

Oil: Return to Battle Stations

Douglas Porter, Robert Kavcic, Benjamin Reitzes

- Oil prices extended their record losing streak this week, with WTI diving below \$57/barrel, its lowest level of the year and down more than 25% just since the start of October. Brent prices have almost precisely followed the same pattern. Compounding the pain for Canada, the differential for Western Canadian Select (WCS) has remained extreme, holding those prices below \$20/bbl for more than a month (*Chart 1*).
- The sudden downdraft in global prices has been triggered by ongoing and relentless gains in U.S. production (up 2 million bpd in the past year alone), over-production by OPEC, and a softening of export controls on Iran.
- The pronounced weakness in WCS reflects at least four factors: 1) a staggering lack of pipeline capacity, with hurdles seemingly multiplying for new projects; 2) temporary U.S. refinery shutdowns; 3) stricter fuel standards for ships (taking effect in 2020); and, 4) weak seasonal factors. Only two of these factors are temporary, with pipeline capacity clearly the biggest thorn. We expect the differential on WCS to narrow in 2019, but nevertheless remain historically wide next year.
- Our economic projections are based on the assumption of an average WTI price in 2019 of US\$63/bbl, down only modestly from an expected average of \$66 this year (and versus just \$51 last year). Note that the latest Bank of Canada quarterly projection, released just three weeks ago, assumed WTI prices of \$70 and WCS of \$35.
- While we remain relatively comfortable with our WTI call for next year, if the recent weakness were to persist, or even deepen, here's a review of how lower oil prices could affect a variety of Canadian economic and financial variables.
- For **Canadian GDP**, the good news is that forecasts were never seriously marked up earlier this year on the rally in crude. This was because the lack of pipeline capacity meant that broader investment in the sector simply was not going to respond to a brief spell of higher prices. For example, capex in the oil & gas sector was still expected to be down 56% this year from 2014 levels (*Chart 2*).
- Still, **the announced production cuts have prompted us to trim Q4 GDP four ticks to 2.1%**, in turn cutting next year's pace to 2%. Even after the downgrade, the risks to our 2019 GDP growth call remain skewed to the low side.
- One economic indicator that will soon reflect the price downdraft is **CPI**. After many industrialized countries at long last saw headline inflation finally push above the 2% threshold in recent months, the deep dive in oil threatens to prompt a quick reversal.

Chart 1

Oil: Low and Lower

(US\$/bbl : as of November 16, 2018)

Crude Oil Prices



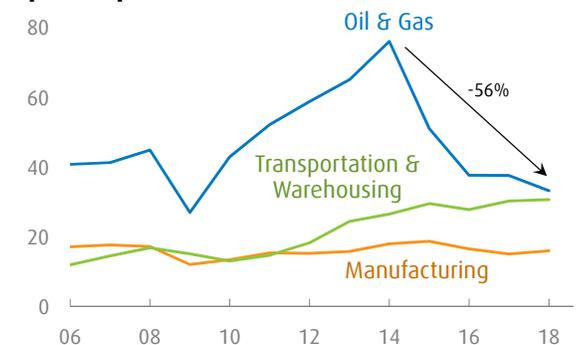
Sources: BMO Economics, Haver Analytics, Bloomberg

