When the Oil Comes Tumblin' Down

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Misdirection is one of the first lessons any budding magician learns—draw audience attention to one thing, to distract them from the much bigger event taking place elsewhere. One has the nagging sensation that we have just been witness to some very big acts of misdirection. In a week dominated by the U.S. "magic" of the midterms, and an initially robust equity market response, here were some other significant developments hiding in plain sight:

1. **The bear market in oil.** Friday marked the 10^{th} consecutive daily decline for WTI, slicing it below $60, and driving it down almost 22% from the peaks hit barely a month ago. This will be the fifth consecutive weekly drop, and—unbelievably—this isn't even (yet) the longest weekly skid this year (there was a seven-week setback in early summer). Factors behind the sudden slide include: rising inventories amid ongoing powerful gains in U.S. production, OPEC over-production, and a watering down of the constraints on Iran's exports. On the first point, U.S. output has vaulted 2 million bpd in the past year alone to 11.6 million, the swiftest annual rise on record and making the U.S. the largest producer in the world. Meantime, there was also talk this week of Saudi Arabia abandoning OPEC altogether, hardly a positive for prices.

   Now before we rush to radically adjust all economic forecasts, there are **a few points to make on oil's slide**. Some of this move simply reverses the steep run-up in anticipation of the Iran sanctions (a classic buy the rumour, sell the fact). The severe drop brings WTI prices back to where they ended 2017, which was actually the highest level of the year. So, current prices are still well above last year's average of $51. We were never big bulls on oil for 2019 in any event, and are keeping our call for next year's average of $65 (from what looks to be an average of about $66 this year). Still, the swift reversal will clearly clip headline CPI across much of the industrialized world at least temporarily, just after most inflation readings had finally pushed above 2% recently. Look for a quick trip back below 2% in many economies in the next few months.

   Among the major economies, **Canada stands out as the most obvious potential growth casualty from the pullback**. Compounding the pain is the glaring fact that WCS was extraordinarily weak even before the broader setback in global oil prices unfolded, posting ugly record spreads to WTI. In contrast to the bulls looking for a quick turn, WCS prices have cratered further to below $17, maintaining the grotesque spread and deeply darkening Alberta's outlook. Markets, forecasters, and policymakers have all been remarkably calm about the prolonged softness in WCS—Governor Poloz noted it in Monday's speech, but blandly suggested that *"a shortage of pipeline capacity has been weighing on prices"* and that the recent *"especially large"* discount was due to maintenance and *"will be temporary"*. Heading into a wave of fall fiscal updates, most notably from Ottawa on November 21, the deep dive in oil is the one new factor that could throw the proverbial cat among the revenue pigeons.

Suffice it to say that the decision by a U.S. federal judge in Montana to grant an injunction blocking the Keystone XL pipeline—on which construction was set to begin next year—adds insult to injury for producers. The news sent an already skidding Canadian dollar for another loop, driving it down 0.7% on the week to below 76 cents (or $1.32/US$). President Trump was quick to call the decision a "*disgrace*", and there is the possibility the ruling could be over-turned by a higher court. Even so, the ruling simply shows the many, many roadblocks Canadian producers will continue to deal with in order to get product out of the country, and keeps the dark cloud hovering over future investment in the industry.

2. **The Fed's steely determination.** This week's FOMC meeting was always going to be a yawner—so much so that some were going to the extreme lengths of quoting Queen to try to liven it up. Typically, the Fed bends over backward to not be an election issue, and tends to make as little noise as possible in the November meeting around any vote. And, given that this was the last meeting without an accompanying press conference, expectations for any major new communications were near zero, let alone a rate change from the 2.0%-to-2.25% range. The Fed delivered on those low expectations… in spades. Making about as few word changes as possible, and keeping the communique as terse as possible, the Fed noted that business investment had cooled from its hot pace, but pretty much everything else was *"strong"*.

