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MACROSCOPE the market bulletin from Luft Financial

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Monday's negative WTI crude price is latest mind-boggling impact of pandemic

The coronavirus pandemic has unleashed one shock after another on the global economy, as investors and governments worldwide have struggled with the cascading impacts of one of the biggest health catastrophes in a century. On Monday, we saw another mind-boggling impact of the pandemic, when the contract for May delivery of West Texas Intermediate (WTI) crude oil fell by more than $55 per barrel to settle at *negative* $37.63 on the NYMEX.

The massive destruction of gasoline demand arising from the global virus-induced lockdown, at a time when the major oil producing nations are pumping out as much crude oil as they can, has resulted in a world awash with oil. With storage capacity getting full almost to the brim, there is simply no more place to store oil. As a result, the normal "rollover" process towards the end of an oil contract's expiration (when speculators sell the near-month contract and buy the next-month contract, in order to avoid taking delivery of the oil barrels stipulated in the contract) was upended on Monday, as panic-stricken speculators sold at any price to close out their contracts.

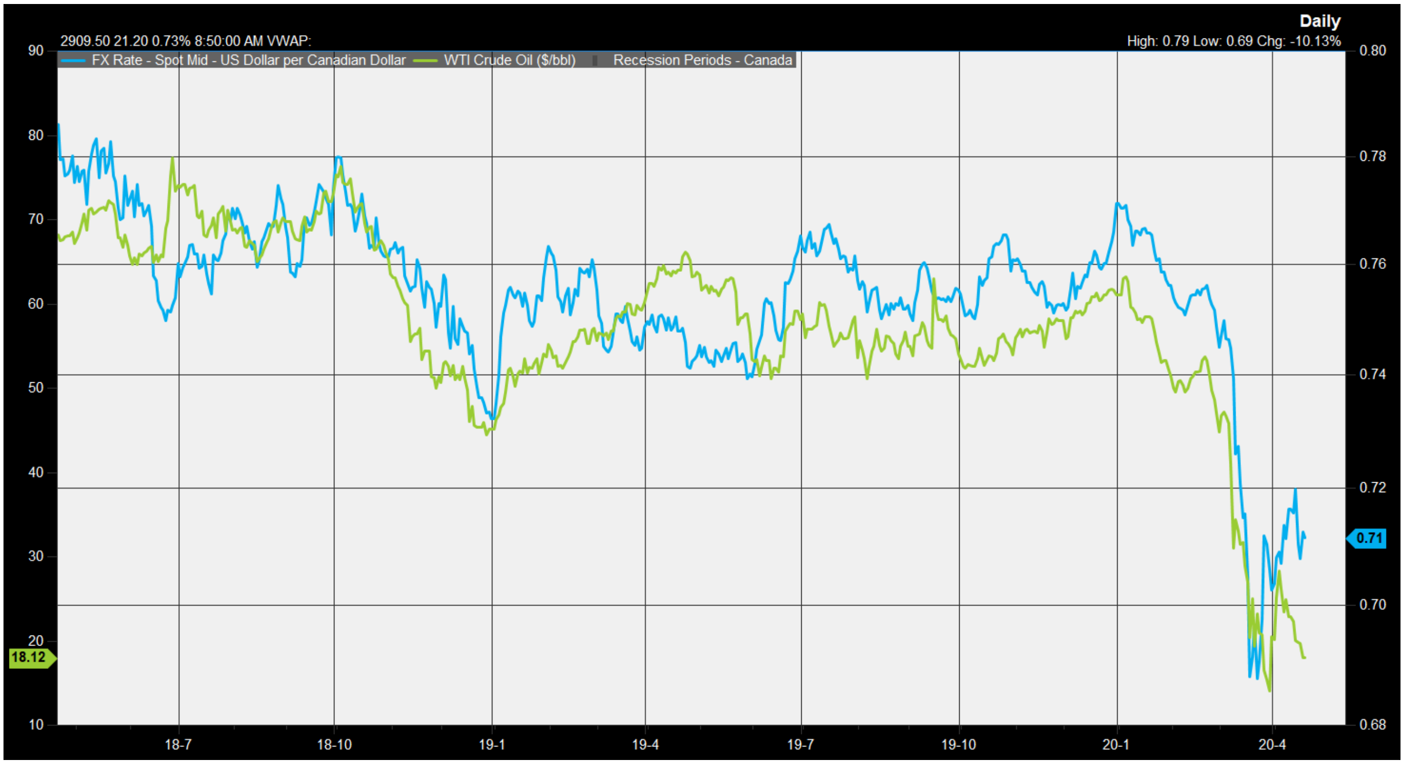
The takeaway here is that oil prices are likely to remain under pressure as long as the enormous supply-demand mismatch continues. Slashing of capital budgets and under-investment in energy infrastructure will eventually lead to a bull market in oil, but that may be many months away. Crude oil is a non-renewable resource, but right now, few seem to care.

Portfolio Impact / Implications

While the Energy sector accounts for approximately 13% of the TSX Composite, our client portfolios are significantly underweight energy. The only energy stocks we hold are pipelines like Enbridge and Pembina, apart from which we have limited energy exposure in the fixed income space. As a result, we have been able to avoid most of the carnage in the energy patch, which is the worst-performing sector on the TSX with a decline of 36%.

In addition to the direct impact of plunging crude oil / energy stocks on Canadian investors' portfolios, the historical relationship between crude oil and the Canadian dollar must also be considered. While this relationship has occasionally diverged, crude oil and CAD tend to move in the same general direction, if not exactly in lockstep (Figure 1). The positive correlation between the two is largely because of the importance of the energy sector to the Canadian economy, as it accounts for more than 10% of Canadian GDP. The likelihood that crude oil prices may remain depressed for months, combined with the other structural headwinds facing the Canadian economy, suggests that the probability of a continued decline in the loonie vs. the USD is higher than that of a rally in the currency. This scenario supports our current 20% unhedged USD position (made up of US stocks and a broad market ETF) in our balanced portfolios.

Figure 1: CAD vs. WTI Crude (1st month futures)



Source: FactSet

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