Chart 2

Canadian Capex: Downside

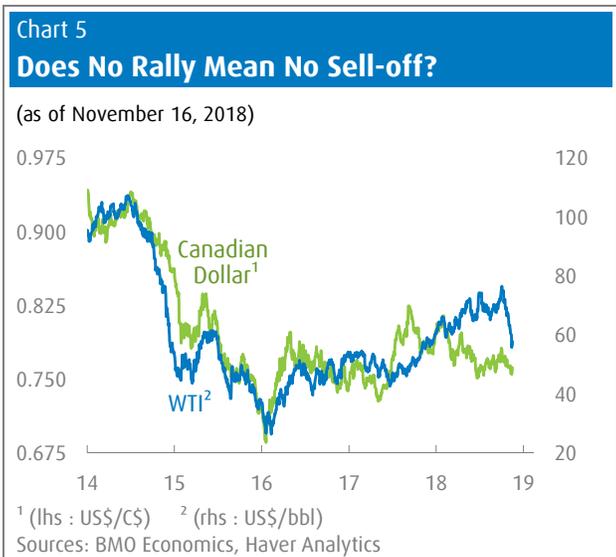
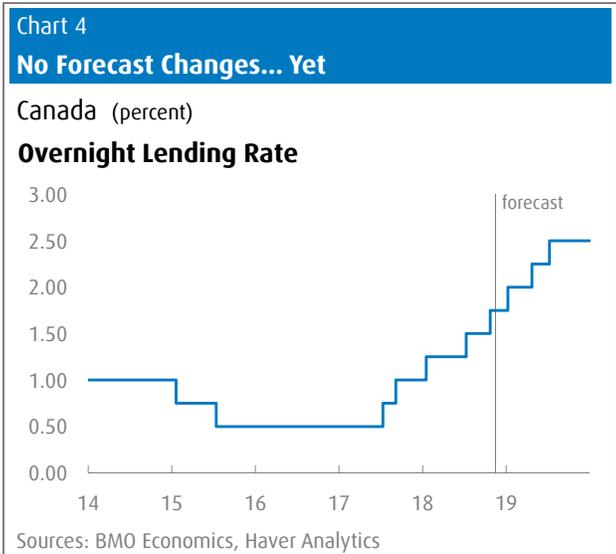
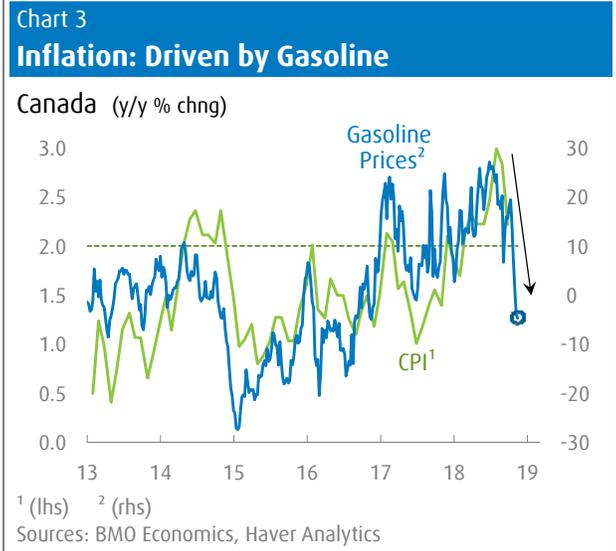
Canada (C\$ blns)

Capital Expenditures

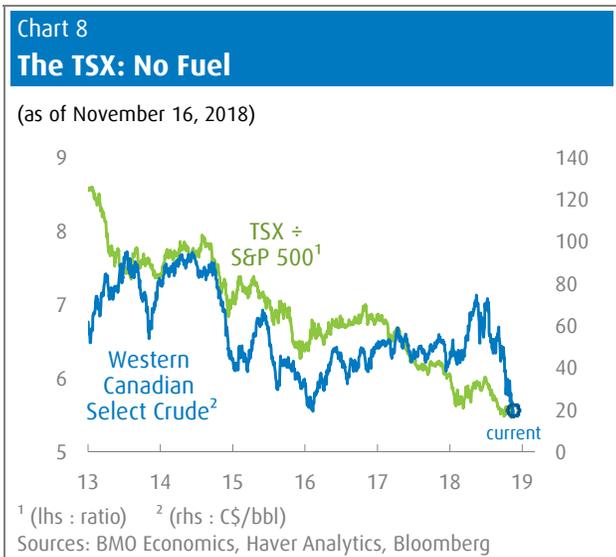
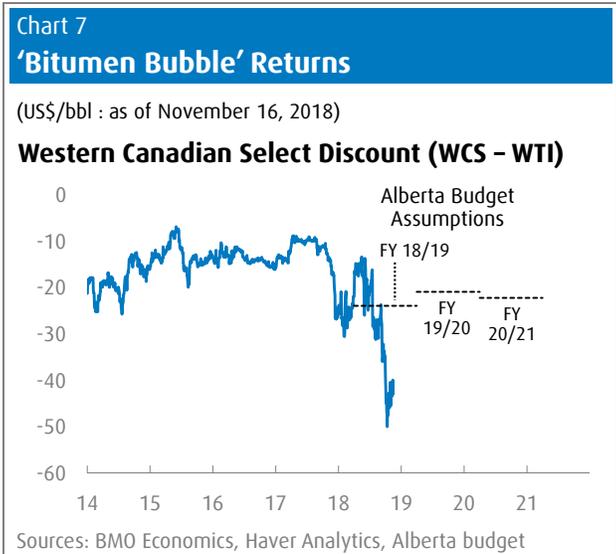
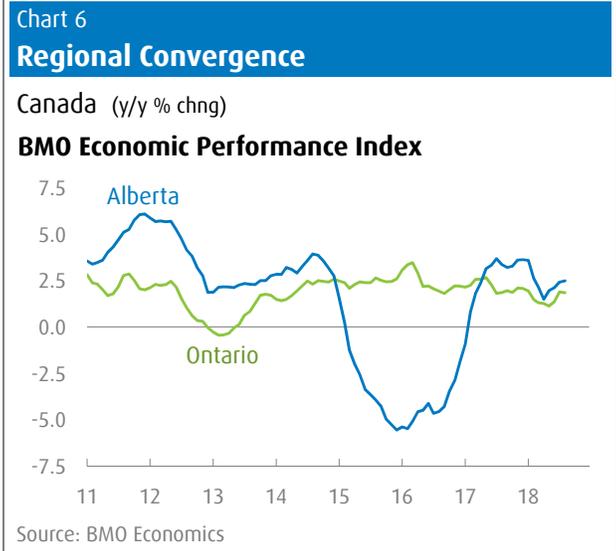