Yet the lead story of a non-event FOMC buried the bigger story of what it didn't say—Sherlock Holmes would be all over the dog that didn't bark in this case: **There was no mention of the market volatility and/or clear signs of cooler global growth**. After all, since we last heard from the FOMC, when they hiked in late September, U.S. stocks had been through a wrenching correction (the second of the year), and global PMIs sagged nervily close to the 50 line. For example, China's composite private sector version dipped to 50.5 last month. The comeback from the Fed would likely be: "true, but the U.S. measures remain at very robust levels averaging almost 60 even with a mild October retreat". As for stocks, the Fed would no doubt note that, even with a Friday spill, the S&P 500 has already recouped half its correction losses (headed for a 2% rise this week), is back above its 200-day moving average and is up 8% from a year ago. Nothing to see here folks. The main point is that **the Fed looks quite determined to get rates back to neutral**, and it's going to take a lot more than a garden-variety correction in stocks to dissuade it from that path.

Ditto for the Bank of Canada. The one key takeaway from the Governor's speech in London this week was that the Bank will not be thwarted from getting back to neutral (2.50%-to-3.50%, versus 1.75% now) by a moderate tightening in financial conditions. On the contrary, Poloz almost seemed to welcome the back-up in bond yields, if not the reset in stocks, as a natural progression of a tighter policy world. Notably, while the Fed said nothing about stocks, Poloz was only too happy to chip in with his views on the market: *"Qualitatively, then, it is logical to expect stock prices to retrace some of their earlier increases and to exhibit a more normal level of volatility."* Guess we won't be talking about the Poloz Put anytime soon!

Sidebar on the Bank's recent hikes: While we wouldn't be quite so sanguine about either the pronounced weakness in WCS, or the ongoing struggles by the TSX, **we still don't have a serious issue with the BoC snugging policy**. It's awfully tough to argue against the Bank slowly lifting rates amid the lowest jobless rate in 40 years and core inflation hovering right around target. Even with the five rate hikes since last summer, **the overnight rate of 1.75% is still negative in real terms**—that is still an abnormally low real rate for an economy that's far from abnormally weak. Having said all that, and even recognizing that the Bank won't be swayed by market volatility, an extended period of weakness in oil prices is one new development that could indeed stay its tightening hand. Let's just say that the odds on a hike over the next two meetings (i.e., by January 9) are lower than the market's guess of 90%.

3. **The USMCA may yet provide some further drama.** Most of us assumed that, after more than a year of clouding the Canadian economy with unwanted uncertainty, the late-September USMCA put the issue to rest. Well, in a belated tribute to Halloween, the issue has been resurrected by the midterm election results. The loonie had a fright this week on a news item that Canada and the U.S. are debating some of the finer points of the initial deal, but that seems like a minor issue compared with the bigger challenge of getting the deal through Congress. It's not the USMCA per se—officially, the Democrats have expressed only mild reservations about the deal—it's more that **the deep political divide may mean that the House could be tempted to block any potential "wins" for the President**. The flip side is that, if the Democrats instead want to set a different and more constructive tone, at least initially, agreeing to approve the USMCA could be a low-pain path.

   Meantime, in another area of potential political drama, it looks like the volume could be turned down. Here's one view from an opinion piece in the Washington Post this week: *"The midterm elections, followed promptly by Attorney General Jeff Sessions' forced resignation, have rendered special counsel Robert S. Mueller III's investigation into Russian interference in the 2016 presidential election politically irrelevant."* The misdirection here of course is that, while pundits were still waist-deep in analyzing the election results, Sessions was being shown the door, which would have been massive news in any other week.

Amid the ongoing drama in Washington, the key point is that **many other critical developments can sometimes be overlooked**. Like two-year Treasury yields rising close to the 3% threshold, their highest level in a decade, and up by more than 2 percentage points from just two short years ago. Or, like natural gas prices quietly hitting some of their highest levels of the past four years this week (at above $3.75). Or, like the Mexican stock market getting clobbered this week by 5% (and almost 7% in US$ terms) on a proposal by the incoming government to curb banks from charging certain commissions. Or, like the same government looking to follow Canada's lead on cannabis legalization, potentially creating a big new competitor and market. Or, like John Mellencamp (nee Cougar) and Meg Ryan getting engaged.