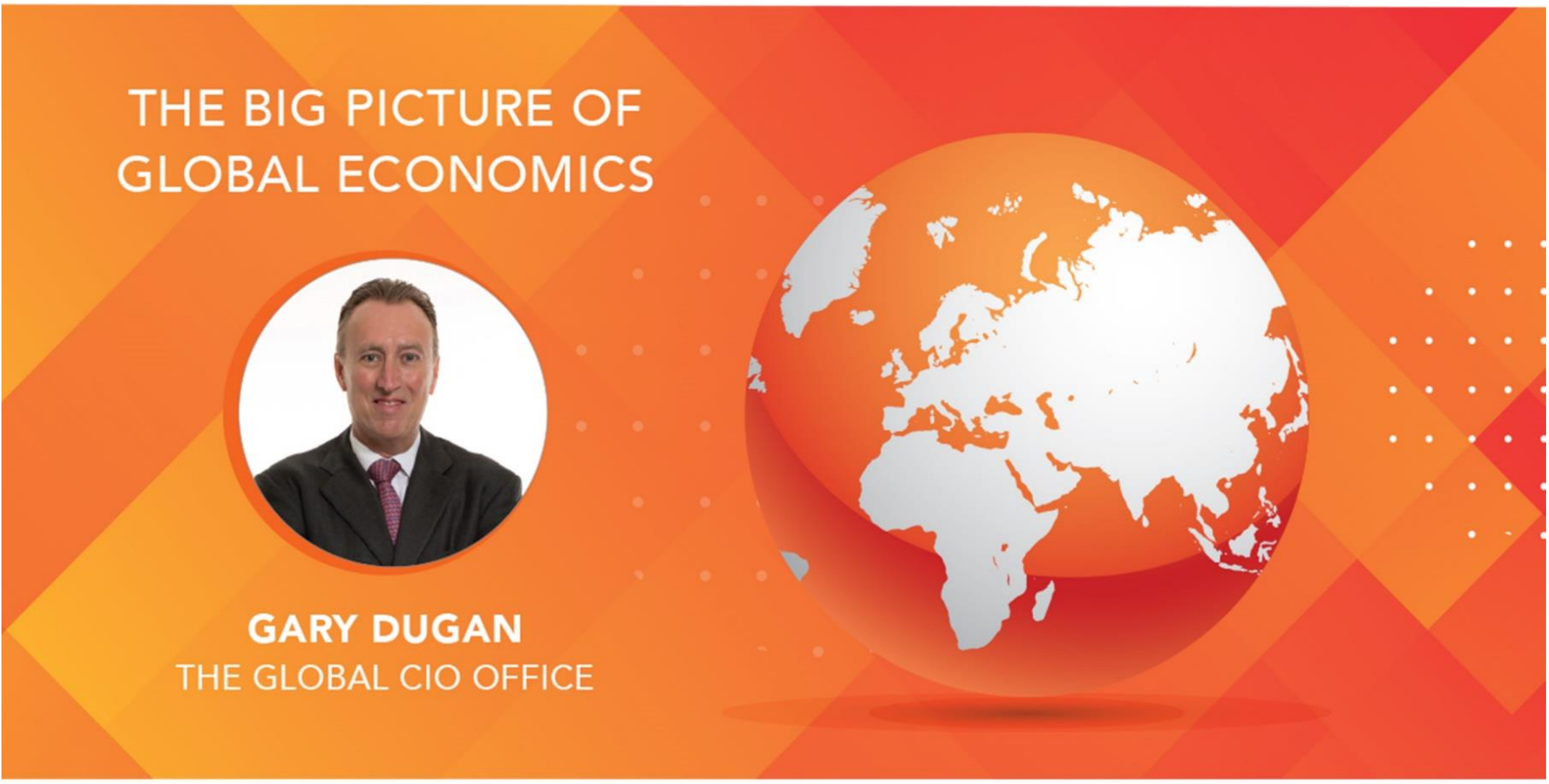
Sanctum Wealth Management



Sanctum View

October 26th, 2020

Is it the Blue Wave or the Next Big Short?