Sources: BMO Economics, Haver Analytics

- In the first nine months of the year, energy prices alone added 0.5 percentage points to overall Canadian inflation, and still added 0.4 ppts in the most recent estimate for September. With gasoline prices plunging in recent weeks, they are now down 6% y/y (versus a 12% rise in September, and 25% in July). While this will barely cause a ripple in the October CPI, the result for November should see headline inflation plunging well below 2% (*Chart 3*). A similar, albeit somewhat less drastic, reversal is likely to unfold in most November CPI results for the major economies.
- In contrast, the latest BoC forecast assumed headline inflation would actually tick back up in Q4 to average 2.3% from the current 2.2% reading.
- The **Bank of Canada** was notably upbeat in the October policy statement and Monetary Policy Report, as the economy is at potential and inflation is on target. The benign backdrop prompted Governor Poloz to largely brush off any concerns about WCS weakness as temporary.
- However, that was before the broader slide in crude. Since the October meeting, WTI is down another \$10, leaving it about 20% below the BoC’s \$70 MPR assumption. The softness in the broader oil market is likely a bit more concerning for the BoC, as the weakness cannot as easily be explained as transitory.
- The latest move in oil lowers the odds of a December rate hike and even introduces some doubt into January. It’s going to be much more difficult for the BoC to sound as upbeat in December if oil prices don’t at least stabilize. Even so, we continue to call for **hikes in January, April and July next year**, as oil is expected to stabilize, allowing policy rates to move back to neutral (*Chart 4*).
- The Canada curve has been supported by the drop in oil, but we have yet to see any major re-pricing. There’s been some pullback in BoC rate-hike expectations, but the move has been modest thus far. Lower inflation expectations should be supportive of longer-term yields as well, as break-evens retreat. Look for the bond market to take its cue from the BoC’s tone in coming weeks.
- **The loonie** has retreated as energy prices have fallen. The currency has been range bound since the summer, a couple of cents on either side of C\$1.30. Perhaps tellingly, the second half of the year has seen the USMCA and a more hawkish BoC, yet the C\$ saw only fleeting support. However, the currency also received little support from the run-up in oil prices in the year to Q3, so there’s no compelling reason to think that it should be hit hard by the move down (*Chart 5*). We remain cautious on the C\$, looking for C\$1.32 at year-end, and just modest appreciation in 2019.



- From a **regional perspective**, growth has converged over the past two years, with the gap between oil producers and non-producers narrowing (*Chart 6*). That should continue through 2019 with most expected to settle in around potential, but the pullback in WTI and wide differential risk pushing the producers (AB, SK and NL) below the national average.
- Alberta is most exposed, but we judge that the immediate economic impact will be small since the majority of producers are hedged with contracts already in place. But, if production growth slows (e.g., a meaningful agreement to curtail output), there would be downside risk. Incomes will surely get dinged if the spread persists, dampening consumer spending and housing over time, while 2019 capital budgets could get ratcheted down.
- The impact on the rest of Canada will be minimal, unless the downturn runs deep enough to slow the pace of Bank of Canada tightening and/or weaken the loonie more significantly.
- Ottawa has assumed \$56 and \$57 for WTI in 2018 and 2019, respectively, while restoring a \$3 billion contingency. The **fiscal impact** at the federal level should be minor.
- The Province of Alberta was careful not to upgrade its WTI assumption much in its latest FY18/19 update, assuming \$61 for WTI, about \$2 below our call, while keeping the C\$ elevated at 78 cents (\$1.28/US\$). Assuming the differential narrows to average \$30 for the fiscal year (versus \$24 assumed in the fiscal plan), the upside and downside should nearly balance out. The real issue will be resetting the longer-term fiscal plan, which assumed more pipeline capacity would allow the differential to narrow to the low-\$20 range (*Chart 7*). The 2019 pre-election budget will likely be based on much tougher assumptions.
- Saskatchewan and Newfoundland & Labrador took more liberties in their most recent updates. The former lifted their WTI assumption from \$58 to \$68, while the latter lifted their Brent crude assumption from \$63 to \$74. Both now face downside revenue risk in the neighbourhood of \$100 million for FY18/19.
- The TSX** has persistently lagged its U.S. counterparts, and the slide in oil is certainly not helping (*Chart 8*). Canadian stocks are down 6% in the past year versus a like-sized gain in the S&P 500. Longer term, the TSX has posted a less than 3% annualized gain over the past five years versus nearly 10% for the S&P 500.
- While the Canadian market suffers from a lack of exposure to what has been working best this cycle (namely technology and consumer discretionary), weakness in oil and the differential have both played a role as well. Keep in mind that energy is still 18% of the TSX versus 5% in the S&P 500.



General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group