Standard Chartered

Market Watch

Oil's collapse and implications

Summary

- **Oil prices fell sharply after Saudi Arabia announced a planned output increase and price cuts. This followed an earlier breakdown in OPEC-Russia output reduction talks.**
- **Following this, and amid continued COVID-19 worries, US 10-year yields fell below 0.50%, S&P500 futures fell 4.9% and EM currencies weakened sharply.**
- **We see three implications – further policy easing, energy equities & US HY bonds weakening under pressure, but stretched technicals offering a breather. We highlight possible opportunities in today's volatile markets.**

Background

- Saudi Arabia announced it was raising oil output and offering price discounts after OPEC and Russia failed to reach an agreement to curtail oil production to support prices. Saudi said it planned to pump more than 10 million barrels per day (mbpd) in the coming month, with reports suggesting this could rise to 11 mbpd the following month (compared with about 9.7 mbpd in February).
- This comes at a time of growing worries over COVID-19's impact on consumer demand. The total number of infections approached 110,000 worldwide (over 29,000 ex-China) as Italy imposed significant restrictions across affected provinces.

How did this impact markets (as of 11:40am SGT)?

- WTI oil fell over 25% when it opened today, one of the largest one-day moves in history. US S&P500 futures were 4.9% lower while Topix was 6.1% lower.
- US 10-year Treasury yields fell below 0.50%, with the correlation between oil and the market's expectations of future inflation being a possible driver. USD/JPY was down 2.9%.

What does this mean for investors?

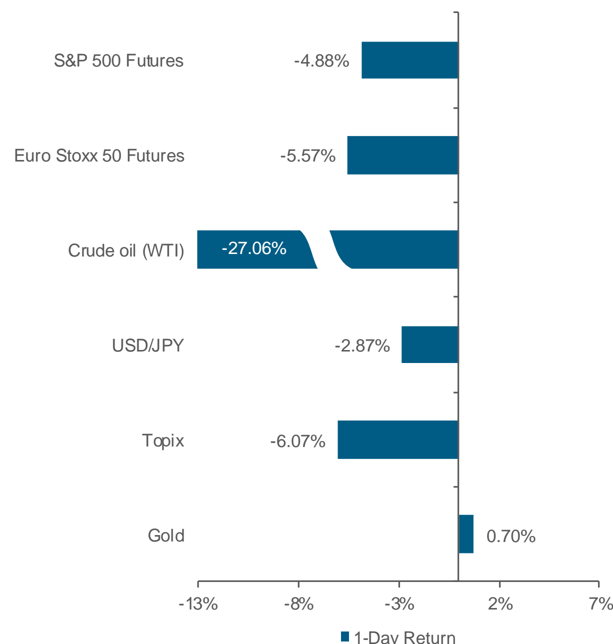
We believe these developments have three major implications.

First is oil's deflationary impact – we see it triggering more policy easing. Oil's collapse has already led inflation expectations sharply lower. In our view, this is one key reason why US Treasury yields have fallen in tandem with oil prices. However, it also creates significant room for policymakers – in the US and around the world – to ease policy further. Indeed, markets are already largely pricing a cut in Fed rates to zero in 2020. This could also trigger a greater willingness to use fiscal spending to support growth in the US, Europe, China and elsewhere.

Second, energy sector equities, US high yield and, to a lesser extent, EM currencies and EM USD government bonds could weaken short-term as a direct result of weaker oil prices. On the supply side, there are 3 key players – OPEC, Russia and US shale producers. Oil price's correlation with their fiscal revenue or

Oil collapse triggers broad volatility

Selected market performance*, local currency



Source: Bloomberg, Standard Chartered; *9-Mar at 11:40am SGT

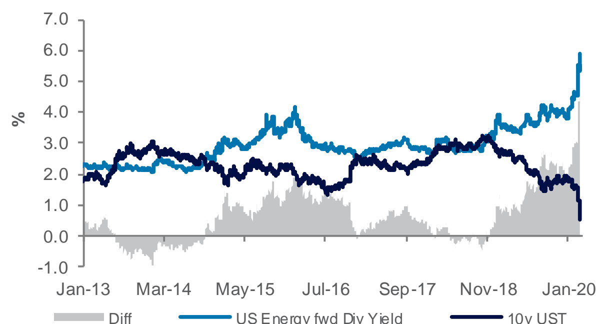
Table of technical support levels for selected assets

Index	Spot*	1st support	% from spot	2nd support	% from spot
S&P500	2,972.37	2,856.00	-3.9%	2,637.00	-11.3%
Stoxx 600	366.80	361.00	-1.6%	327.00	-10.9%
MSCI Asia ex.Jp	646.83	630.00	-2.6%	571.00	-11.7%
UST-10Yr	0.50	0.50	-0.5%	0.13	-74.1%
Gold	1,684.55	1,595.00	-5.3%	1,565.00	-7.1%

Source: Bloomberg, Standard Chartered; *Equity indices as of 6-Mar close; UST10yr, Gold as of 9-Mar 11:40am SGT

The US energy sector's yield premium at its widest in recent history, but dividends may be at risk

US energy sector forward dividend yield vs. 10yr UST yield



Source: Bloomberg, Standard Chartered

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corporate earnings growth means, eventually, one of the three is likely to blink, or fail. Indeed, it is possible that the resultant solution ultimately forms a long-term base for oil prices. In the interim, though, asset classes linked to oil are likely to face further weakness. Energy sector equities and US high yield bonds could be most at risk.

