Are the Price of Oil and the Stock Market Portending Recession in 2016?

By Bob Deitrick, ChFC
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Plunging oil prices - down more than 22% this year - have been the primary factor contributing to the market's worst start since 2009. U.S. stocks suffered a pathetic January as the slump in oil coupled with China's economic slowdown have roiled the global markets. For January - the S&P 500 clocked a decline of 5.1%. We look forward, as we know you do, to the market finding a foundation to this selloff in oil, which should create a rebound to the equity markets.

Steven and I believe some analysts have been hasty predicting an economic slump and today may be the time to purchase "beaten-up" assets. You may be asking – "what is the outlook for the global economy?" Many markets are pricing in the probability of recession. Do we think a recession is on the immediate horizon, or not?

We do not for see the economy sliding into recession in 2016. If one looks at the data, there certainly are clouds on the horizon. However, the American consumer is solid and consumers represent almost 70% of our economy. This should keep our economy intact. Now is the time to focus on valuations, understanding the technical factors cheapening these markets (which have to do with people liquidating assets) and looking to be a contrarian in 2016. Stock market guru, Warren Buffet, has famously said:

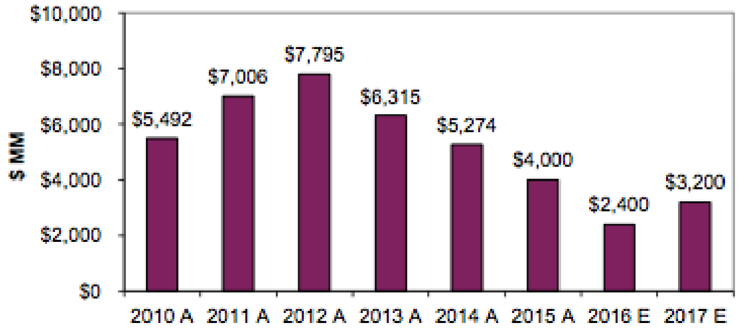
"The stock market has predicted 9 out of the last 5 recessions."

Data released last week suggested U.S. economic growth slowed to 0.7% in the fourth quarter. This was down from the annualized 2% growth seen in the prior quarter. In 2015, our economy grew by 2.4 percent, after a similar expansion the year before. We do not expect a sharp rally back to where the market was at the beginning of the year but now is the time to look at "beaten-up" assets as opportunities in the market.

The price of oil is affecting the stock prices as well as many economic fundamentals ranging from industrial production (ISM) and top and bottom line earnings (P/E ratios) to the credit markets. Oil prices in this super-cycle have been beaten down by weak economic data from China, concerns about increased oil production from Iran, and a strong American dollar. Nonetheless, we believe oil will move higher in 2016 even if no coordinated cuts in production take place. In countries where the government does not control production - like the United States, Great Britain and Brazil - we are seeing severe austerity as firms under-invest to stay afloat. Evidence of these company-induced supply cuts can be seen as giants Schlumberger and Haliburton recently indicated they are seeing significant capital cuts among their exploration clients.

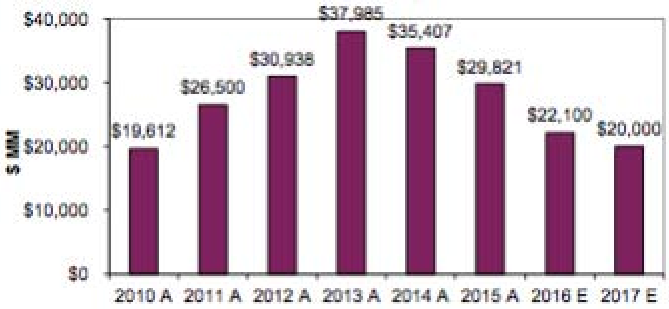
As this "<u>oil austerity"</u> plays out, it will rebalance the market. Steven and I suspect oil will rebound to a price of $40 to $60 per bbl this year - perhaps higher. Supply and demand will tighten driven by solid growth in demand and weaker supply as cuts in exploration take hold.

And while some significant cuts are coming from smaller exploration companies with highly-leveraged balance sheets, we are seeing significant cuts from "the majors" as well. BP reported a 4th quarter earnings decline of 90%. Exxon-Mobil's fourth-quarter was a beat due to their refinery business; nonetheless, they are cutting spending 25% this year. Anadarko Petroleum anticipates an initial 2016 budget of $2.8 billion - a 50% drop from last year. Hess, which has high exposure to oil-shale, cut its preliminary 2016 capital budget by 25%.



Source: Hess, Raymond James research

Last week Chevron confirmed its 2017-2018 budget plan of $20 billion to $24 billion, a level that hasn't been seen since 2008-2010. The 2016 budget represents more than a 20% reduction from 2015 levels.



Source: Chevron, Raymond James research

Another concern is the demand side of the equation coming from China where their GDP growth decelerated to a rate of 6.9% in 2015. In 2015, Chinese demand for oil ended up 6% - twice what was expected at the beginning of year.

Region	2014	2015E	2016E	2017E
North America	0.3%	1.0%	1.9%	0.6%
Europe	-1.5%	1.9%	0.5%	0.0%
Pacific (mainly Japan)	-2.4%	-0.2%	0.1%	-0.5%
CIS (mainly Russia)	4.5%	-1.1%	0.5%	0.5%
China	3.5%	6.0%	2.7%	2.5%
Other Asia	2.0%	3.9%	3.2%	2.5%
Latin America	2.6%	-0.2%	1.0%	2.0%
Middle East	1.8%	1.3%	0.5%	2.0%
Africa	1.7%	2.3%	2.0%	2.5%

Source: IEA, International Monetary Fund

As China builds its own middle class and transitions to a service-based economy - demand for oil in China will grow. This will boost the global-demand picture. It should be noted as well that global oil demand is rising slowly, but broadly, from other emerging economies in Asia and in Europe.

Greater predictability in the market will arrive when oil and other commodities around the world show greater stability. We need to see stabilization in commodities which should take place this year. Another subjective factor to the equation - that no one can control - is the political parties, from the right and left, are lampooning Wall Street and the stock market every chance they get... This is making stocks a weak asset class to own which makes no sense at all. But, politicians will do anything to get elected - at least in our view.

We do not see recession on the immediate horizon, but the price of oil, China's second currency devaluation in six months and the political climate are making it difficult for equities over the short-term. There will be opportunities in stocks this year, but we must be selective and contrarian to our approach as we get closer to the peak of this cycle.

Having said this, we highly value your opinion and would like to hear your thoughts on the state of our economy as well. Please provide us with one paragraph of your thoughts and your opinion on the state of our economy - if and when time permits. Thank you!

We have elected to have seminars this spring at Eddie Merlots and at Brio to discuss all of these issues on April the 19th and 22nd. More information on these market update events will follow. Please try to relax, call us at any time and have a terrific week!

Bob Deitrick   Steven Morgan