Oil Price War Creating More Questions for Investors

The failure of Saudi Arabia and Russia to agree on an oil production cut extension, and subsequent indications of an all-out oil price war, has sent global stock markets and bond yields sharply lower overnight. The Eurostoxx 600 index is trading down 6 percent, with the energy sector dropping 14 percent. This is, of course, on top of the declines experienced over the previous several weeks, bringing the total decline in European equities to a bear market 20.7 percent. This follows overnight declines in Asia ranging from 3 percent in China to 8 percent in Thailand. Futures in the U.S. are trading down almost 5 percent. The price of West Texas Intermediate crude oil is down $9 a barrel overnight, or 22 percent. This is on top of a $4.60 a barrel, or 10 percent decline on Friday. Bond yields are continuing to fall, as the ongoing flight to safety has gathered strength, pushing the ten-year Treasury yield to 0.40 percent and the thirty year to 0.82 percent.

U.S. stock prices fell sharply at the opening of trading on Monday, quickly triggering an automatic 15-minute halt in trading known as a circuit breaker. After attempting to rally midday, stocks were once again under pressure in the afternoon, and with 90 minutes to go in the session were trading at their lows of the day. Both the Dow Jones Industrial Average and the S&P 500 were lower by more than 7.5 percent on the day, the worst day for stocks in almost ten years. The energy sector was suffering the steepest losses, down almost 20 percent, followed by financial stocks, down 12 percent. All eleven sectors were sharply lower on the day.

Last week, stocks managed to climb despite the elevated daily volatility and intensifying COVID-19 (coronavirus) concern. The S&P 500® index climbed 0.6 percent on the back of two daily gains in excess of 4.0 percent on Monday and Wednesday. That was just enough to offset the sharp moves lower on the other three trading days. While any gain is a welcome development, it paled in comparison to the 11.5 percent loss of the previous week, and judging by today’s further move lower, contained no hint of improving sentiment. The Chicago Board Options Exchange VIX index remained above 30 throughout the week and closed at its high reading of 42. Prior to the start of the current correction on February 19, the VIX had averaged a reading of 14 since the start of the year.

Bond Market Experiences Unprecedented Moves

As headline grabbing and as painful as the correction in equities has been, until today, it had not been especially deep. The S&P 500 had declined by 12.2 percent, not dissimilar to the average correction since WWII of just under 14 percent. Of course, as today’s price action reminds us, that tells us nothing about where it goes from here. But the bigger news has been what’s been happening in the bond market. Yields have collapsed in an extraordinary flight to safety. From
February 19, through Friday, the yield on the ten-year Treasury note has more than halved, falling from 1.57 to 0.76 percent. The thirty-year bond yield had dropped from 2.02 to 1.29 percent. Last week the Federal Reserve enacted an emergency rate cut of one-half percent, yet the futures market was already pricing in an additional half percent rate cut when the Fed meets formally in two weeks, and an additional quarter point cut by April. While stocks had fallen 12.2 percent between February 19 and last Friday, the Bloomberg Barclays U.S. Treasury Total Return Index had risen 5.7 percent.

Concerns are beginning to mount that if the economy slows sharply enough for long enough there could be a meaningful increase in impairments among highly indebted speculative grade credits that would see both a decline in cash flow to service their debt, as well as a loss of access to the ability to refinance. High yield spreads have widened sharply in the past three weeks, but not to a point of concern. Since February 19, the Bank of America High Yield Master II index spread has widened from 357 to 554 basis points, leaving it still not far above its ten-year average spread of 491, but nevertheless the widest in three years.

The Economic Impact of the Virus Being Tested

Until today, the extent of the moves in stocks and high yield bonds during the current correction had certainly manifested a heightened level of concern about the coronavirus and its impact, but not to the extent of true risk aversion. In addition, these declines had restored a measure of fairness to valuations that were inarguably stretched. But the fact that the declines were not dissimilar to typical market corrections also suggested an expectation that the economic impact of the virus would be relatively mild and temporary. And while we believe that will still be the case, that relative degree of confidence is being tested.

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The Dow Jones Industrial Average (DJIA) is likely the most widely known measure of American stock market indicators. The index is more than 100 years old, includes only 30 individual stocks and is comprised of the largest, most established firms across a broad range of industries. The DJIA is calculated based on share price – providing a greater weighting within the index to those companies with a higher share price. Due to the small number of issues contained in the index, it does not always provide the most accurate measure of aggregate stock market performance.

The S&P 500 Energy Select Sector Index measures the performance of energy stocks, as classified by the Global Industry Classification Standard (GICS). Every Select Sector stock is also a constituent of the S&P 500 Index. It is float-adjusted market capitalization weighted.

The Shanghai Composite Index is a capitalization-weighted index of all stocks on China’s Shanghai Stock Exchange.

The Standard & Poor’s 500 Index (S&P 500® Index), an unmanaged index of common stocks, is frequently used as a general measure of market performance. The index reflects reinvestment of all distributions and changes in market prices but excludes brokerage commissions or other fees.

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a widely used measure of market risk. It shows the market's expectation of 30-day volatility. The VIX is constructed using the implied volatilities of a wide range of S&P 500 index options.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region.

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A 10-year Treasury note is a debt obligation issued by the United States government that matures in 10 years. The 10-year yield is typically used as a proxy for mortgage rates, and other measures.

The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

The Bank of America Merrill Lynch High Yield Master II Index is an unmanaged index comprised of over 1,200 high yield bonds representative of high yield bond markets. It includes zero-coupon bonds and payment-in-kind (PIK) bonds.

The Bangkok SET Index is a capitalization-weighted index of stocks traded on the Stock Exchange of Thailand.

An index is a statistical composite that is not managed. It is not possible to invest directly in an index

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