1 June 2018

How to play the oil price swings

Didier BOROWSKI
Head of Macroeconomic Research

Lorenzo PORTELLI
Multi Asset Strategist

Francesco SANDRINI
Head of Multi-Asset Balanced, Income & Real Return

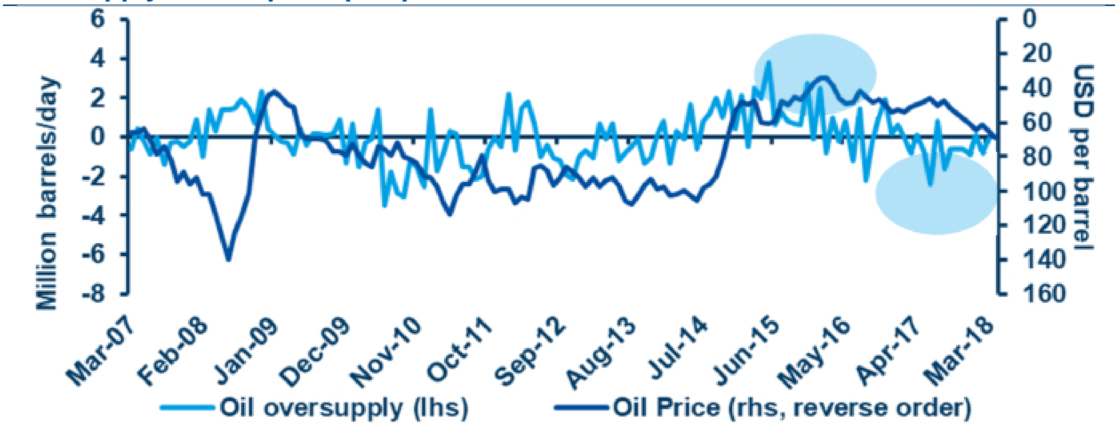
With the contribution of:
Giuseppina Marinotti
Investment Insights Unit

- ***Oil price**: We confirm our target price for the next 12 months in the range of $60-70 per barrel. Geopolitical risks have pushed the price up above 70$ per barrel in the past weeks but the overshooting phase has been suspended by speculations of a potential policy shift by Saudi Arabia and Russia to revive production. The issue will be probably discussed in the next OPEC meeting in June.*
- ***Inflation**: The recent increase in oil price is expected to have very limited impact on core inflation as the rise in oil price is perceived as temporary. The "base effect" on headline inflation does not alter the inflation environment, which remains benign at a global level.*
- ***Growth**: On growth impact, there are winners and losers. Higher oil prices are having large redistributive effects (from sector to sector and country to country). Higher oil prices are weighing on the purchasing power of households, while businesses are seeing an erosion of their profit margins. Having said that, we don't see risks of recession driven by the oil price creeping higher, as the economic costs are expected to be temporary.*
- ***Investments**: In this maturing phase of the cycle, which remains mildly favorable for risk-assets but with limited directional conviction, the resilience of the oil price may open opportunities for relative value exposures i.e. a preference for the energy sector in the equity space and in US HY, unless there are significant deviations from the current OPEC policy which would require a reassessment of the investment case.*

What is your outlook for the oil price in the short/medium term? What are the main drivers?

Portelli: The overshooting phase of oil price above 70 USD per barrel driven by geopolitical risks has been suspended by speculations of a potential policy shift by Saudi Arabia and Russia. The two countries announced – in a move not coordinated with OPEC partners- a possible increase of their output. The issue will be probably discussed in the next OPEC meeting in June, so far we confirm our target price for the next 12 months in the range $60-70 per barrel.

Oversupply and oil price (WTI)



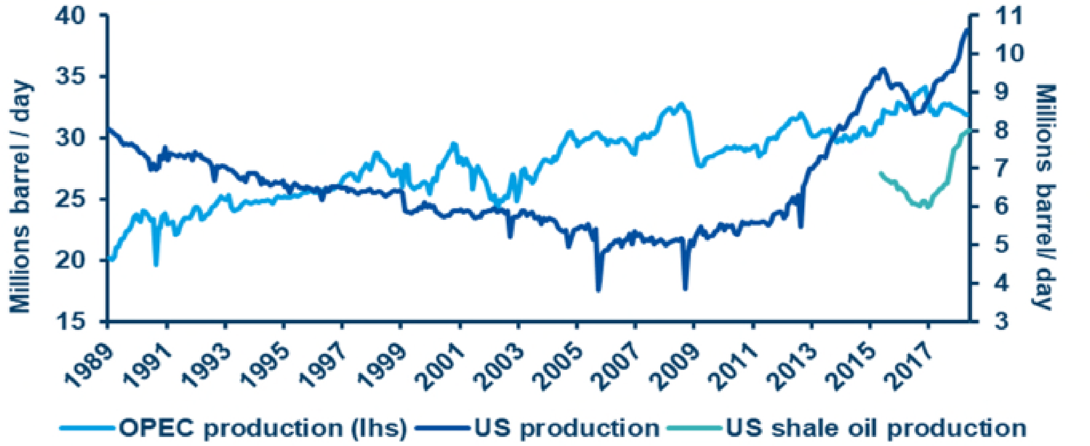
Source: Amundi, Bloomberg. Data as of 14 May 2018.

