Are Oil and Stocks Blood Brothers Or Distant 4th Cousins?

By Bob Deitrick, ChFC
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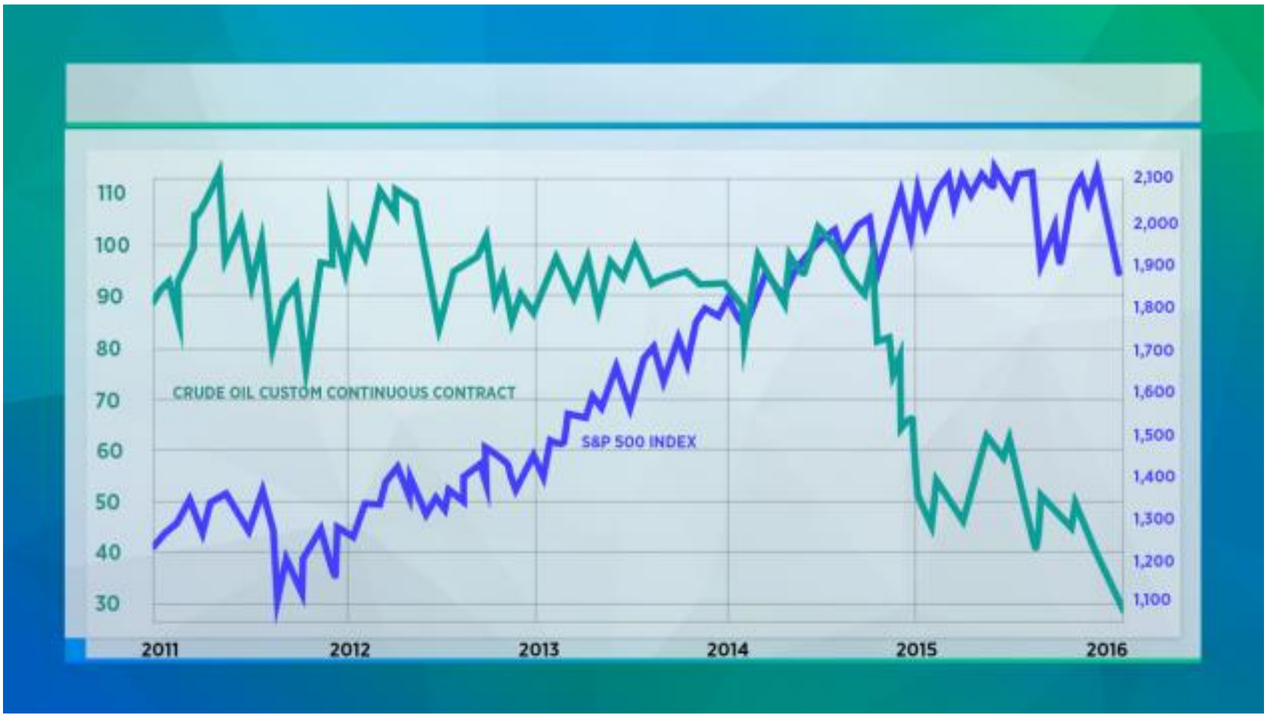
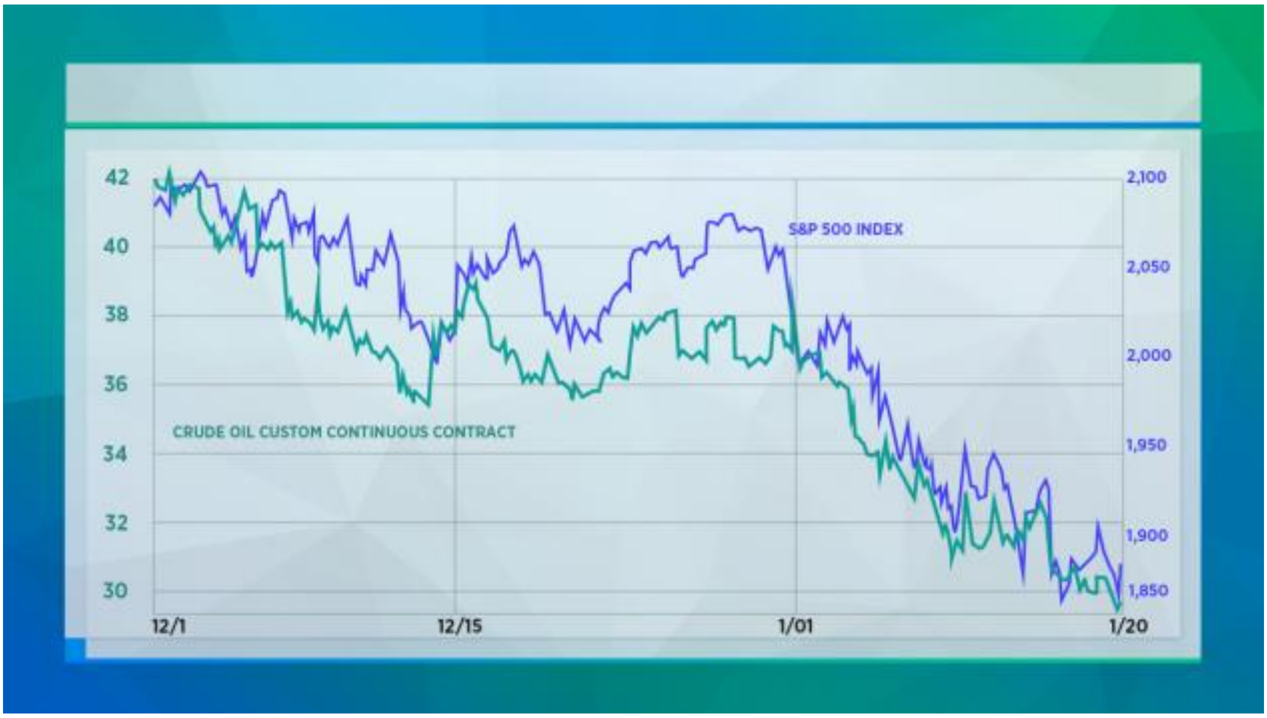
So you may be asking, why are stocks and oil trading so closely of late? We believe what has transpired over the past three weeks of the New Year has been exaggerated and is an anomaly. The price of oil was crushed in first 12 trading days of this year. We thought it would be worthwhile to discuss this in order to create some perspective for you:

