



## **KMI News Bulletin - Markets Update**

As the markets take fright, Guy Foster, Brewin Dolphin head of research, has provided some context on the drop in the oil price that has prompted the current market volatility.

- The energy market has historically operated as the world's most high-profile cartel. Typically frowned upon as allowing producers to exploit their power over consumers, the OPEC was considered to be in the mutual interest of both parties, helping to stabilise the price for their respective incomes and costs. OPEC began to collaborate with Russia in order to try and maintain this price stability.
- That cartel was broken by the emergence of US shale oil which produces oil at generally lower costs than traditional producers. Since 2017 OPEC attempted to limit their own production in order to keep the price at reasonable levels, however the net result of that has been to allow shale oil to keep taking market share with higher profit margins.
- A combination of lower demand driven by efforts to constrain the spread of the coronavirus, and a realisation that their strategy was not working has led to all discipline breaking down in the OPEC group. Producers are now increasing their production, despite low demand, causing prices to plummet.
- A lower oil price discourages further investment in bringing on new oil supply. Therefore, bringing supply and demand back into balance. This process can take some time but because oil supply declines anyway by a little over 5% a year, this and a reduction in new investment will bring the oil price back to a new equilibrium price. This is what the large oil companies will use to base their expectations on, before embarking on any new investment.
- The current economic outlook is unusually ambiguous. Measures will, in due course, be implemented in many countries around the world to slow the spread of the coronavirus. These measures will have an economic impact, but without knowing the extent of that economic impact and while that uncertainty exists, market volatility will remain high.
- Over the course of the next several months the uncertainty will be resolved by events. The great strength of the capitalist system is that it motivates companies to evolve, be agile and to be opportunistic. This disruption seems destined to hit profits for 2020, but companies will work to ensure they are able to deliver the longer stream of earnings into the future upon which their valuations are based.

And

- Deferring to experts in epidemiology, we understand that it is not practical to prevent this virus spreading globally. Rather the emphasis from health authorities will now be on slowing the

spread. Although cases within China have been well-contained, the measures being taken there are draconian and unlikely to be applied in many other countries.

- The market is likely to worry more about the degree of disruption caused by the measures being implemented to slow the spread of the virus. Generally measures to limit physical interaction seem to have been effective. These include school closures and the cancellation of some mass gatherings (as we are seeing in Italy). These will inevitably have some impact on the demand and supply of goods and services.
- Financial authorities will focus on limiting the extent to which temporary disruption leads to companies failing or cutting back on employment in large scale, as that would potentially lead to recessionary characteristics.
- Over the coming months Some economic activity will be deferred and some will be lost, but the majority of companies will anticipate a return to full activity once the measures can be relaxed.
- Company valuations are based upon expectations of future earning potential rather than just the current year. Hence something which is tangibly temporary in nature need not impact valuations as much as might be imagined.
- Thinking about the disease itself, the outbreak will be temporary. It now seems likely that the ultimate number of people suffering severe symptoms will be high in absolute terms, albeit low as a share of the population. Fears about the mutation of the virus to make either more or less virulent seem misplaced as it has stable genome and does not need to mutate in order to spread more effectively.



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