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Macro Market Insights

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Divergence Part II

The focus of financial markets has certainly stuck with the fallout in the price of crude oil, and rightly so as its impacts will be far reaching from global economic growth projections to domestic monetary policy. One thing that's seems to be lost, however, is not the over excitement of lower energy prices putting approximately $75 billion back in US consumers wallets and a similar story around the globe. Instead, what's missing is the lack of focus going to a diminishing global growth picture out of emerging markets and a continuing weakening demand for crude oil and energy. The story with oil and lower prices warrants as much concern over weakening demand as it does over a supply glut, and the price action to end the week in all markets illustrates that.

This week for the markets was a classic risk off environment with equities and commodities ending the week lower and bonds and the US dollar moving in a positive direction. Unfortunately, as optimistic as most have been over the positive benefits of lower energy prices, the financial markets are tied too closely with the pressure of falling oil prices. Concerns particularly over the balance sheets of a number of oil producers, and in particular their debt loads, have sparked fear over the stability of the resource sector, and leave investors puzzled. In a week that already saw oil prices fall 12 per cent, at what point will this market find stability?

The other factor to key in on was a report released at the end of the week from the Paris based International Energy Agency that said demand growth for crude oil next year would be less than a million barrels a day. This is driven by weaker outlooks for countries like Russia, China, and Brazil, and the prospects of a strong dollar stunting other emerging markets. The strong dollar impact on emerging markets has the potential to be somewhat far reaching.

A number of the emerging economies of the world benefitted tremendously during the aftermath of the financial crises as the US Federal Reserve's weak dollar policies caused exchange rate appreciation in their markets, which not only made them attractive for capital investment, but also lower their import costs. Essentially, in today's market we are seeing the opposite. A strong dollar is increasing the burden of their US denominated foreign debts and increasing the cost of the raw materials they purchase to fuel the growth of their economy. Emerging economies do not see the same benefits of lower energy prices that those of advanced Western economies might.

Looking to next week (FOMC meeting Tuesday-Wednesday) and beyond, investors will be looking for an answer as to what impact this has on fed policy. Expectations vary from March until about September for when the Federal Reserve will begin to raise their key policy rate. If they drop the "considerable time" phrase from their statement when referring to the duration of a 0 to 25 basis point fed funds rate is something that could support a move sooner rather than later.

Last week I wrote on the topic of divergence between North America's economies and the rest of the world, and its impact on financial markets. It's a topic that was further explored by many economists and commentators this week. The question is whether this sharp drop in oil prices keeps the fed at bay because lower energy and producer prices keep downward pressure on inflation, and the global economy poses too much of a risk, or does it accelerate the likelihood of this divide?

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