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QCAM MACRO UPDATE

2015/16 déjà-vu?

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The financial downturn that started in early October had several triggers and drivers (US monetary policy, US-China trade conflict, BREXIT, Italian budget standoff etc.). Increasingly, though, it is becoming clear that the main worry is growth. That explains why equity and credit markets continue to trade soft, while government bond yields are back down after their initial increases. Probably the best sign of the global growth concern is the plunge in oil prices. Since the end of September, the WTI oil price fell about 30% from above 73 $/b to just 51 $/b. True, the US has been pumping more oil, but supply in the rest of the world has been restrained. Moreover, the downturn was not limited to oil but affected most commodity prices. Broader commodity price indices fell since the end of September between 15% and 20%. Thus, the decline in oil prices reflects primarily actual and expected demand weakness.

The last time oil prices fell sharply was between the second half of 2014 and early 2016. Back then, oil prices dropped in total more than 70%. Initially, the price decline was caused by OPEC boosting supply to squeeze US producers out of business. However, in the course of 2015 and into early 2016 this was overshadowed by global growth concerns, emanating largely from China. This time is not a simple replay of 2015/16, but it is again China that is part of the growth worries. The downturn three years ago did not end in disaster, largely because policymakers came to the rescue. The Fed halted its policy normalization program, the ECB and the BoJ stepped up their asset purchase programs and China relaxed both fiscal and monetary policy.

This time the situation is somewhat different. First, while financial markets have taken a beating, economic indicators though weaker are not yet flashing red alert. On the other hand, the business cycle is more advanced. This makes it more vulnerable to shocks and at the same time causes policymakers to be more reluctant to boost growth in fear of creating more inflation. Markets are speculating that the Fed may soon stop its interest rate hikes. We are less convinced. The ECB has already signalled that it will keep interest rates low at least until next summer, but another wave of large-scale bond buying as in 2015 is unlikely. China has already eased policy, but so far the signs are mixed that stimulus is having the desired effects. Thus, while we do not see a recession around the corner, global growth will probably continue to ease going into 2019. And with that, oil prices are likely to stay soft and will probably fall further.

The relationship between oil prices and exchange rates is not always one directional. Major oil exporters with floating exchange rate regimes typically see their currencies fall when oil prices tumble. In other words, oil price changes drive the exchange rate and not the other way around. A good example is the Russian Ruble. Major commodity currencies like the Canadian and the Aussie Dollar are also sensitive to oil prices changes but other factors influence their exchange rates as well. For the USD, causality goes

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both ways. This is because oil is quoted in USD. In periods of USD weakness, oil prices often trail the USD exchange rate. These are also usually periods when global growth outperforms US growth. In periods when oil prices fall, however, it is the USD that tends to strengthen in response to the decline in oil prices. This is because oil exporters are more prepared to let their currencies fall when oil prices drop to stabilize revenues in domestic currency terms. This has even second-round effects on currencies of oil importers like the Euro.

To be sure, there are more moving parts than just oil prices. Yet, persisting global growth weakness and, thus, lower oil prices are not a low probability scenario for 2019. That would be a handicap for commodity currencies and could be a factor that supports the USD more broadly even if the support from better business cycle conditions and higher interest rates fades and the twin deficits move more into focus.

Oil price and USD trade-weighted exchange rate

Source: St. Louis Fed and US EIA

Best regards,

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