Global Macro View

Geopolitics

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Understanding how geopolitical risks in the world affect various markets is crucial to investing properly. Conflict between countries affects global economic growth and international trade, both of which have direct implications on the macroeconomics of individual countries. Furthermore, uncertainty in how events will affect these macro factors will cause investors to be cautious and invest in safer assets. Therefore, investors will leave the equity markets and invest in fixed income, gold, and the U.S. Dollar.

Over the past week (May 21st – 25th), sanctions on Venezuela and Iran have caused oil prices to initially skyrocket but OPEC's decision to increase supply lowered prices significantly by the end of the week.

See-Sawing Oil Prices

Oil started the week on a high note as the U.S. imposed new sanctions on Venezuela and had vowed to be stricter with sanctions on Iran. The re-election of Venezuela's president, Nicolás Maduro, had been considered a sham by the U.S., since Mr. Maduro had contributed to the collapse of the country's economy that resulted in massive inflation and food shortages. Therefore, the U.S. has released fresh sanctions on Venezuela's petroleum industry to help control the corruption of the country. Furthermore, in an attempt to force Iran to the bargaining table for a new nuclear deal, US Secretary of State Mike Pompeo promised to impose the "strongest sanctions in history" on the country. Both of these events have pushed West Texas Intermediate (a benchmark in oil pricing, acronym WTI) to a three and a half year intraday high of $72.34.[1] This is due to the sanctions lowering the supply of oil in the world, and since demand has not been affected, this raises the price of oil.

However, by the end of the week oil prices have dropped significantly down to $67.88 (-6% from the high) and are likely to continue falling.[2] This trend started on Thursday, sparked by OPEC's comments on decisions to increase production. This will help balance the decrease in oil supply caused by the Venezuela and Iran sanctions.[3] The reason OPEC has done this is to capitalize on the high oil prices, so they are selling their reserves and thus increasing the world supply. Demand of oil is fairly inelastic, meaning that a change in price does not affect the demand as much due to our inability to cut the demand for oil without inconvenience. For example, if you drive to work, you will continue to do so even if oil prices go up. Furthermore, oil consumption goes up during the summer since people tend to travel and drive more, especially with the warmer weather in the northern hemisphere. All these factors allow OPEC to sell their supply without impacting oil prices too drastically. Even though they have dropped after OPEC's announcement, oil prices are still high which will allow OPEC to capture large profits in the near future.

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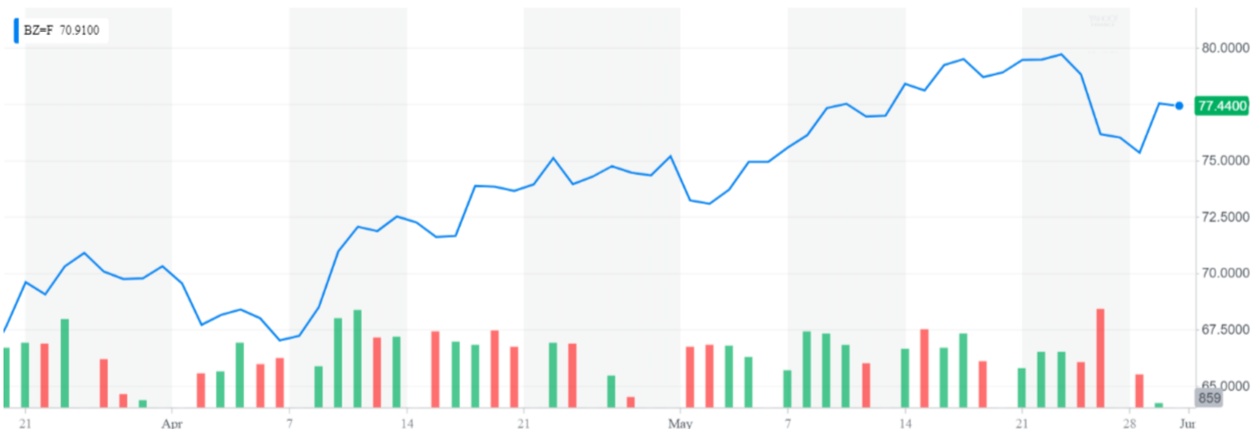
[1] Oil rises as US unveils fresh sanctions on Venezuela – Financial Times (May 21st 2018)
[2] Oil prices fall on talk of hike in production, raising hope for dip in gasoline prices – USA Today (May 25th 2018)
[3] Oil prices drop on potential increase in OPEC output - Reuters (May 23rd 2018)

Effect on the Markets

A lower price of oil has many implications on the economy and various markets. Cheaper oil results in lower input costs for most businesses and allows consumers to spend less on gasoline which increases their discretionary spending. Therefore, corporate earnings will increase if everything else is held equal. However, because there are so many factors in the stock markets, oil prices are not correlated to general stock prices. What is correlated to oil prices is the transportation industry since their dominant input cost is fuel, so airline and trucking companies are a good investment if we believe that oil prices will continue to decrease. Also, countries that are dependent on their oil exports will have their currency weakened. For example, companies will need fewer dollars to buy oil from Canada which lowers the demand for the Canadian Dollar, and thus weakens it. **Overall, these are good investment opportunities, but further research should be done to decide if this decrease is a long-term trend.**

Brent Crude Oil Prices



Source: Yahoo Finance