OPEC has mainly been responsible for recent swings in supply. OPEC increased production to discourage US shale oil producers during the period when the economic environment was fragile. We would note, however, that the cartel cut production during the 2017 global economic recovery, with April of that year showing the lowest production level in three years.

We expect WTI crude oil to stabilize in the 60-70$ range in the next 12 months.

The OPEC production cuts appeared to be structural, aimed at maintaining the oil price at a relatively high level, as not only production but also long-run capacity has been reduced. On the other hand, US shale oil production has moved partly counterbalancing the effects of the OPEC cuts. US crude oil production has increased since 2017, as shale oil production tends to rise as the oil price moves higher than USD50/bbl. We thus believe that US supply will eventually cause the market to rebalance. It may take a little longer than initially expected, as US oil production is already at an all-time high and US stocks are very low, as the country is about to enter the summer driving season.

Oil production



Source: Amundi, Bloomberg. Data as of 14 May 2018.

We strongly believe that the recent rise in the oil price does not represent a shock on its equilibrium price.

On the demand side, strong global growth has supported oil demand growth in the past year. We could see some deceleration of demand, especially from China, after a strong 2017. We strongly believe that the recent rise in the oil price does not represent a shock to its equilibrium price. As a result, in 12 months, we would expect the price to return to a level closer to USD60/bbl.

Would a change of the assessment of geopolitical risk have an impact on your forecasts?

Portelli: We still think that a higher price range – USD70-80/bbl – is only likely given an escalation in geopolitical tensions, especially in the Middle East. Based on our estimates, the current oil price discounts around a 1mb/d supply disruption, which seems consistent with the reinstitution of sanctions on Iran following the Trump administration's decision to withdraw from the Iran nuclear deal, and given the sanctions imposed on Venezuela by the US after Maduro's victory in recent elections. Only a deterioration of these risks, which would likely lead to more dramatic production cuts, could justify further increases in oil prices, in our view.

We don't see the risk of a recession driven by the oil price creeping higher, as the economic effects are expected to be temporary.

How is the rise in oil price affecting inflation and global growth?

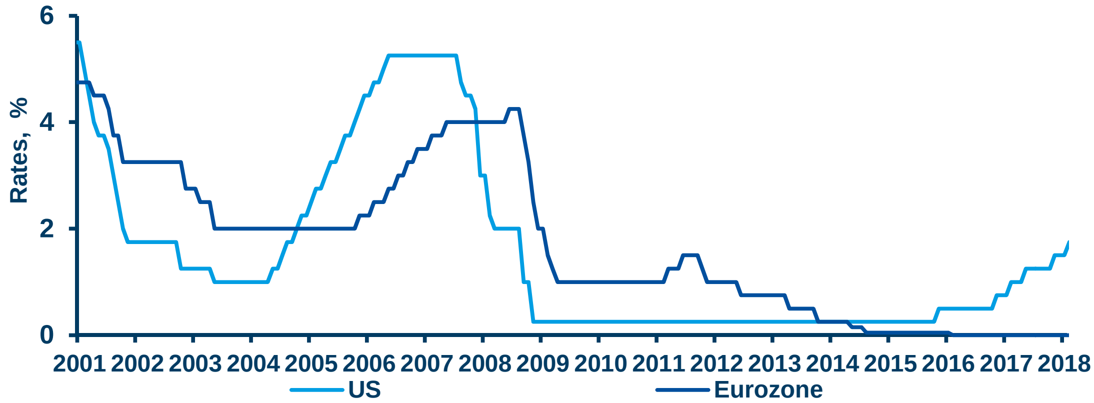
Borowski: The rise in the price of oil will mechanically translate into more inflation in the short term. But it is a pure "base effect" that does not alter the inflation environment, which remains benign at a global level. Indeed, inflation rates are still low at this stage of the cycle in most countries. And there are very few economies where rising consumer prices can feed a wage/price spiral. In addition, the impact on core inflation will be very limited (with no direct effect by definition and an indirect effect that should remain muted, in particular if the rise in oil prices is perceived as being temporary). In the EM space, inflation rates are expected to remain within central banks targets in 2018 with very few exceptions (Turkey, Mexico, Argentina and Philippines). It is not the impact on inflation that is most to be feared, but the impact on aggregate demand and especially on household consumption. **Indeed, the shock on oil prices will reshuffle the deck**. There are winners and losers. Higher oil prices are having large redistributive effects (from sector to sector and country to country). On the one hand, net exporters of commodities will benefit (higher export earnings and tax receipts). On the other hand, in most advanced countries –most of whom are net importers of commodities– rising energy prices will weigh on economic activity. Even so, it's not a zero-sum game at a global level. The substantial share of global GDP accounted for by net importers of oil outweighs that of exporting countries; higher oil prices will thus have a negative impact on global activity. The transmission channels are well-identified. Higher oil prices are weighing on the purchasing power of households, while businesses are seeing an erosion of their profit margins. Having said that, we don't see risks of recession driven by the oil price creeping higher, as the economic costs are expected to be temporary. Once oil prices stabilise, the negative effects will tend to fade over time (within two years). Baring a large and long-lasting rise in oil prices, there will be no medium-term impact.

