The remarkable lack of price disruption this year has not been evident in all markets—oil and commodities have been the notable exceptions. This was a key discussion point during our latest investment policy meetings, in which the team took a deeper dive into the factors driving the price swings and their possible implications.

Price disruption in commodity markets is often created by a temporary imbalance between supply and demand. While Chinese stimulus measures adopted in 2016 to support growth boosted demand for oil and other commodities, the picture has rapidly changed this year. China’s central bank has shifted toward monetary tightening and there has been further deleveraging of the financial system. The combination of these factors has led to a significant decline in commodity imports, such as iron ore and copper.

At the same time, the deal struck by the Organization of Petroleum Exporting Countries (OPEC) last November to cut oil production has been challenged by increased U.S. supply. U.S. oil inventories are near all-time highs as shale producers there have responded to rising prices by increasing production. They have become a larger contributor to global oil supply and can now operate profitably at lower price levels given their increased efficiency. This puts further pressure on OPEC, which meets later this month to discuss whether to extend production cuts.

“The Russian ruble is most at risk. Russia is a large oil exporter, and the current valuation of the ruble is not reflecting the recent oil price correction.”

—Ju Yen Tan, global fixed income portfolio manager

All of this means that the path for oil prices is far from certain and there could be further bouts of volatility ahead. With this in mind, the global investment team looked at the possible implications for markets, focusing on potential anomalies and sensitivity behavior. “The Russian ruble is
most at risk,” said Ju Yen Tan, global fixed income portfolio manager. “Russia is a large oil exporter, and the current valuation of the ruble is not reflecting the recent oil price correction.”

It’s not just about emerging market currencies, though. The combination of lower commodity prices and a potential Chinese slowdown means that currencies such as the Canadian and Australian dollars are also vulnerable given their dependence on commodity exports. While this may already be reflected to a large extent in the valuations of these currencies, both of which have depreciated since the end of March, further bouts of weakness are possible in the current climate.

“A stabilization in commodity prices—in particular if the price of oil stays above U.S.$40 per barrel—could benefit TIPS, so I would look for opportunities to add and diversify my risk.”

–Ju Yen Tan, global fixed income portfolio manager

Credit markets are not immune to a potential downside trend in commodity prices either. Energy is one of the largest sector weightings in the U.S. high yield market, comprising almost 15% of a typical index. This exposure makes it more vulnerable to moves in oil prices. Shorting the U.S. high yield market as a hedge against further oil price disruption may therefore be an option, particularly as spreads are currently trading at expensive levels.

But what happens if the supply/demand imbalance sorts itself out quicker than expected? Looking at different markets, the global investment team identified the U.S. Treasury inflation protected securities (TIPS) market as a potential beneficiary should prices stabilize. “TIPS valuations have suffered lately from weak consumer price index prints, and breakevens are trading at the low end of recent ranges. A stabilization in commodity prices—in particular, if the price of oil stays above U.S.$40 per barrel—could benefit TIPS, so I would look for opportunities to add and diversify my risk,” added Mr. Tan.

After all, a good roller coaster always has lots of twists and turns.

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1 BofA Merrill Lynch US High Yield Index as at April 28, 2017.
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