FirstPoint Financial

WEEKLY MARKET THOUGHTS

June 16, 2014

Something's Going On…

As our regular readers know, I'm somewhat of a history buff, in general, and am particularly interested in financial market history. Last week's piece, titled "Carry On," highlighted that, from a news perspective, the week prior to the writing was very quiet. This week, we have something notable to talk about that impacts history, in general, as well as financial market history. Global drivers of asset values never take long vacations.

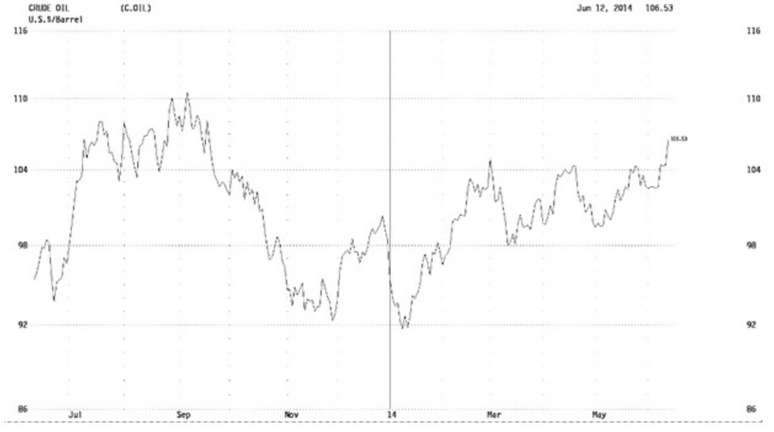
Instability in the Middle East – What Else Is New?

We have a new organization in the Middle East, of which many in our country haven't been aware. ISIS (Islamic State of Iraq and al-Sham) is an offshoot organization of al Qaeda that seems to be well-financed and well-organized. The fighters of ISIS have, over a two day period, overrun the Iraqi cities of Mosul and Tikrit. For those counting, Mosul has a civilian population equal to that of Philadelphia. ISIS apparently is planning on attacking other cities, continuing to move south toward Baghdad.

Four Iraqi army divisions have melted before the ISIS onslaught. The apparent goal of ISIS? To establish a Muslim state in the heart of the Middle East, which would directly affect Persian Gulf stability, politics and economic activity (oil). This would provide a "safe harbor" for future terrorist activities – something the United States and other nations fear. Is the United States going to idly stand by and let this happen? The answer to this question is beyond my scope as an economic/market pundit.

As noted above, I am a student of history. Let's take a look at other unsettling historical events in the Middle East and how they have affected oil prices.

Crude Oil Price Chart

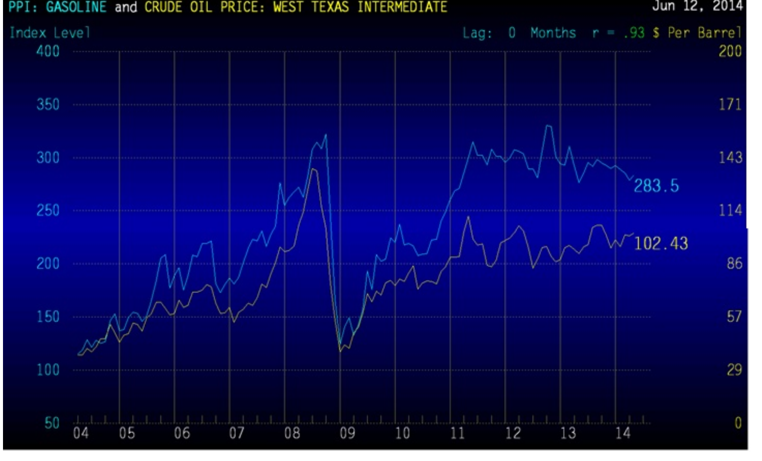


Background

Oil was trading at $106 per barrel late last week, up from a low of $91 per barrel earlier this year (as noted in the Gasoline and Crude Oil Price chart). Over the last week, oil prices have risen by about $4 per barrel, a slight reaction to the events occurring in Iraq. Since 1990, there have been 21 destabilizing events that have occurred in the Middle East. From Operation Desert Storm in 1990 to the Anbar Clashes in 2013, the area has had both major and minor political/military disruptions. Over the last 23 years, on average, oil prices have risen by 5.4% 30 days following the beginning of a disruption – as compared to the current oil price increase of 3.9% (to date). It is interesting to note that on average, oil prices haven't simply risen over the first week of a Middle East crisis. Normally, following the first period of price surge, still-higher prices follow. Historically, three months after the start of the crisis event in the Middle East, oil prices have risen by 9.2% from their pre-crisis levels. If this average holds true, the world can expect oil prices to approach $112 per barrel later this summer.