Will the rise in the oil price potentially widen the a-synchronicities in DM?

An oil shock may contribute to decouple further the US and Eurozone cycles and subsequently reinforce the decoupling between the Fed and the ECB.

Borowski: Yes, indeed. The US and the Eurozone are in very different situations. An oil shock may contribute to decouple further the US and Eurozone cycles and subsequently reinforce the decoupling between the Fed and the ECB monetary policies. The US occupies a special place in the advanced countries. The shale gas boom has changed the game. The US has not only become one of the major oil producers, but it has also become a top oil exporter (the US became a net exporter of natural gas in 2017, for the first time in 60 years. It remains a net oil importer but probably not for long given the pace of production growth). As a result, the negative effect (on households and businesses in the non-energy sector) should be offset by new investments in the energy sector. The central issue is how fast oil investment will grow in the current environment. In particular, will shale oil producer be able to finance new investments as easily as they did in the past? If not, the negative impact on consumption may materialise more quickly. Note however that new investment in shale oil does not require persistently high expected oil prices. There are bottlenecks and even a temporary oil price surge should make new investment profitable, because shale oil production is expected to respond more quickly to oil price increases than conventional oil production. To put it in a nutshell, the rise in oil prices threatens to boost inflation in the US but to slow the economy in the Eurozone. In the US the rise in the price of crude would feed through to inflation faster than in the Eurozone, as full employment in the US means employees can demand (to some extent) compensatory wage rises. The situation is very different for the Eurozone, a net oil importer. Growth would be harder hit (and, in that case, the inflationary impact would be short-lived). We estimate at this stage that the price of a barrel remains at its current level, this should extend the soft patch to Q2. In that case, we would probably lower growth by a few tenths in the Eurozone in 2018 and 2019. However, it would hardly impact GDP growth in the US. In these circumstances, even if it does not derail the ongoing recovery, risks would be viewed differently by the Fed and the ECB.

Fed and ECB rates: higher oil price could exacerbate CB divergences



Source: Amundi, Bloomberg. Data as of 23 May 2018.

Emerging economies will also be differently impacted by the oil price increase whether they are oil producers or oil consumers.

The Fed would probably see a rise in oil prices as threatening to push up nominal GDP (with little impact on real growth but some effect on inflation). This is clearly in line with what the tone of the last FOMC minutes (released on 24 May) that confirm that a rate hike is likely in June. The ECB, however, will likely see the increase in oil prices as putting downward pressure on nominal GDP, with a negative impact on real growth but little (and short-lived) inflationary impact. All else being equal, these divergent trends in nominal GDP could persuade the Fed to opt for further rate hikes (or at least to continue to raise rates once per quarter this year) while the ECB could be persuaded to further delay any rise (with the ultimate risk that it would not be able to normalise its monetary policy.)

What about the dispersion in EM economic performance?
Borowski: Emerging economies will also be impacted by the oil price in very different ways country by country, based on whether they are oil producers or oil consumers. In the first group, we find, for example, Middle Eastern countries, Russia, Mexico, Colombia and Brazil; in the second, we see Eastern European and Asian countries (with the exception of Indonesia and Malaysia). In most countries, a higher oil price will tend to deteriorate at the same time the fiscal and the current account balances, with very different consequences, depending on the initial state of the economy. In India, the impact would remain manageable. Together with deteriorating economic conditions in terms of growth and inflation, in order to alleviate the burden on consumers and not pass the whole increase on to them, the government would reduce oil excise duties and/or review the subsidies policy, generating a fiscal slippage. Turkey, in contrast, is much more at risk. The rise in oil price may push the economy into financial turmoil, given its high level of external vulnerability (a classic case of a balance of payments crisis). All in all, it shows that investors must monitor the situation on a country-by-country basis regarding both DM and EM.

We maintain our preference for the energy sector relative to the SPX index; bottom up selection also points to opportunities among the European Oil Majors.

