Market Commentary

INVESTMENT STRATEGY GROUP | APRIL 23, 2020

What Do Negative Oil Prices Mean for Investors?

In mid-February, global economic activity began to rapidly slow due to coronavirus (COVID-19), causing oil prices to come under pressure. In early March, Saudi Arabia initiated an oil price war with Russia, exacerbating over-supply in the oil market.

Then on April 20, oil prices temporarily went below zero for the first time ever amid growing concern that storage capacity would soon be exhausted. The nearest-expiry contract for U.S. crude oil declined 289% in one day to *negative* $37.63, meaning that sellers were effectively agreeing to *pay* $37.63 to deliver a barrel of oil to buyers. At a time when historic events seem to unfold daily, negative oil prices are extraordinary.

Clearly, there is a severe, near-term imbalance in the oil market. To restore equilibrium in the months ahead, demand will need to increase, or production will need to decrease. It's difficult to estimate when this will happen due to the unpredictable nature of the novel coronavirus and how quickly OPEC and other suppliers will cut production. However, we do know that the spread of coronavirus has slowed, widespread economic shutdowns are unsustainable, and current oil prices are nonviable for producers.

Leading up to the crisis, some of our portfolios had a small allocation to a broad basket of commodities, including oil, to provide diversification from traditional asset classes that were expensively valued and to protect against a low—yet material—possibility of higher inflation over intermediate- and longer-term horizons. Of this small allocation, our commodities exposure is only slightly more than one-third oil and invests across several delivery periods with no exposure to the contract that plunged on April 20, so we were spared from the worst of this oil price collapse.

With oil prices around 20-year lows and the potential for inflation to rise due to unprecedented levels of fiscal and monetary policy intervention, some see extraordinary potential in commodities. While we too recognize increased upside potential in commodities, we are maintaining our allocation, as stocks and corporate bonds have also become more attractively priced in the sell-off. By investing in stocks and bonds, we can partner with human productivity, which combines human creativity and natural resources, and gain a more predictable return stream due to the cash flows they generate. Therefore, whenever valuations are attractive enough to offer returns that are likely to exceed our return goals, we prefer stocks and bonds over commodities.

Yet, there are still ways we hope to benefit from the extraordinary volatility and valuations in commodities. First, our commodities fund is actively managed, and the large dislocation in commodity markets has presented various opportunities for our fund manager to take advantage of perceived mispricings. Second, individual commodity positions within the fund are rebalanced monthly, which can be beneficial in volatile environments. Finally, even though we didn't increase our overall allocation to commodities, rebalancing portfolios will have the same effect as commodities exposure must be increased back in alignment with its target allocation.

In the near term, there will likely be many new developments affecting oil supply and demand, and oil prices are likely to be very volatile as a result. Although we do not know how long this disequilibrium will last, we will continue to monitor the markets for any potential impact and opportunities for our investment solutions.
