The Oil Price Is -$0: What Should Investors Do?

Description

The oil price fell dramatically yesterday. West Texas intermediate (WTI) fell far below $0 — the first time in history a barrel of crude oil has traded negative. As I write this, WTI is back in positive territory, while Western Canada Select (our national crude index) is trading at US$9.4, an all-time low. In other words, oil is unbelievably cheap.

Markets seem to be pricing in months of low or negative oil prices ahead. Much of the global economy remains shut down due to COVID-19. A sudden plunge in road and air travel has caused a demand shock for the market. Unfortunately, the Canadian economy hinges on the oil price. Crude exports are a significant portion of national income.

So, how should Canadian investors prepare their portfolios for months of low or negative oil price? Here's a look.

Sell oil stocks

Oil and gas producers are at the forefront of this mess. Several large energy companies have already pulled back investment plans and cut dividends. **Vermilion Energy**, for example, has cut its sizable dividend and lost 75% of its market value since February alone.

Even blue-chip stocks in the industry have suffered wealth destruction. Warren Buffett's favourite Canadian oil stock **Suncor Energy** has shed half its market value since mid-January.

There could be plenty of pain ahead. For the average investor, the risk is simply not worth the potential reward. I'd stay away from the oil patch for the rest of 2020.

Banks at risk

As with any monumental economic collapse, the shock wave spreads far beyond the core industry. Stable oil prices encouraged producers to borrow money at a relentless pace over the past decade. Now, the industry's debt burden is so immense it threatens the lenders' balance sheets.

Bank of Montreal and **Scotiabank** seem to have the most exposure to Canadian oil and gas giants. Oil producers account for more than 2.5% of total lending for both banks this year.

Banks could also be exposed to consumer credit and household mortgages in Alberta. Alberta's economy hinges on crude oil exports, which means the unemployment rate and residential real estate correction in the province could be severe. Banks that are overexposed to Alberta's economy could see magnified pressure on their balance sheet.

Bet on companies that benefit

Under usual circumstances, it's easy to pick winners from a collapse in the oil price. Any industry that uses fuel as input benefits from cheaper crude. Airlines see their margin expand, plastic manufacturers have lower costs of production, and car sales surge, as people can afford gas guzzlers.

However, these are far from usual circumstances. People cannot buy cars or travel through airlines during a global pandemic. I believe investors should take a long-term approach and consider industries that will recover faster than the oil patch.

I prefer luxury goods and airline stocks, since I believe discretionary spending and air travel will recover faster than the oil price. However, it could be years before we see these gains emerge. Investors should probably bet on a prolonged economic recovery.

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Date
2025/07/27
Date Created
2020/04/21
Author

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