FirstPoint Financial

WEEKLY MARKET THOUGHTS

December 15, 2014

Oil and Stock Prices

This past week the U.S. equity market gave in and corrected in price as oil prices continued their downward march. There seems to be a fundamental disconnect between declining oil prices and declining stock prices. Nonetheless, the Dow Jones Average dropped 678 points, or 3.8 percent last week. The S&P 500 index lost 73 points, its largest point decline since 2011. Meanwhile, oil prices continued their rapid paced decline with West Texas Intermediate closing at $57 per barrel, down 12 percent this month.

Until this past week, the U.S. stock market was disconnected from oil prices. From the end of October to December 5, the Dow Jones Industrial Average rose by 2.8 percent while oil prices declined by 20 percent. We've been postulating, and most agree, the decline in oil prices will act as a net positive for the United States and world economies (on balance).

The decline in oil prices has been, in our opinion, ***primarily due to a rise in supply***, and not a shortage in demand. Most significant oil price declines in the past have been driven by weakness in demand, which is driven by economic recessions. ***While global economic growth isn't robust, the world is far from recessionary conditions. The latest read shows that 62 percent of the world's Composite Leading Indicators are above 100 (indicating future economic growth).***

As was written in an earlier piece, if weak demand was the primary driver behind the current downward move in oil prices, we suspect other industrial commodity prices would also show serious weakness. Over the last three months, while oil prices collapsed by 37 percent, industrial metal prices fell by a mere 7 percent (per the iPath Bloomberg Industrial Metals Sub-Index). While it's understandable a portion of oil price weakness is due to weak growth in Japan and Europe (and weakening growth in China), the other economically sensitive commodities are withstanding the current downward movement.

Want further proof the U.S. economy isn't slowing dramatically? Consider the following recent

economic releases:

1. Consumer confidence: The Bloomberg Consumer Confidence index rose early in December to the highest reading in seven years.
2. Recent data from retailers about consumer spending patterns are uniformly bullish. Excluding gasoline sales, retail sales rose 0.9 percent in November.
3. Yardeni Research recently reported their Earned Income Proxy (which is related to net earned income gains/losses) rose by 0.7 percent during the month of November, bolstering the view that gains in consumption are being financed by earned income, and not simply debt increases. This lends to the view that consumption growth may be reasonably sustainable.

Stock Prices Decilne – Globally

But, as noted above, stock prices have now capitulated and appear to be tied to the oil price collapse. Most market pundits have been calling for a rise in corporate earnings next year. The average expectation is for earnings to rise by approximately 8 percent. Some have made the contention the decline in oil prices will eventually reduce capital spending by oil companies. Individual company budgets are being cut as we speak. Energy company capital spending is outsized as compared to other companies.

For example, ***energy companies' stocks makeup about 9 percent of the S&P 500 index capitalization, but 30 percent of large company capital spending***. It appears the weakness in the equity market can be tied to a reduction in planned capital expenditure by oil companies. That contention is offset by reality…since 1950, the S&P 500 price performance has been loosely tied to oil prices – the longer-term price correlation between the S&P 500 and oil prices has only been 0.33 – a weak positive tie, at best.

It is important to remember, during this time of high volatility and weaker prices, the positive economic effects (lower gasoline prices lead to higher discretionary consumption growth) far outweighs the negative effects of lower prices (lower capital spending). This is true in the United States, Japan, Europe, and most of the emerging economies. For example, in the United States, consumption spending represents approximately 70 percent of overall economic activity. The average U.S. family is spending nearly 4 percent of their monthly budget on gasoline. Prices for gasoline have fallen by 35 percent over the last three months. Simply "doing the math" shows the average U.S. consumer is experiencing a "tax cut" of 1.4 percent. This equates to a potential rise in discretionary spending of 1 percent of U.S. GDP. This far outweighs the "cost" to the U.S. economy of falling capital spending within the oil patch.

Our Thoughts on Declining Stock Prices

If we're right in our view that the oil price decline will be additive to overall economic growth, why did stock prices (which are highly tied to overall positive economic activity and corporate profit growth) swoon by almost 4 percent last week? On a speculative basis, I believe the overall stock market swoon occurred due to the "uncertainty" factor. Let me explain.

Corporate budgets (particularly manufacturing-based industries) are built on many macro and micro assumptions. Energy costs can be one of those major assumptions. Taking this one step further, there are few economic variables more powerful, on a global basis, than energy costs. Lower energy costs are a net positive for most economies, but the degree and magnitude of the current oil price shift has occurred so quickly and has been so large, the stability of most forecasts has been thrown into a cocked hat. Perhaps the reason the stock market is showing increased volatility is primarily due to the level of volatility within the oil patch.

Additionally, increased price volatility of any tradable investment tends to raise investor anxiety. As anxiety rises, people tend to not trade freely, which lowers liquidity within a market. Lowered levels of liquidity tend to raise price volatility…and then a vicious cycle can start to take place.

Stabilizing Oil Prices

If our analysis is correct, and the main driver behind lower oil prices is excess supply, then either a rapid ramp in demand will need to occur (highly unlikely) or further supplies will need to be cut. This scenario has started to occur. ConocoPhillips has announced a capital spending cut. ***We, along with many others, expect many oil companies to cut capital spending budgets by 20 percent or more.*** This activity will eventually slow the deliverability of oil supplies to the market, but it will take time.

In the meantime, it appears oil prices may continue to fall. The Energy Minister from the United Arab Emirates stated OPEC won't cut production, even if oil falls to $40 per bbl. ***Meanwhile, the number of operating oil rigs has declined from a record 1,609 as U.S. oil drillers idled the most rigs in almost two years. This is how the free market is supposed to operate. When too much supply is present in the market, adjustments to that supply are made.***

The Risk to Our Outlook

We're viewing the lower oil prices as a significant positive for the world's economy, and consequently, a major positive for the world's equity markets. Stock prices have moved to the downside due, specifically, to the oil price decline. Are we missing something? Perhaps. If oil prices are moving downward primarily due to a contraction in demand, (which we are not yet witnessing) then we are misreading the price decline. If this is the case, there is more downside potential in stock prices than we currently believe…the world may be on the doorstep of an economic recession. But, the weight of the economic evidence does not currently point towards this possibility.

Currently, we maintain our positive bias towards stock prices in general and the U.S. and emerging markets in particular.

Just for Fun

Formula for success: rise early, work hard, strike oil.

J. Paul Getty

A century ago, petroleum – what we now call oil – was just an obscure commodity; today it is almost as vital to human existence as water.

James Buchan

And finally –

Let me tell you something that we Israelis have against Moses. He took us 40 years through the desert in order to bring us to the one spot in the Middle East that has no oil!

Golda Meir

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