November 19, 2018

Over A Barrel

Seven weeks ago we wrote about the nascent, albeit burgeoning bull market in crude oil. West Texas Intermediate (WTI) crude at the time was having a moment in the sun, trading up to around $75 per barrel, a year-to-date high. Brent crude, WTI's equivalent from across the pond, was trading at around $85 per barrel, also a year-to-date high after climbing from roughly $70 just six weeks prior. The parabolic move higher in price for the commodity was attributed to impending U.S. sanctions on Iran that would prohibit U.S. allies from obtaining Iranian crude, in theory at least, and supply-related angst tied to an OPEC meeting where member and non-member nations expressed no desire to increase production to make up for lost Iranian supply on the global market. Oh, how quickly things can change!

Shortly after we wrote that further upside in crude prices was possible into year-end given the aforementioned supply dynamics, the whole situation turned upside down. As of the end of last week, WTI was trading around $57 per barrel, while Brent traded closer to $67, declines of 25% and 22%, respectively, from year-to-date highs reached back in early October. So, what caused the precipitous drop in crude prices and where are prices likely to go from here? Moving into October, markets developed serious concerns surrounding whether crude inventories ex-Iran would be sufficient to meet global demand, and at that time OPEC had no cause to increase supply as prices crept ever-higher. Variables have since changed, and significantly so. U.S. economic growth had been humming along through the 3rd quarter, but concerns began to arise once we turned the page to October - seemingly out of nowhere, that perhaps economic growth was less than meets the eye. The U.S. had been the one constant glimmer of hope for growth across the global landscape in 2018, so if U.S. growth was in fact slowing faster than expected, who would be left to prop up the global economy?

Fears of a global recession, not just an oft-mentioned and anticipated slowdown, materializing sometime in the near future led to crude long's turning into sellers en masse over the past seven weeks. As if a global growth "scare" wouldn't sufficiently rattle markets and shake confidence, the Federal Open Market Committee (FOMC), up until last week at least, appeared oblivious to this new, albeit mysterious "information" that market participants had been trading on. The FOMC has maintained a hawkish stance on inflation, and the expectation appears to be that rate hikes will rapidly slow U.S. economic growth, lower demand for crude, and lead to significant oversupply and lower prices.

In conjunction with economic slowdown/recession fears bubbling up, the murder of Washington Post journalist Jamal Khashoggi inside the Saudi consulate in Turkey in early October sparked a firestorm as well. Numerous high-level U.S. government officials and corporate executives previously committed to attend and speak at the Saudi Arabian investment conference known as "Davos in the Desert" elected not to attend in the wake of the news, fraying relations between the U.S. and Saudi Arabia. Historically, any potential supply disruption out of the Middle East would have served to send crude prices higher in parabolic fashion, but not this time. President Trump had been pressuring the Saudis/OPEC to increase production amid higher prices, a request OPEC had largely ignored. The murder of Khashoggi, a U.S. resident and vocal critic of the Saudi regime, had the potential to send U.S./Saudi relations spiraling downward, making it more likely that the Saudis and OPEC would ultimately acquiesce to the President's request to increase production in an effort to stay in the good graces of the U.S. At least this was the perception on how the situation would play out. The reality is closer to status quo, as the recent decline in crude prices now has OPEC and the Saudis at the forefront discussing curbing supply to support, or preferably boost, prices.

So, where do we think crude prices are likely to go from here? We believe fears of a recession materializing in early 2019 aren't grounded in reality, and are significantly overblown at this point. We would back the economic slowdown thesis, evidenced by our 2.6% GDP growth estimate for full-year 2019, down from 3% in 2018, but a recession seems unlikely near-term given a plethora of constructive economic data points. Our current situation is likely a case of a jittery market extrapolating one or two recent data points to conclude that we're in for an economic collapse, which is a stretch. If the FOMC softens its hawkish tone into year-end, or should trade relations between the U.S. and China get ironed out at the G20, crude is likely to rebound, as should the market's expectation for global economic growth. Catching a falling knife (crude) isn't advisable, but a bottom could be close in our view, and late in the economic cycle energy-related equities tend to do relatively well, historically.

