Oil: Return to Battle Stations

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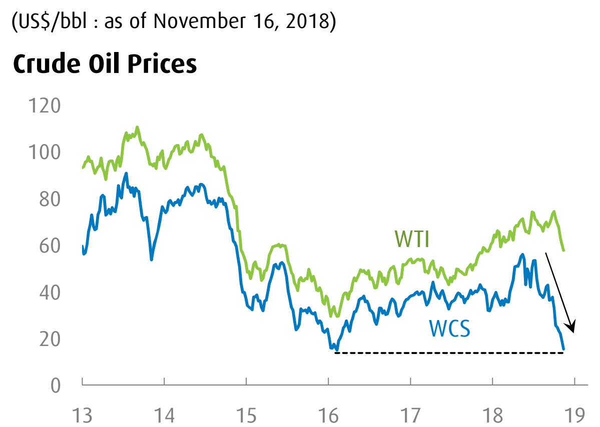
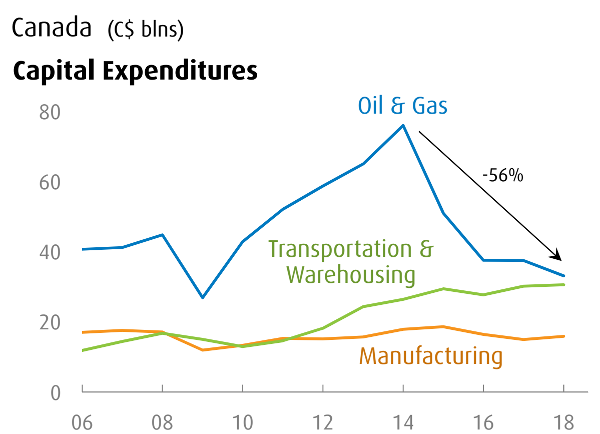
- Oil prices extended their record losing streak this week, with WTI diving below $57/barrel, its lowest level of the year and down more than 25% just since the start of October. Brent prices have almost precisely followed the same pattern. Compounding the pain for Canada, the differential for Western 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



Sources: BMO Economics, Haver Analytics, Bloomberg

Chart 2
Canadian Capex: Downside

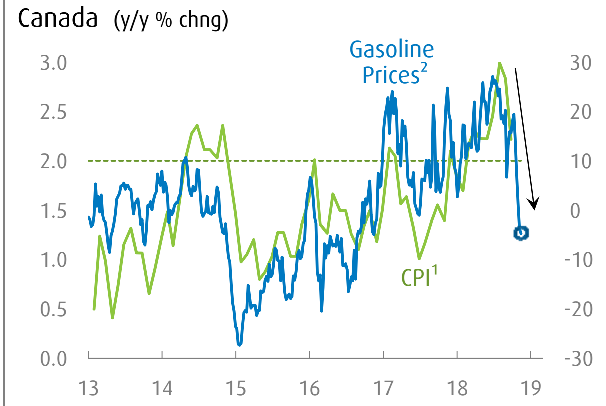


Sources: BMO Economics, Haver Analytics

- 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.

Chart 3

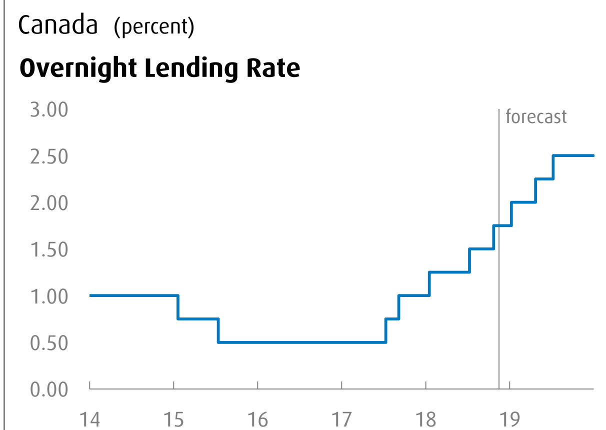
Inflation: Driven by Gasoline



¹ (lhs) ² (rhs)
Sources: BMO Economics, Haver Analytics

Chart 4

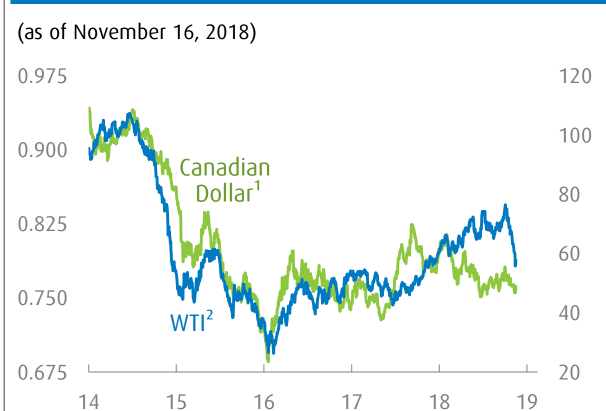
No Forecast Changes... Yet



Sources: BMO Economics, Haver Analytics

Chart 5

Does No Rally Mean No Sell-off?



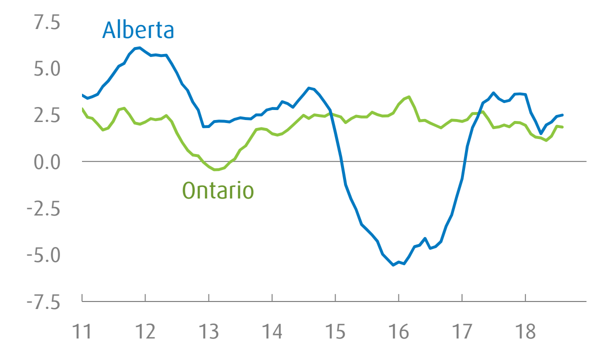
¹ (lhs : US$/C$) ² (rhs : US$/bbl)
Sources: BMO Economics, Haver Analytics

- 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.

Chart 6
Regional Convergence

Canada (y/y % chng)

BMO Economic Performance Index

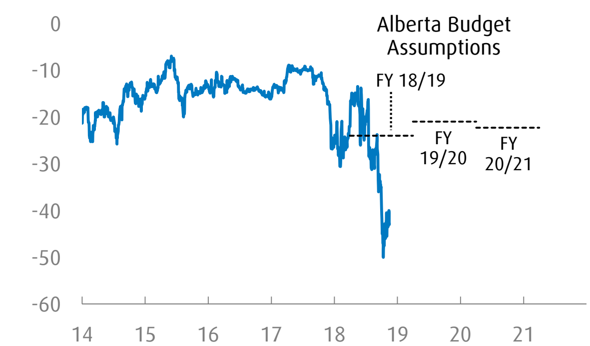


Source: BMO Economics

Chart 7
'Bitumen Bubble' Returns

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

Western Canadian Select Discount (WCS – WTI)



Sources: BMO Economics, Haver Analytics, Alberta budget

Chart 8
The TSX: No Fuel

(as of November 16, 2018)

[1] (lhs : ratio) [2] (rhs : C$/bbl)
Sources: BMO Economics, Haver Analytics, Bloomberg