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Is oil driving markets?

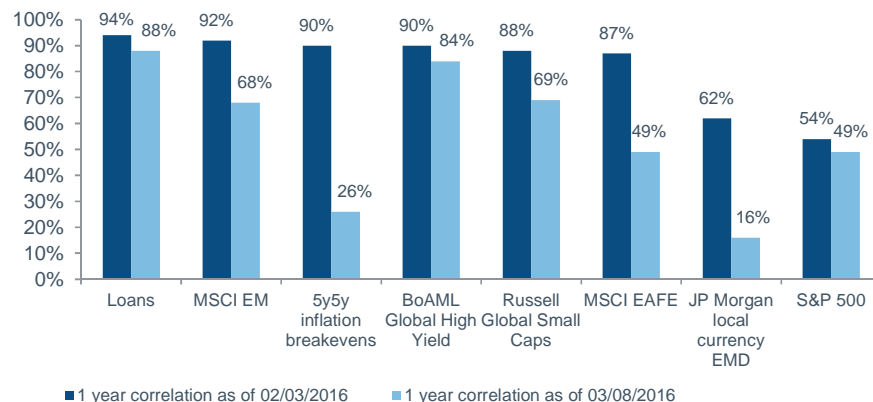
One way to assess the driving forces behind markets is to look at correlation data. Over time, correlations – or the degree to which asset prices move together – can change, potentially revealing market insights. This can be particularly useful when thinking about how to allocate to different asset classes within a portfolio. Oil is a good example because it has so many real economy implications.

Oil correlations surge in early 2016

As markets moved sharply into risk-off mode at the start of 2016, there was a notable surge in correlations between oil and a range of other assets. One-year correlations to oil increased significantly from their 10-year measure; the correlation of the S&P 500 to oil moved from a barely positive 17% on a 10-year basis to 54% on a one-year basis. Markets largely saw the oil price as a barometer for global growth, with weaker prices reflecting lower demand. In this environment, it was reasonable to expect that growth-sensitive asset classes like equities would sell off, particularly with US equities having struggled to deliver earnings growth in preceding quarters.

However, even areas which might have been expected to better shield investors from oil driven volatility disappointed. Leveraged loans, for example, displayed an almost perfect correlation, despite having historically displayed little relationship with oil. For investors in early 2016, it truly was a case of there being few places to hide.

Chart 1: One year correlations to oil March 2016 vs. August 2016



Source: Bloomberg, August 2016

Six months on however, the picture is very different. Correlations to oil across a broad range of asset classes have fallen as shown in Chart 1, most notably those with equities, inflation break-evens and local emerging market debt.



GEORGE EFSTATHOPOULOS joined in September 2011 as a Fixed Income Research Analyst for Fidelity Solutions, and was promoted to Assistant Portfolio Manager in December 2013. He became a Co-Portfolio Manager in January 2015. Prior to joining Fidelity, George was responsible for Fixed Income manager research and portfolio management at Stamford Associates.

George has an MSc in Management Science and Operational Research from Warwick Business School and holds a BSc in Management from the University of Southampton.

Inflation break-evens surprise

Perhaps the most surprising break in correlations to oil over the past six months has been for inflation break-evens, which have fallen well below their 10-year average (Chart 2). Even as oil prices have risen throughout 2016, US inflation break-evens have remained suppressed and are close to all-time lows, indicating little concern about price pressures.

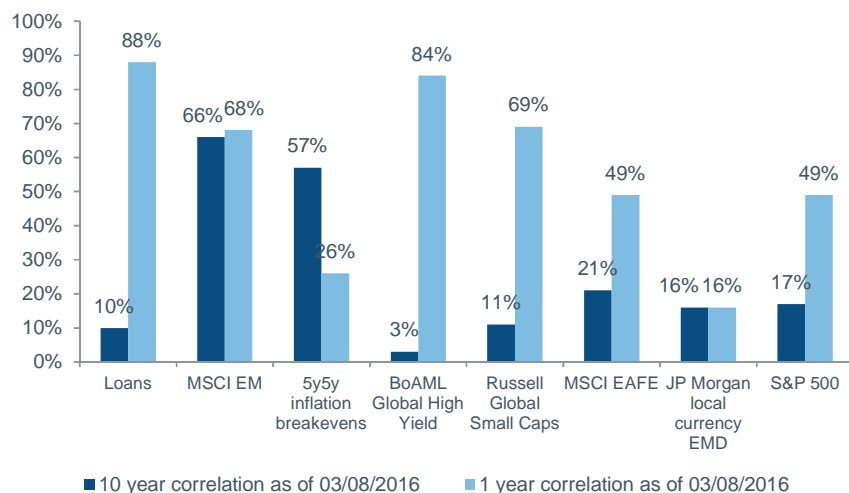
The clear risk for investors is that break-evens may be mispricing the potential for inflation. The combination of higher trending wage growth in the US combined with oil price base effects beginning to kick-in could result in sharp upward moves to inflation break-evens. More worryingly, record low bond yields mean that only a small upside surprise in inflation or growth is needed to cause losses to nominal bond investors.

Will oil's correlation to other assets rise once again?

With oil having fallen 15-20% from its recent highs before rallying again in August, a key question for investors is whether we could see the return of higher correlations. This is clearly an important question for asset allocators since correlations are fundamental to multi asset portfolio management.

Looking at the one and ten-year correlations for other assets (Chart 2), we might expect that the current phase of high correlations with oil will pass. Yet while risk assets have broadly trended upwards over the past six months, it appears that investors in global high yield bonds and loans are still being driven to a large extent by the outlook for oil. The current period of calm in markets therefore looks unlikely to last, with markets still vulnerable to a broad sell-off if we see renewed concerns over what a low oil price signifies.

Chart 2: One and 10-year correlations to oil



Source: Bloomberg, August 2016

More broadly, the correlation data in chart 2 shows only absolute correlations. The relationship between oil and local emerging market debt, for example, is actually negative on a ten-year basis. While the recent fall from 62% to 16% might therefore seem reassuring, the degree to which correlations can reverse and suddenly spike should be a source of concern to all multi asset investors.

Indeed, it highlights the vulnerability of many asset class stories and their relative attractiveness. Broadly, this supports a strategy where asset allocators look to add on weakness, reinforcing the market pattern of the past year where periods of volatility have been followed by significant rebounds.

Of course, whether we see the return of high oil correlations depends on how investors view the current drivers behind the oil price. A lower oil price could simply be seen as the supply side of the market taking longer to rebalance, rather than acting as a risk-off signal for a wide array of asset classes. It seems likely however that investors will remain nervous around the prospects for oil and its correlations rising again. Asset allocators will be watching markets carefully, more fearful of the downside than excited about any potential upside.

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