Lincoln Private Investment Office

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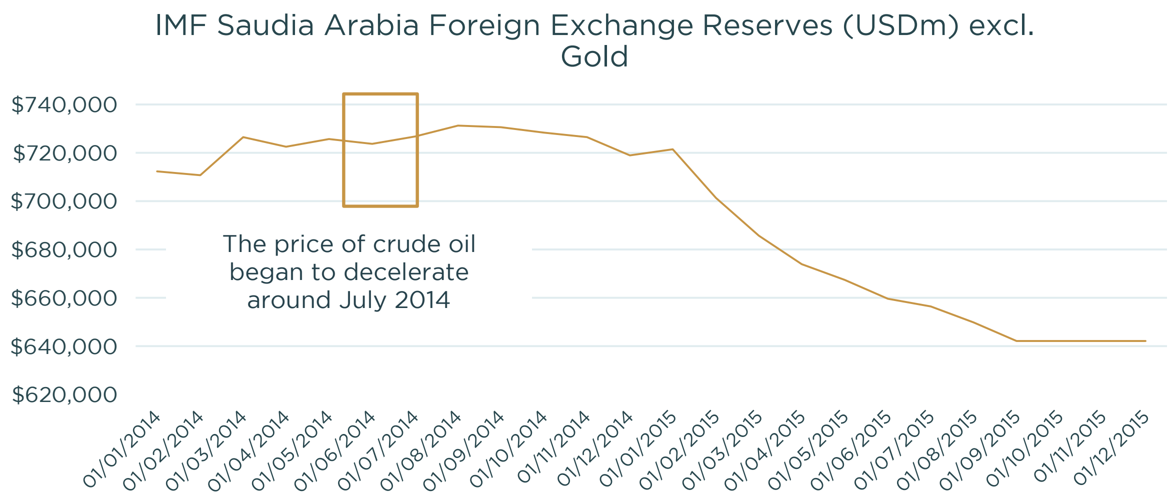
$30 Oil Looms

Commodity commotion has hit markets once more this week. Even a proxy war in the Middle East failed to provide respite, with the price of oil hitting a new 6-year low seemingly every other day.

The effects on beleaguered producers became clear in 2015, with the commodity-heavy FTSE struggling at every fresh selloff and US shale oil producers eliminating dividends. This predicament is of course not new to us. Over-accommodative monetary policy has contributed to a deflationary supply glut by allowing cash-strapped companies that would otherwise have gone bust to stay in business. The bubble in energy credit inflated since the 2008 financial crisis is a prime example of this kind of financial excess. With demand from income-hungry investors seeming unquenchable, the digging and drilling could, in theory, have continued indefinitely - at least as long as the Fed and other central banks didn't capitulate to the Saudis, who appeared set to outlast the cheap debt that was keeping would-be insolvent oil and gas companies afloat.

That said, even the Saudis can only play the waiting game for so long. Nearly 75% of the kingdom's revenue comes from oil, despite efforts to diversify the economy. And, like China, it has an exchange rate that is pegged to the US dollar. The 2016 budget plans to run an $87bn deficit[1] – but this assumes the average price of crude at $45 a barrel[2]. The price is currently oscillating around $32, while the US dollar continues to strengthen. With the country now running a large budget deficit, there have been rumblings of a China-style currency devaluation. Of course, Saudi Arabia was in a similar position in 1998, until a rebound in oil prices alleviated the need for such drastic measures. But the cost of maintaining the state has increased since, in part due to the late King Abdullah's social spending as the Arab Spring uprisings toppled leaders elsewhere. An actual devaluation could have profound effects on the oil price. It would mean that one of the most significant oil producers would, in effect, be lowering its cost base. This could allow the price of oil in US dollars to fall even further, with the effects spilling over into the currencies of other oil dependent nations.



The kingdom's shaky currency peg with the dollar has come under record pressure as speculators in the forward market for Saudi riyal have caused spikes in volatility as investors bet on a devaluation. The Saudi Arabian Monetary Agency, as the central bank is known, reiterated their commitment to the 30-year old peg today. However, Iran looks set to come on-stream, bringing with it a further 500,000 barrels of crude daily[3], and a further four interest rate hikes forecast this year in the US mean that dollar strength could be set to continue. Saudi central bankers may have to revisit their models, and their current stance on the future of the currency peg.

Commodities are an interesting asset class; whilst we are very focussed on oil, we do not believe the risk/reward benefits are clear enough in the current, confused environment to warrant adding exposure.

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[1] Source: International Monetary Fund
[2] Source: Saudia Arabia Monetary Agency
[3] Source: Rokneddin Javadi, general manager of the National Iranian Oil Company