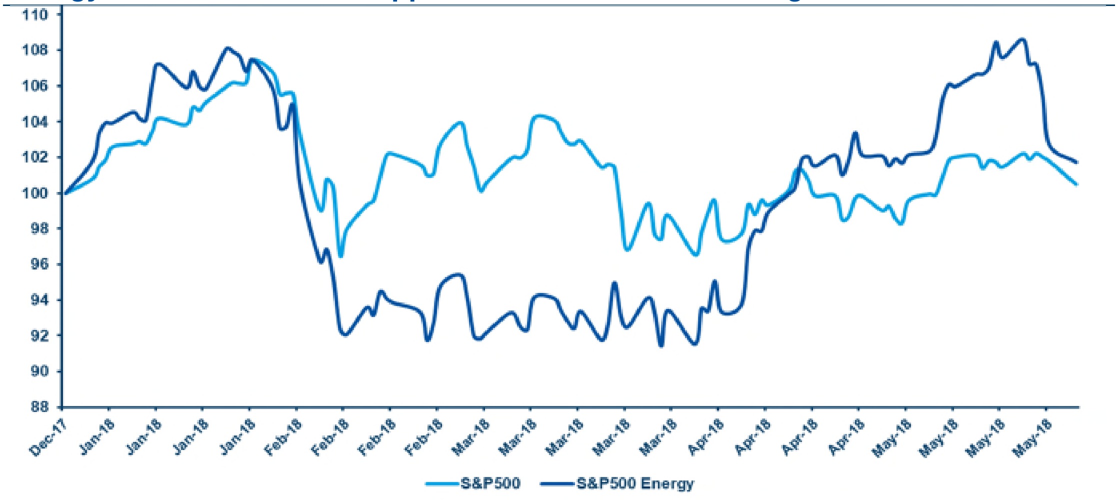
Which assets could benefit most from a high oil price?
Sandrini: In this maturing phase of the cycle, which remains mildly favourable for risk-assets but with limited directional conviction, a resilient oil price would open opportunities for relative value exposures. Having said this, we are monitoring the possibility of significant deviation from the current OPEC policy in light of the recent declarations from Russia and Saudi Arabia so tactically we suggest a neutral approach. More strategically, considering an oil price stabilizing in the 60/70 range, the energy sector fundamentals remain favourable. Both European (meaning the Oil Majors[1] comprised in the STOXX Oil and Gas) and American (IXE Index Members) companies are strongly correlated to the price of the Benchmark Crudes and Oil-products. Bottom up selection also brings interesting opportunities among the European Oil Majors, which are currently leaders in the capex recovery, with major projects in the pipeline driving organic growth. European majors stay well ahead in the divesting process compared to global peers.

Among all the credit carrying securities, US HY has been one of the most resilient sectors with the OAS spreads levels still slightly below the start of the year printings. Certainly , although credit conditions have somehow tightened, the macroeconomic outlook has been favorable with a late cycle fiscal expansion implemented by President Trump, but we must acknowledge also the excellent performance of US Energy HY Bonds (-45 bps OAS YTD) at least to middle May following a sustained increase of Oil price amid a deteriorating geopolitical outlook. The US HY sector looks better balance then EM in terms of flows, although perhaps more expensive when looking to spreads per unit of leverage, accounting for the very mature leverage cycle in US. Prolonged US real rates increase in combination with a deteriorating oil price can show the vulnerability of the sector.

In conclusion we believe that owning assets positively correlated with commodity prices would be wise in this late-cycle phase for multi-asset investors. However, we are more cautious as the possibility of an OPEC policy shift could bring further volatility.

[1] Oil Majors generally refer to multinational oil companies. The Majors are typically "integrated" companies, with divisions in exploration, production, marketing, refining, transportation and distribution divisions.

Energy sector vs. S&P500: Opportunities linked to oil swings



Source: Amundi, Bloomberg. Data as of 29 May 2018.

We currently don't think there is a case for explicitly hedging against a stagflation scenario driven by a higher oil price.

How could investors deal with the risks of excessive oil price swings?

Sandrini: Tactically, we believe investors should deal with risks of oil price corrections by adopting rigorous stop-loss discipline on assets exposed to the oil price. On a more medium-term perspective, investors need to consider the risks that an uptrend in commodity prices may bring to inflation and economic growth. A way to cover inflation risk due to cost pressures related to a high oil price is through inflation-linked bonds. Regarding growth, the answer is more difficult, given the recent inflation dynamics related to the US and the structure of the oil supply, to attribute a meaningful probability to an oil price spike that could severely jeopardise global growth via a rise in inflation. On the opposite side, some further oil price upside could continue to support the pick-up in investment spending. Hence, we currently don't think there is a case for explicitly hedging against a stagflation scenario driven by a higher oil price.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at our website

www.amundi.com

Visit us on:

www.amundi.com

Amundi
ASSET MANAGEMENT