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Oil change

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The quirks of oil markets have been laid bare in recent days as a slump in global demand caused by the coronavirus lockdowns and issues within the oil markets themselves have collided. Essentially, there is too much oil and nowhere to store it.

Brent Crude, which is the most significant crude oil benchmark in Europe, saw its price fall to an 18-year low below $20 a barrel earlier this week. Extracted from the North Sea, Brent Crude is principally a seaborne commodity, moved around the world via tankers that can be redirected relatively easily to wherever demand exists, or supply shortages are foreseen. In contrast, US oil markets, represented by West Texas Intermediate (WTI) crude, are much less flexible, requiring storage facilities on land and with a cumbersome regional, rather than national, oil transfer framework and mechanism. It is the WTI oil market that has seen most disruption in recent days as vast oil storage facilities like the one in Oklahoma are rumoured to be close to capacity.

This dislocation in oil markets is not just related to the rapid fall in global energy demand caused by the coronavirus crisis. It has been brewing for several months as a stand-off between OPEC and Russia, in terms of agreeing cuts to oil production, has continued. Earlier this month an agreement was reached to cut production by around 10%, or around 10 million barrels a day, a move that under normal conditions would have provided some support for oil prices. But that level of reduced production is only scheduled to last for two months from the beginning of May, coinciding with a period when seasonal demand naturally declines, and storage facilities are typically in greater need. Production cuts taper off for the remainder of the year and into next, so unless there is a surprise rebound in global demand, which at this stage looks highly unlikely, oil prices can be expected to remain under pressure for some time.

What impact is this hiatus having on stockmarkets? At a global level, not too much, other than highlighting the general uncertainty about the impact of the virus on world economic activity and reduced demand for energy. However, as noted, there are other technical factors unrelated to the virus itself that are contributing to the current negative oil headlines. Of more immediate relevance to investors, though, is the impact that exposure to energy companies has been having on regional stockmarket performances. This is particularly noticeable in the case of the UK stockmarket relative to other parts of the world, as this note will go on to outline.

Our core UK equity funds had minimal exposure to oil stocks going into this crisis, and still do. But at the start of this year anyone investing passively into the UK stockmarket via a tracker fund would have had around 15% invested in two oil stocks, BP and Royal Dutch Shell, by default. At the markets' recent nadir in late March, these two heavyweights had fallen by more than 50% since the start of the year and are still down well over 30% in the year to date. Given their dominance, these two stocks alone are responsible for over 5% of the UK stockmarket's near 25% decline so far this year. This influence can partly explain why the UK stockmarket has lagged the US market, for example, where the S&P 500 Index has less than a 3% exposure to oil and energy-related companies.

Aside from potentially helping to advance important debate about the world's reliance upon oil, the search for alternative energy sources and longer-term demand trends, recent events clearly highlight oil's varied influence on regional stockmarket returns (particularly the UK) and the importance of being in a position to steer away from stressed sectors like this through the use of active managers.

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We already know that the global pandemic is going to leave a big, and in some cases a lasting, imprint on all our lives, as well as on the global economy. Whilst many businesses are likely to struggle for some time, and many may not even make it through to the other side, the pandemic will also give a firm nudge and further impetus to a wide number of trends that had been evolving in recent years. This can be illustrated by observing the simple rotation in the make-up of the world's largest companies. The world is not suddenly going to stop needing oil, but its longer-term dependence on this commodity is being squeezed by the adaptations we are all making to the way we conduct and live our lives, go about business and spend our income. Two sectors in particular, Information Technology/Communication Services and Healthcare, are likely to include companies that should not only come out of this crisis in good shape but can make further advancements going forward.

It is no accident that seven of the world's top ten companies by market capitalisation now fall into the broad category of information technology, including services revolving around the internet or online commerce: this does not just include the well-known US companies like Microsoft, Apple, Amazon, Alphabet (Google) or Facebook, but Asian businesses too such as Alibaba and Tencent. Nine years ago, just two of the top ten global companies fell into this categorisation, whilst six were in the oil or wider energy sector. There are now no energy companies in the world's top ten. How times have changed.

Being aware of the different market biases is important as it not only explains a lot about the differences in regional stockmarket performance, but also shows where opportunities might be more prevalent. The table below highlights three of the aforementioned broad industry sectors and their presence in a range of regional stockmarket indices:

Stockmarket	Oil/Energy	IT/Communication Services	Healthcare
UK	13.0%	5.8%	13.3%
USA	2.6%	36.2%	15.4%
Europe ex. UK	3.4%	12.6%	17.7%
Japan	0.7%	21.5%	11.1%
Asia ex. Japan	3.3%	31.7%	3.7%

Source: MSCI as at 31 March 2020.

As can be seen, even after the recent falls in oil prices, a passively invested allocation to the UK stockmarket would still mean a 13% allocation to the Energy sector, compared to around 3% or less elsewhere in the world. The table also shows that a passive allocation to the UK stockmarket gives very little exposure to IT and communication services companies compared to the US and Asia ex. Japan, whilst healthcare businesses are generally more broadly spread. International opportunities seem greater than in the UK based on this very high-level analysis.

Our investment strategies already had a bias towards overseas stockmarkets going into this crisis, and this emphasis is likely to increase further in the coming months and years. We want to give the underlying active managers we deploy the best chance of uncovering the drivers of future economic growth, which in turn should allow our clients to participate in the economic revival, when it comes. As the above table illustrates, this may require an even greater tilt to international companies to find the best opportunities. The biggest companies, as represented by the composition of stockmarket indices, may not necessarily be the best companies, but a helicopter view of the landscape below does at least give an indication of where some of the more exciting businesses appear to be listed and where they find it easier to trade and innovate, whether it be to tap into local demand or something on a much grander scale.

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This crisis will almost certainly cause all investors to think differently about how capital is allocated in the future. It will also reinforce the need for active management. Oil producers may be struggling to find demand and store excess supply, but there is still plenty of capacity among active managers to find long-term homes for capital. We are still wary of increasing exposure to stockmarkets until we are a little clearer on the likely depth and duration of the economic slowdown. We also need more confidence in there not being a second wave of the virus that accentuates and prolongs the current situation. In the meantime, we are using the lockdown time wisely to focus on speaking with active managers and researching the areas that are likely to have the upper hand coming out of this crisis and are more likely to be incubating tomorrow's investment success stories.

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