not see the rise in oil prices as automatically leading to a faster pace of Fed tightening.

Exhibit 2: US has become a major oil producer

Source: UBS Asset Management, Macrobond.

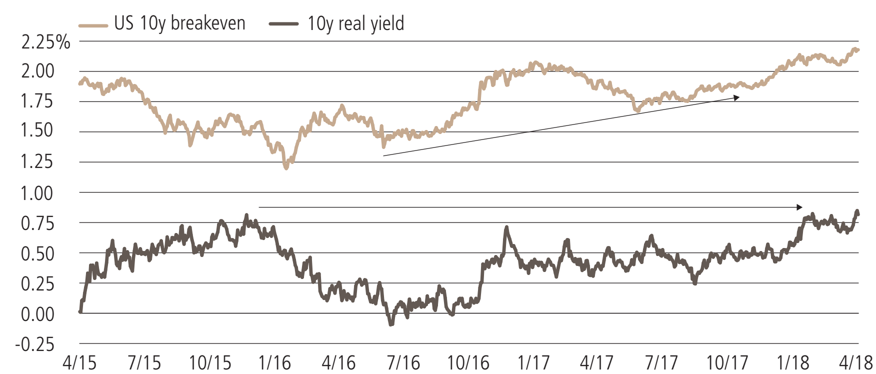
Higher oil prices have been a key driver of government bond market volatility and as a byproduct, much of the equity market volatility observed this year. However, when breaking down interest rates into key components of real yields and expected inflation rates—often referred to as 'breakevens'—we find that higher oil prices explain much of the rise in breakevens (Exhibit 3). This makes sense, as investors in inflation-protected US Treasuries are insulated from gains in headline, as opposed to just core inflation. And while real yields rose to start the year, largely reflecting the effects of expansionary fiscal policy in the US, they are generally in the range they've been in for the past five years (Exhibit 4). Thus, even though nominal yields have risen, there has not yet been a sufficiently meaningful tightening of financial conditions resulting from higher rates to believe a US recession or a major drawdown in equity markets is imminent. Exhibit 5 shows how recent major bear markets in equities tend to require a convergence between real GDP and real yields. Higher oil prices are not likely to drive the former much lower nor the latter much higher. In short, while we do see further potential downside to bonds from higher oil prices via higher breakevens, we do not see it as a meaningful threat to global equities.

Exhibit 3: Oil explains much of the rise in inflation breakevens



Source: UBS Asset Management, Macrobond.

Exhibit 4: Breakevens have trended higher in recent years; real yields in a multi-year range



Source: UBS Asset Management, Macrobond.

Exhibit 5: Major bear markets happen when equities and real yields converge

Source: UBS Asset Management, Macrobond.

In addition to more recent dynamics, commodity prices tend to outperform late in economic cycles as demand outstrips supply constraints. Amid historically unstable correlations between bonds and equities, commodities exposure may provide some compelling diversification properties for multi-asset investors. They also provide some hedge protection against a rise in certain geopolitical risks, particularly escalation in Middle East tensions. Where investors are not able to invest directly in commodities, energy stocks, inflation-linked bonds and energy high yield credit provide alternatives. There are opportunities in FX too—we currently see value in the currencies of major oil producers such as Norway and Colombia.

The bottom line: Asset allocation

While energy prices can remain elevated near-term, we suspect that ultimately US production will ramp up further and Brent oil will stabilize in a USD 60 to 80 range. But in any case, the rise in oil prices is consistent with our underweight in global duration. At this point we do not expect higher oil prices to negatively impact growth in developed markets enough to shift our equity overweight. Oil sensitivity in emerging markets differs by region and by country, but in general the rebound in commodities should support broad-based EM asset strength. Yet independent of forecasts for any particular commodity, exposure to commodity-linked assets can provide useful diversification benefits for multi-asset investors late in the economic cycle.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

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