Close Brothers
Asset Management

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Investment Insight

An update on market movements

WHAT HAS HAPPENED?

Over the weekend talks between OPEC and Russia broke down which led the world's largest oil producer, Saudi Arabia, to launch a price war. The price of oil immediately fell by nearly a third. About 10% of the UK equity market is composed of oil producing and oil service companies so they in turn fell by c.7% directly dragging down the overall UK equity market by 8% on the open. This in turn has dragged down the value of other companies in the UK as their value in comparison to the oil companies has also fallen – a bit like a domino effect.

WHY DID IT HAPPEN?

The talks broke down over disagreements over production quotas especially between OPEC, led by Saudi Arabia, and Russia. Such an oil price war will directly negatively impact revenues of oil producing nations such as Russia, Venezuela, Iran and, of course, US companies associated with oil production from shale reserves.

WHAT IS OUR VIEW?

While the value of companies associated with oil production will fall, a reduction in the oil price is usually stimulative for oil importing nations and for consumers as a whole, as they consume it for transport (driving and flying) and, in some countries, to heat their homes.

This oil price fall comes as a by-product of weaker oil demand due to the Covid-19 virus, increasing uncertainty over economic growth and stock market volatility.

Central banks have already shown that they are prepared to act to support liquidity, and further action is likely to also take account of any detrimental effects of the oil price fall as well. The UK Budget on Wednesday is likely to contain short-term measures to support the UK economy in the face of these headwinds.

Also, one should remember that, over the long-term, equity returns outpace those of other assets and, in the past, these dips in equity markets have provided good entry points for buying assets relatively cheaply. We believe this is another such opportunity and we will be looking at some point to deploying our cash to buying assets we think are very undervalued compared to their long-term prospects. As a result, we recently reduced our equity target weighting to neutral in order to raise cash for deployment as and when our investment managers see fit.

FAQs

WHY HAS THE OIL PRICE FALLEN?

The spread of Covid-19 meant that the demand for oil was easing as consumers drove and flew less and industry slows. Against this background, the leaders of OPEC, Saudi Arabia, wanted to reduce supply in order to support the price of oil but couldn't get agreement of the non-OPEC partners, such as Russia. The breakdown in the agreement led to Saudi Arabia declaring a price war over the weekend comprising both an immediate oil price reduction and intention to step up supply. As a result, the price of traded oil fell immediately c.30% and may fall further as supply is increased over the coming weeks.

WHY HAS THE IMPACT ON EQUITY MARKETS BEEN SO LARGE?

Lower oil prices weigh on the earnings of businesses exposed to the oil industry, and current prices make higher-cost producers uneconomical. The oil dispute could also be a source of geopolitical risk, which weighs on markets.

Although oil has only a c.10% weighting in the UK equity market, BP and Royal Dutch Shell are regarded as bellwether companies so their share price declines has a knock on effect on the overall UK equity market. These companies are also relatively large dividend payers and anything that threatens their capacity to pay these dividends effects how global investors

perceive the value of the UK market. In addition, a large number of engineering companies service the oil and gas sector, so their prospects will also be negatively affected.

WHAT WILL BE THE EFFECT ON THE ECONOMY?

A lower oil price is often good for energy-importing economies, boosting the spending power of consumers (via lower petrol and heating oil prices) and reducing energy costs for industry. However, for energy exporting economies, weaker oil prices weigh on corporate and government revenues.

Over the last 20 years the US has grown a substantial shale oil industry, which has reduced its dependence on oil imports from the Middle East to zero. However, if oil prices remain below USD40 per barrel for a substantial period of time, this high-cost extraction method is uneconomical.

The impact of recent events will likely depend on how quickly the global economy recovers from Covid-19 and how governments of OPEC countries and Russia choose to respond to the weekend's decisions. City commentators are downgrading their economic forecasts at present and the emerging consensus is that economic growth over calendar year 2020 will be lower than otherwise expected but, at the global level, still positive over the year as a whole.

WHAT WILL HAPPEN TO YIELDS?

Yield, or the income from financial assets, has declined and is likely to continue to be weak. Financial markets have anticipated the likely action by central banks to reduce interest rates, in order to mitigate the effect of Covid-19 on growth. Reducing interest rates helps companies' cash flows during a period of weak demand. Further monetary stimulus is expected.

WHAT DOES THIS MEAN FOR MY INVESTMENTS?

It is not yet clear how long it will take for Covid-19 to ripple through the global economy and we are monitoring developments closely. We recognise that markets are likely to remain volatile. However, we note that, once the growth impact is priced in fully, our research capability allows us to identify mispriced companies, presenting a buying opportunity.

Financial markets tend to overreact in these downturns providing investors with long-term investment horizons (such as ourselves) with an opportunity to find investments at very attractive valuations. In anticipation of this, we have recently reduced our target weighting in shares to raise cash, on order to take advantage of companies trading at valuations that misprice their long terms prospects.

As global, multi-asset and long-term investors, our portfolios continue to benefit from diversification and it is in times such as this that our allocation to fixed income and alternative assets is also important. We will remain vigilant in seeking the best way to navigate this current crisis, and have the ability to act quickly to both respond to further risks and to anticipate emerging opportunities.

IMPORTANT INFORMATION

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