Oil importers would be key beneficiaries, though for the EM USD government bonds asset class there is a risk the losers start outweighing the winners if oil continues to fall. The sharp move lower in EM currencies may be a signal of this. So far, EM USD government bonds have benefited from falling US government bond yields, which has helped offset wider yield premiums. However, it is unclear if this trend will extend with US government bond yields already relatively close to 0%.

Third, stretched technicals could point to a breather. The long-term outlook notwithstanding, technical indicators look extremely stretched across major equity indices, gold and major currencies. This suggests that a counter-trend move is likely at least for now.

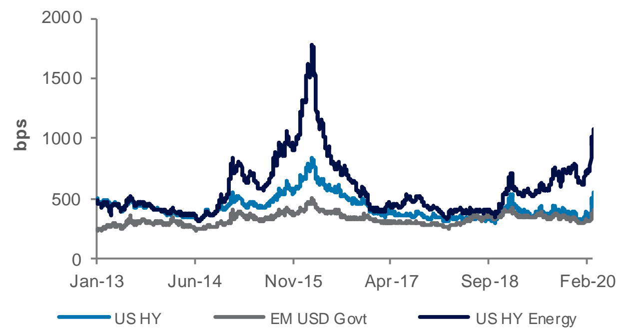
Is this a buying opportunity?

We hesitate to be unequivocal buyers given the risk of negative momentum extending in the short term, particularly in energy sector equities and US high yield bonds. Having said that, we would look for opportunities in three areas:

1. In the very short-term (intra-week, for instance), the excessive pessimism signalled by stretched technicals could offer a trading opportunity independent of the long-term outlook.
2. Looking beyond the next few days, equity volatility is approaching post-2008 peaks (touching a post-2008 high intra-day). This could create opportunities to generate attractive yields with some downside protection, especially since major equity indices are already significantly below their recent peaks.
3. Over a longer 12-month horizon, we continue to monitor which of the two global growth scenarios is likely to unfold (a rapid recovery following policy support – our baseline – or a more prolonged downturn; see the *Global Market Outlook* for details). This also means we would closely monitor the pace of new COVID-19 infections, which is a key input into our scenarios. We would become more comfortable adding long-term exposure to our preferred asset classes if we see increasing indicators following the first scenario.

Pressure on US shale oil producers likely to widen US HY credit spreads. EM USD government bonds also at risk if oil price losers outweigh beneficiaries

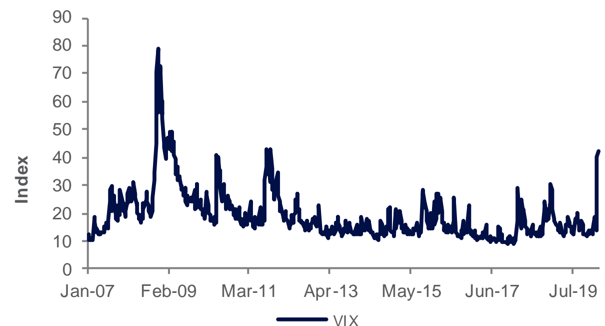
Credit spread (yield premiums over Treasuries)



Source: Bloomberg, Standard Chartered

US equity market volatility touch a post-2008 high intraday

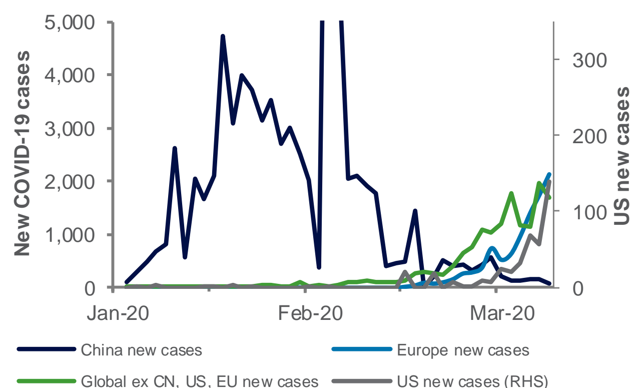
S&P500 volatlity index (VIX)



Source: Bloomberg, Standard Chartered

New coronavirus cases continued to accelerate outside China. This is key to the longer-term outlook

COVID-19 daily new cases as of 7-Mar-2020



Source: Bloomberg, Standard Chartered

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