- **US long-dated bond yields rise**
- **Hopes for a blue wave - Biden presidency and Democrats taking the Senate**
- **However hopes for a large fiscal package may not warrant a prolonged rise in rates**
- **The oil sector is a stand out underperformer that may have hopes of better times**
- **Market starts to eye a potential rebound in oil prices**
- **We see room for a tactical sharp rebound, but the long term is still very challenging**

Is it the Blue Wave or the new Big Short?

Last week, long-dated US Government bond yields rose to levels last seen in early June. The 10-year bond yield rose to 0.87% before settling a tad lower by the end of the week. The narrative around this rise is a popular "Blue Wave" theory. It holds that Joe Biden has a built enough momentum to win not only the presidential election but to catalyse a Democratic sweep of the House of Representatives and the Senate. The market believes such a win could trigger a wave of spending to prop up the faltering US economy and lift it out of its COVID-induced funk.

In unison with the rise of yields, there was a spike in the probability of a Biden win as priced by online betting markets, despite opinion polls remaining more or less unchanged. Option-markets watchers in the US report that the size of the short position into the futures market is becoming pretty noticeable. The cost of taking option protection on rates (as expressed in the level of implied volatility indices) has risen markedly in October, an indication that market participants are more willing than before to pay to hedge exposures.

All of the above raises questions. The Fed has made it clear that it is not in the mood to hike interest rates until the inflation rate has spent some time above the target rate of 2%, given it has spent so much time below it. At the same time, Congress has shown its willingness to add massive stimulus to the economy, a willingness that is unlikely to wane post-election. It will have an avenue too if there is Democratic control of the White House and both houses. The bet is that the extra spending will be so inflationary as to threaten the “lower-for-longer” mantra of the Fed.

Assuming for a second that there will indeed be a blue sweep, we still struggle to see that it creates inflation. The markets implied assumption that there could be an inflation wave to accompany a supposed spending spike ignores the fact that a vast quantity of stimulus has, to date, not succeeded in getting inflation close to the target. A lot of capacity has been eliminated in several industrial sectors, thanks to COVID. In our view, cash infusions will ease the pain but do little to bring pricing pressure. Similarly, much stimulus will be required to support the current levels of consumer expenditure. Economists expect no enhancement of spending levels, just support. This is not in itself inflationary. All of this additionally rests on the assumption that Democrats will be in a position to enact stimulus in an unfettered way: by no means a certainty at this point.

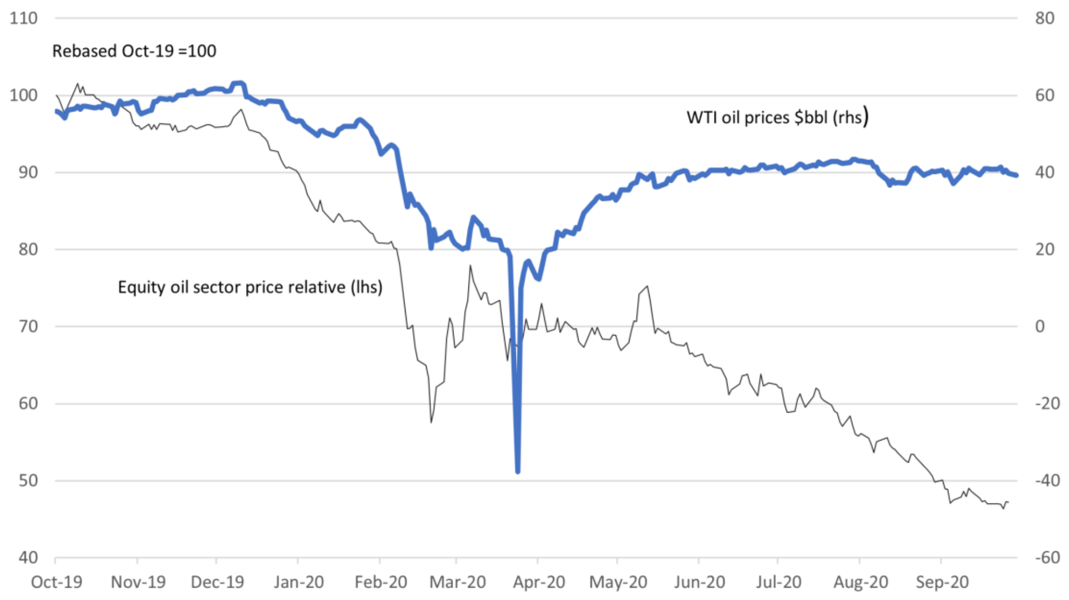
A further question raised is one that the Fed might have to answer at some point next year, namely just how committed it is to keep the long end of the yield curve in check. It will be a futile exercise to add cash to the economy on the one hand, but then to see the benefit dissipated through a rise in debt servicing costs on the other. The Fed can influence the curve through direct and targeted purchases of debt. Should there be a rise in inflation, it may have to step in to keep matters under control. A number of the Fed governors in recent weeks have alluded to the fact that they have the scope to lengthen the maturity of the bonds that they are buying.