Recently, every time the price of oil drops or rebounds, the stock market has followed in lock step. Last week on Wednesday the 20th, February WTI (West Texas Intermediate Crude) oil futures tumbled 6.7% to their lowest point in this super-cycle to $26.55 per barrel, and the S&P 500 slumped 1.17% that day. The next day, oil rebounded back to $29.53 per barrel, and the S&P 500 and the markets closed up. In trading this past Friday, both oil and the S&P 500 marched higher in lockstep. The NASDAQ had a huge day Friday and was up more than 119 points. Other indices were up 1.3% to 2.66% with the Biotech sector leading the pack up 3.21%. The Energy sector which was up more than 4.5% last Friday. Oil surged ***9.21% on Friday closing at $32.21 per bbl.*** So, we may have seen the low point in this super cycle last week. Time will tell.
It turns out this marriage between oil and the stock market is unusual; in fact ***there has not been a strong correlation between oil and the S&P 500 over the past five years (see the chart below).*** Last year, these two indices were trading in opposite directions. Steven and I



S&P 500 vs. Crude Oil Futures (Source: Yahoo Finance)

A Research study I found conducted by the Federal Reserve Bank of Cleveland in 2006 found no statistical correlation between the S&P 500 and the price of oil. This means that oil and stocks have historically moved independently of one another. According to data we found - the correlation between the S&P 500 and oil has been only about one in four times or 25% over the time over the past 20 years. Yet, over the past 7 weeks, since early December, the correlation has been 90%. See the chart below:



S&P 500 vs. Crude Oil Futures from December 1st 2015 to January 20th, 2016

Cheap oil is beneficial for the US consumer which makes intuitive sense. Gas prices were at $1.41 per gallon this weekend locally. Lower gas prices have created what is the equivalent of a $250 billion tax cut for Americans this year. During the great bull cycle of the '90's, oil traded in the narrow range of 15.66 to $27.39 per bbl for an entire decade. Lower oil is beneficial for the economy or it should be… So what is happening today?

First of all, part of what is happening is something we call the ***"law of diminishing returns."*** In other words, cheap oil can be too much of a good thing. The price of gasoline has decreased from $3.79 in the summer of 2014 to $1.41 today. ***In other words, the price of gasoline locally has dropped 63% in 18 months - an unbelievable fact. We are now paying an inflation adjusted price for gas that is equivalent of gas prices more than 20 years ago!***

In addition, the new oil industry in the United States is primarily coming from the extraction of oil from shale. Shale drilling is expensive and is highly capital-intensive. It also takes a long time for these companies to adjust to major price swings like this one. ***The break-even price to extract oil from shale in the United States is a remarkable $73 per bbl. Unlike the Saudi's whose break-even price for extraction is $3.00 per bbl.*** US shale drillers must issue large amounts of debt and equity to raise funds for their operations years before they reap a penny of profit. As oil has plunged almost 75% over the past 20 months, the concern has spread that these shale drillers may not be able to repay their loans which has created problems for the world credit markets.

Over 99% of the 559 oil and gas companies in the United States are in a bear market as of last week. Further, ***one-third of those companies have fallen 90% or more from their highs.*** If oil does not come back, bankruptcies and defaults are likely. This creates severe implications for many banks which have exposure to these oil companies in the form of loans that may not get repaid. Wells Fargo's fourth-quarter report showed $90 million in losses from its oil and gas portfolio, while Citigroup recently added $250 million to its reserves specifically for bad energy and oil loans. These losses are minimal from a macro-perspective, but the concern is that this contagion may spread. Having said that, ***Steven and I suspect oil will rebound now that this super cycle has found a floor.***

This strong correlation between oil and the equity markets may continue over the short-term and it will likely create more volatility as well. However, once we have hit the bottom in oil futures, the stock market is likely to rebound as the credit contagion disappears. ***Over the long run, we do not expect this close partnership between oil and equities to last much longer. If oil gets back to where it was last summer, when it traded in a range of $40 to $60 per bbl, the equity markets will likely be fine with that we suspect as this will reduce the threat to the credit markets.***

As always, we highly value your input and we are concerned about this volatility, so this newsletter was designed to explain what is transpiring. Please feel free to write or call us any time or to set up your next meeting as well. Have a great week!

Bob Deitrick and Steven Morgan