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Fundamentals Flash

Asset Management

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Prepared by: Affin Hwang Asset Management

Oil Price War Ignites Sell-Off

What happened?

Oil prices plunged by almost 30% after Organization of the Petroleum Exporting Countries (OPEC) and its allies failed to strike a deal regarding production cuts. This culminated in Saudi Arabia, the world's largest oil exporter ramping-up production and slashing prices, leading to fears of an all-out price war.

Saudi Arabia's price cut followed a breakdown of talks in Vienna last week, where OPEC members had recommended additional production cuts of 1.5 million barrels per day starting in April and extending quotas until the end of the year.

But OPEC ally Russia had rejected the additional cuts when the 14-member cartel and its allies, collectively known as OPEC+ met last week. The meeting subsequently concluded with no directive about the production quotas that are currently in place, but are set to expire by the end of March.

As an act of retaliation, Saudi Arabia had announced over the weekend massive discounts to its official selling prices for April. The kingdom is reportedly also set to increase its production above 12 million barrel per day. Oil prices have already moved sharply lower this year as the coronavirus outbreak has led to softer demand for crude. A potential supply glut could pressure prices downwards further.

How did markets react?

Oil & gas related stocks took a hit falling by over 20%-30%, when markets opened. Banks with large debt exposure to the oil & gas sector may face additional strain as companies within the industry are unable to service their borrowings. Smaller O&G companies particularly with weaker balance sheets may face credit stress and struggle to repay interest.

We view the recent moves in oil price largely as a result of a **self-induced supply shock, rather than a sudden collapse of demand which is more detrimental to the economy**. Viewed through a wider geopolitical lens, the move by Russia is also seen as strategy to weaken US shale players and hurt its economy, beyond just gaining market share. We expect further pain ahead for oil markets, before any OPEC+ countries can be brought back to the negotiation table.

What about impact to Malaysia?

As a net oil exporter, Malaysia may see its oil revenue depleting and budget deficit widen with already limited fiscal room to manoeuvre. According to estimates, every $10 change in oil prices would lead to a loss of over RM7 billion in government revenue.

If oil price continues to weaken, state-owned oil major Petronas may move to cut upstream spending and capex activities which would have spill-over effects to the rest of the industry. Service providers may see margins narrow as contracts are renegotiated and maintenance players prolong schedules due to a lack of activity. The local currency which has held up well so far could weaken if the situation prolongs. The Ringgit weakened as much as 4.50 against the greenback at the height of the 2014 oil crisis when oil prices fell below US$ 28 per barrel.

How are our portfolios positioned?

On portfolio positioning, we remain prudent and would continue to stay defensive as markets tend to overreact in the short-term due to knee-jerk selling. Capital protection would take precedence as we await for further clarity before we deploy back into markets again.

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What should investors do?

Investors may be tempted to react impulsively by taking profit as markets have sold-down fiercely due to Covid-19 fears and the recent plunge in oil prices. But, it is extremely difficult to time market conditions and if indeed the market has reached the tail end of the bull cycle. Economic forecasts have certainly softened due to strict containment measures taken as well as supply chain disruption caused by the coronavirus.

However, It is crucial that investors stick to their asset allocation plan and not be swayed by market volatility. Once Covid-19 recedes, we believe the global economy will bounce back as months of pent-up demand flows into the economy. Lower oil prices may even bode well for emerging markets over time. Ultimately, markets will find its equilibrium and normalise by finding new levels.

Investors who remain disciplined in their approach by investing consistently and stick to their long-term asset allocation would eventually reap the benefits and fare better overall.

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