Eyeing The Dollar

So far, October and November have been downright dreadful months for equities, which is counter to the typical strong seasonal trend. The S&P 500 has declined 6%, the tech-heavy Nasdaq Composite Index is down 9.9%, and the MSCI Emerging Markets Index has continued to take it on the chin, falling another 8.8% in the last 7 weeks or so. One of the few charts we can find that continues to trend up and to the right is that of the U.S. Dollar Index, or DXY. It's no coincidence that as the dollar has continued to rally, stocks have struggled. After climbing some 5.5% from the end of January through June, the greenback marked time from July through September, allowing U.S. equities to rebound, while also providing emerging markets with a chance to come up for air after precipitous declines over the first half of 2018.

The dollar's strength relative to the currencies of our trading partners has been due to a combination of stronger relative economic growth in the U.S. while economic growth abroad has stagnated or rolled over, as well as the normalization of monetary policy by the FOMC while the European Central Bank and Bank of Japan remain accommodative. FOMC Chair Jerome Powell appeared to soften his stance last week, potentially laying the ground work for a pause in the rate normalization cycle after a hike in December, while the economic slowdown scenario addressed in the "Over A Barrel" portion of this commentary appears to be gaining traction among investors. These two variables shifting make it possible that the greenback could have hit a near-term peak last Monday. Time will tell, but there are a few early signs that the tide pushing the dollar higher may be ready to ebb again into year-end.

Source: Bloomberg, Factset

	Price/Yield	Total Return (%)					
	11/16/2018	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	25413.22	-2.15	-1.23	4.87	10.78	16.09	12.43
S&P 500	2736.27	-1.54	-2.43	4.11	7.88	12.33	11.02
NASDAQ	7247.87	-2.09	-5.06	6.00	7.81	14.60	14.01
Russell 2000 Index	1527.53	-1.37	-4.23	0.55	4.06	11.26	7.93
MSCI World ex US	1810.56	-1.47	-2.84	-8.80	-5.65	5.62	2.37
MSCI EM	986.30	0.72	0.23	-12.73	-9.89	9.54	2.36
Bloomberg Barclays US Aggregate	3.55	0.47	0.22	-1.95	-1.59	1.38	2.00
Bloomberg Barclays Global Aggregate	2.21	0.40	-0.40	-3.07	-2.06	2.23	0.59
Bloomberg Barclays US Corporate Index	4.30	-0.18	-0.62	-3.71	-2.64	2.74	3.07
Bloomberg Barclays 10-Year Muni Index	2.86	0.49	0.50	-0.80	-0.57	2.14	3.37
Bloomberg Barclays High Yield Index	7.19	-1.29	-1.95	-0.08	0.79	6.94	4.50

	Price/Yield						
	11/16/2018	1 Week Ago	1 Month Ago	12/31/2017	1 Year Ago	3 Years Ago	5 Years Ago
1 Month LIBOR (rate)	2.30	2.31	2.29	1.56	1.28	0.20	0.17
30 Year Mortgage (average rate)	4.75	4.82	4.75	3.86	3.78	3.87	4.26
2 Year Treasury (yield)	2.80	2.93	2.87	1.88	1.71	0.84	0.30
10 Year Treasury (yield)	3.07	3.19	3.16	2.43	2.32	2.27	2.71
30 Year Treasury (yield)	3.33	3.39	3.33	2.76	2.77	3.06	3.80
WTI Crude (closing price)	56.47	60.19	71.93	60.46	55.14	41.68	93.80
Brent Crude (closing price)	66.79	69.01	80.53	66.73	61.18	40.28	108.55
Gold (NYM $/oz)	1220.80	1206.40	1227.30	1306.30	1277.40	1083.70	1287.30

Source: FactSet

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