

Quick Hit – Higher oil to lead to stronger loonie?

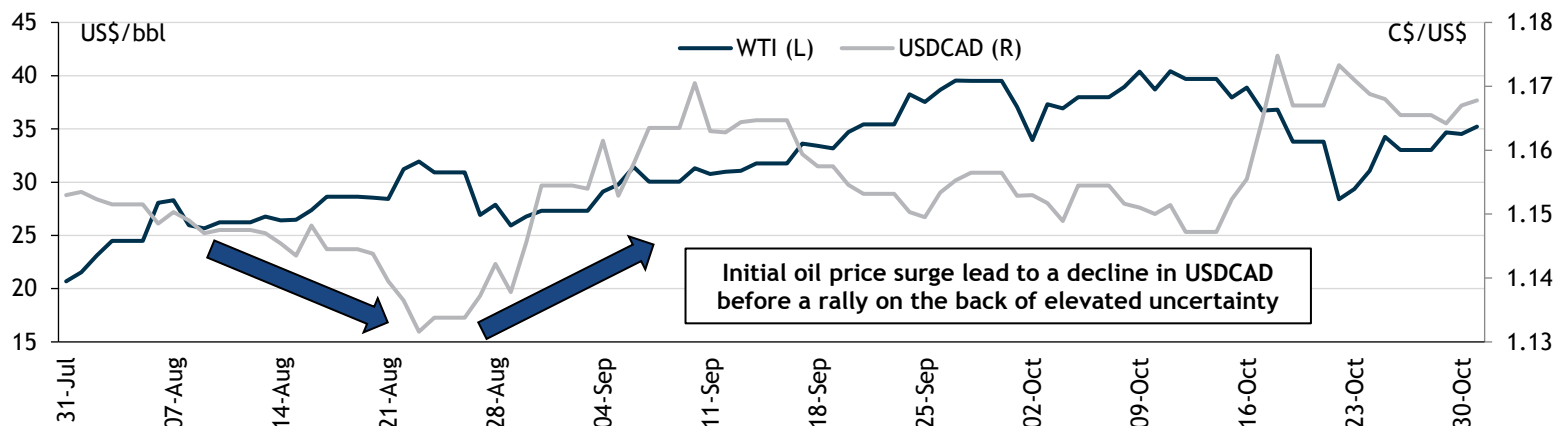
By Sandra Kagango

At a time when oil markets had been in the shadows of a weak global macroeconomic backdrop and the global central bank easing rhetoric, this weekend's events have brought geopolitical risks for oil prices firmly back to the forefront. The strikes on Saudi Arabia's oil infrastructure have led to the largest disruption to crude oil supply in history...and it's got us thinking to the last time we had a similar oil market disruption. To be sure, we've had plenty of supply disruptions in recent times, as countries like Nigeria and Libya continue to see their output fluctuate as a result of militant activity. Others like Venezuela are still reeling from production declines due to political turmoil. So, while we aren't trying to sound cavalier about this, geopolitical news has long affected oil prices at the margins and is hardly shocking. Yet, this attack feels different, and not just because Saudi Arabia is one of the largest oil producers/holds most of the world's spare production capacity. But because outright military attacks have been far rarer in history. Indeed, the August 1990 oil price shock that occurred in response to the Iraqi invasion of Kuwait comes to mind. At that time, the Republic of Iraq invaded the State of Kuwait, removing its production from the market and putting Saudi Arabia's massive crude output under threat, as oil prices nearly doubled over two months. The loonie appreciated +1.4% in the following 20 days but depreciated thereafter on the risk-off tone as tensions escalated before eventual US-led military intervention in mid-October. Other assets were hardly immune, with equities slumping and yields selling off on the pass-through to inflation (Chart 2).

While the market is still unclear on the outcome of the attack, and just how quickly output will be fully restored, production cuts (even if they last months) might not be outright bullish for the loonie, especially if tensions remain high. What is for sure is that the weekend's events have introduced a new source of geopolitical uncertainty for investors already grappling with the effects of a trade war. Something that's typically held back our currency.

Chart 1: Production cuts may not be outright bullish for the loonie

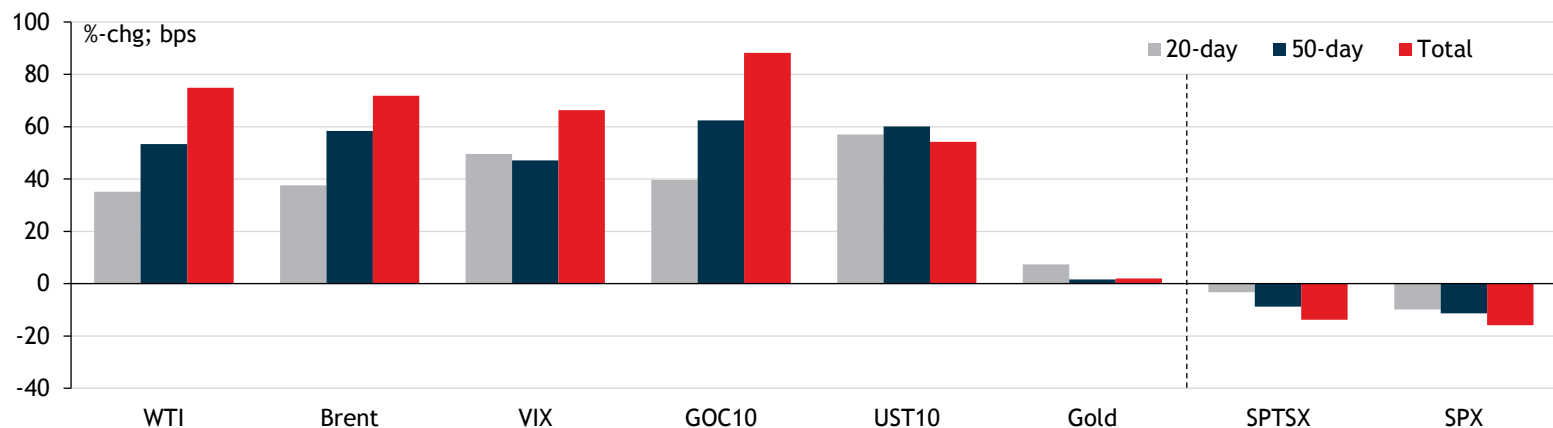
Canadian dollar & WTI oil during the 1990 oil price shock



Source: NBF, Bloomberg

Chart 2: Performance of other select indicators during the 1990 oil price shock

Change in select market indicators between August 2nd & WTI oil price peak (October 11th)



Source: NBF, Bloomberg | Note: GOC10, UST10 chg in bps; other variables chg in %-terms

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