Pain at the Pump

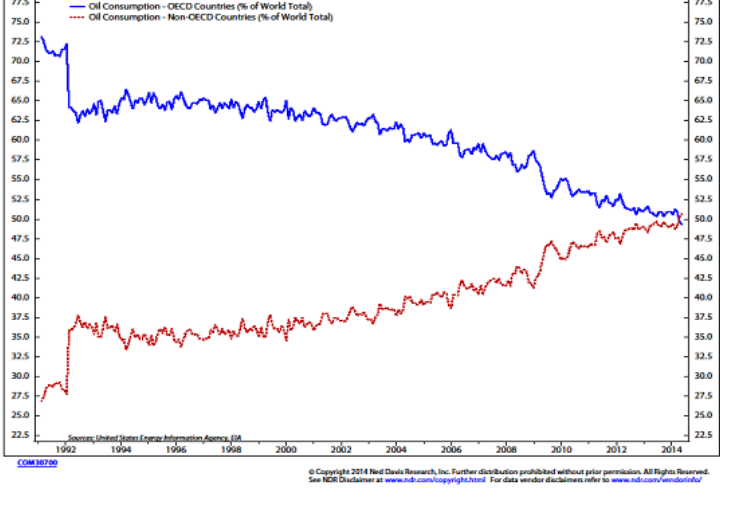
Gasoline and Crude Oil Prices



Of course, there is a direct correlation between oil prices and gasoline prices at the pump. Nationally, gasoline prices have risen by 4.6% so far this year. Over the last 10 years, there has been a positive correlation between oil prices (West Texas Intermediate) and gasoline prices of +.93 (see chart). In other words, oil prices and gasoline prices have been positively correlated 93% of the time. If this correlation holds true and oil prices rise to reflect the $112 per barrel oil price mentioned above, we should expect gasoline prices to rise by 9.2% from the pre-crisis level. That means prices could exceed $4 per gallon later in the summer.

Who Pays the Price?

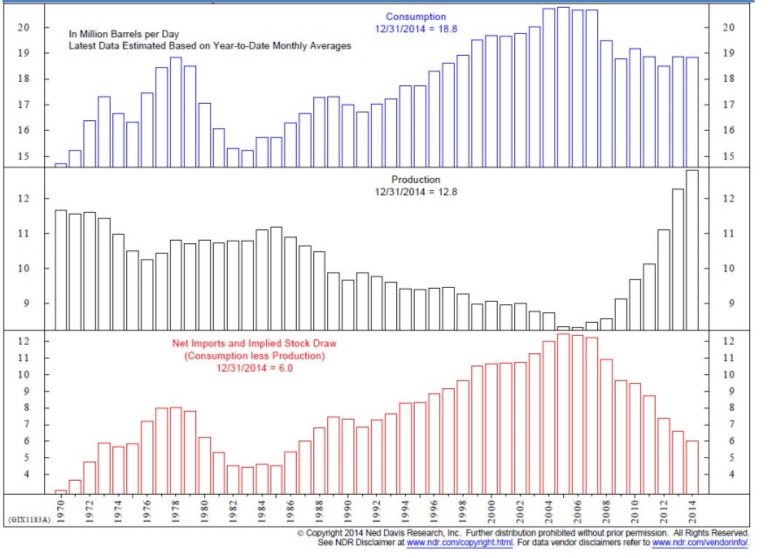
Oil Consumption OECD and Non-OECD Countries



Who (or what countries on balance) pays the price for rising oil costs? Historically, the OECD countries (large, developed countries) have been the largest consumers of oil in the world. That historical truism has changed over the last number of years. As can be seen in the Oil Consumption chart, the OECD (developed countries) consumed 72% of the world's oil production in 1992. Today, that percentage has fallen to 49%! The non-OECD (developing) countries now consume 51% of the world's energy output. The negative economic impact of rising oil prices has historically hurt the developed world more dramatically than the emerging economies. No more.

What About Home Base?

U.S. Petroleum Consumption and Production



What about closer to home? What about the United States? Well, rising oil prices hurt overall consumer spending, but not as dramatically as has been the case in the past. Note the chart entitled U.S. Petroleum Consumption and Production, which shows historical consumption of oil, domestic production of oil and net imports of oil – all shown in millions of barrels per day. As illustrated, oil consumption has declined from a high of almost 21 million barrels per day in 2004 to the current 18.8 million barrels per day. Strikingly, domestic oil production has risen from less than 5 million barrels per day to 12.8 million barrels currently. That means that oil imports are running at an annualized rate of around 6.0 million barrels per day, down from well over 12 million barrels per day in 2004.

If oil prices rise due to a possible supply disruption from Middle East tensions, the impact will be real on a global basis, but should be less pronounced in the United States than was the case 10 years ago. So, while we may see higher oil and gasoline prices, consumption of oil products has declined rather dramatically over the last 10 years and imports of oil have been reduced significantly. This lowers the impact that rising oil prices/supply disruptions will have on overall economic activity and raises the level of national economic security.

Fluid Environment

By the time this is read, the situation in Iraq indeed may have changed. Nonetheless, the fragility of the political/military environment in Iraq is so high that we expect oil prices to remain volatile during this period of unsettlement. As highlighted above, disturbance in our national economic environment due to an upward push in oil supply disruptions isn't as high as it has been in the past. Nonetheless, oil price volatility – when extreme – can lead to overall financial market unsettlement. It may be a long, hot summer as we move forward.

Wealth of Nations

As I mentioned in last week's piece, we have started putting together our thoughts regarding global and national productivity and the prosperity that increased national/global productivity has brought to mankind. We will be presenting the initial piece on this subject later this week.

We will stay in touch…

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