Fixed Income Focus.

An oily mess

The price of oil has collapsed, creating a number of winners and losers across fixed income markets. But the long-term implications are far more important.

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Ben focuses on allocation within the credit funds as well as providing the credit input to macro strategies.

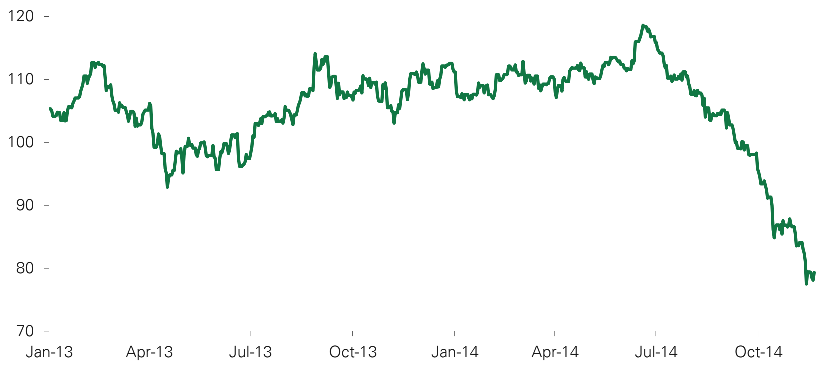
Fixed Income Focus represents the viewpoint of the Active Fixed Income team at LGIM.

Commodity prices in general and oil in particular dominated our latest round of strategy meetings. In terms of US retail spending, cheaper gasoline prices should be supportive given the $30 drop in oil prices since the summer represents a $120bn windfall for the US consumer.

POSITIVE FOR MANY

From a corporate bond perspective, this should be good news for companies that can tap into this improved spending power. Auto manufacturers are an obvious example, as are restaurant chains together with leisure and entertainment companies that benefit from discretionary spending. It's not quite as strong a story for consumers elsewhere as weaker currencies (e.g. the euro and the yen) offset price declines in dollars. In any case, there are not many countries that can replicate the US consumer's sensitivity to gasoline prices. But still, the impact remains positive to a varying degree.

Figure 1: Oil Price (Brent USD per barrel)



Source: Bloomberg L.P.

LESS SO FOR OTHERS

Looking at the other side of the transaction, this reduced spending on fuel is not good news for sellers of oil such as the fledgling US shale oil industry. More broadly, the energy sector represents a large portion of global capital expenditure, and falling commodity prices will negatively impact future plans. The overall US economic impact is still positive given the immediate boost to consumption versus a longer-term drag from capex, but there are still notable losers amongst corporate bond issuers.

Legal & General INVESTMENT MANAGEMENT

The US dollar high yield market is worst hit given the relative size of the energy sector (15% versus 11% for investment grade) and the fact that highly levered companies are more sensitive to declining revenue. There have already been some big price moves within the high yield universe and if oil prices continue to slide, I'd expect a few companies to get into trouble next year and even look to restructure their debt. This possibility is also not great news for the broader high yield bond market as the prospect of defaults may undermine investor confidence and lead to a repeat of the fund outflows that plagued the asset class during the summer.

MIXED EFFECT IN EMERGING MARKETS

Emerging market debt has also been affected by declining commodity prices. The market reaction feels as simple as commodity exporters weakening and importers strengthening. So many Latin American countries such as Brazil, Colombia and Venezuela are under pressure, and markets have been particularly harsh on Russia, which was already suffering due to international sanctions related to the Ukraine crisis. On the other hand, countries that import oil – for example Turkey, India and China – have received a boost. From an investment point of view, some traps are now being laid. For example, Turkey has been very fortunate this year that US monetary policy has not been tightened as much as feared, aiding their external financing. And now a lower oil price improves the country's trade balance, further reducing their reliance on external financing. But behind this is a very difficult political story and very confused monetary policy. Without implementing reforms, Turkey is vulnerable should financing conditions deteriorate once more. India, on the other hand, appears to be implementing structural reforms following the election success of Narendra Modi, and we are happy to take investment opportunities even if the oil price decline starts to reverse.

THE WIDER IMPACT

Finally, and most importantly, is what caused the decline in oil prices in the first place. A combination of factors all came together to push prices lower: increased supply, a stronger dollar in anticipation of tighter US monetary and disappointing global growth.

While the supply-side explanation drives much of the above analysis, disappointing growth and a stronger dollar have repercussions beyond commodities. Six years after the collapse of Lehman Brothers, government bond yields remain near all-time lows, the Bank of Japan is monetising the country's massive deficit, the ECB is buying bank debt and China, the world's growth engine for much of the last decade, has just cut interest rates. Despite extremely loose global monetary policy, inflation is falling across much of the world and declining commodity prices increases the chance of outright deflation. My concern is that central bankers have already used up their deflation-fighting ammunition. Let's hope that the US consumer aggressively spends their windfall from cheaper gasoline and drives the global economy out of its slumber.

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