As a final point, it bears noting that every bout of extra balance sheet expansion by the Fed, from 2008 onwards, has been accompanied by a drop in the velocity of money circulation. Commentators observe that much of the intended liquidity support is not reaching its intended target. It is becoming more pronounced over time. It is possibly part of the reason why central bankers are so keen to nudge their fiscal counterparts to enhance the level of intervention they apply to economies. The hope is that direct government spending will be a more effective inflation and growth spur. Evidence for this hope is scant so far. Read together with some of the other assumptions above; we wonder if the market is not getting ahead of itself going for the new Big Short.

Is there near-term hope for the oil sector?

The oil sector has to be up there in any search for assets that have the potential for a sharp rebound when times get better. Year-to-date, the equity oil sector has been a disastrous investment. The oil sector is down 50% year-to-date relative to the global equity index. Throughout the year the sector has shown few signs of reversing that trend. However, at the end of November, there are some hopes that a crucial OPEC meeting could offer hope for a rebound in the sector. But just how realistic are those hopes for better times?

Chart 1: Oil sector has serially underperformed



Source: Bloomberg

Last week there were a few days of better performance from the oil sector. News broke that Russia might support OPEC+ keeping the currently targeted production cuts in place beyond the end of the year. Remember that OPEC + agreed to production cuts to bring stabilisation to a fragile oil price in the face of much-reduced demand in the wake of COVID-19. Those production cuts were due to roll off at the end of this year. However, in the face of still weak global oil demand, and particularly after the most recent spike in COVID-19. OPEC+ could announce that they will leave the full production cuts in place at their meeting at the end of November.

However, the situation has been complicated by a (thankful) ceasefire in Libya. This has allowed Libya to increase oil production again. In August, Libya was only pumping 80,000 barrels a day, its lowest output in nine years. Analysts believe that Libya in aggregate is producing around 380,000 b/d at present, potentially on their way to the 1.2m b/d of output seen at the start of the year. To be fair to OPEC, despite analyst downgrades to oil demand, and the recent pick up in supply, the oil price has been rock solid around $40 for the past four months.

We suspect that any upside for the sector is likely to be highly tactical. We note that the sector did have a couple of 20% rebounds in June and August. One other thing going for the sector is that the pace downgrades by analysts to earnings forecasts appear to be abating at least somewhat.

More certainty from the US Presidential election could undoubtedly help. The market might even see a Biden win as a net positive as he is clearly no great supporter of the oil industry. Also, a vaccine for COV19 would bring hopes of more robust global growth and a recovery in demand, for oil.

A more substantial consistent outperformance from the sector is likely to have to wait for the massive cuts back in oil drilling to inevitably lead to at least some shortages in the supply of oil. In the United States, the oil rig count has dropped from 1930 at the peak in September 2014 to 257 today. Even in the Middle East, the rig count is down from 282 from 430.

However, a more substantial re-rating for the sector has serious headwinds. The not inconsequential long-term issue is that of an increasing number of investors will not invest in the industry. And as Oil Change International have pointed out that if the world is to achieve its target of meeting its target of holding global warming to just 1.5 degrees, then even some of the developed oil and gas reserves will have to stay in the ground.

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