Investment Update

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The Winners and Losers of Lower Oil Prices

As the saying goes, there are always two sides to every trade...buyers and sellers, upside and downside, and ultimately, winners and losers. In economics, a single variable can have both a positive and negative influence on different aspects of the economy. Oil has moved from a high of $105 per barrel early this summer to its current price of under $60 per barrel, down over 40%. While many oil companies—producers and exploration firms—have been negatively impacted by the decline in oil prices, there's another group, consumers and businesses, who are in a position to benefit.

No Longer Only About Demand

The $64,000 question: Are falling oil prices good or bad for the overall economy? Historically, soaring oil prices in the U.S. have been followed by recessions. But is the opposite true? Will falling oil prices lead to economic expansion? As with most questions regarding price, it comes down to supply and demand.

Looking back in history to the late 1970s and early 1980s, a slowing economy brought on by high oil prices and high interest rates subsequently led to a fall in the price of oil as we entered a recession. This fall in oil price was a precursor to lower overall equity prices, which did not find their ultimate bottom until the summer of 1982.

The current environment is much more complex. It was not so long ago, 2008 to be exact, that we were talking about "peak" oil as the price reached $145 per barrel. Industry experts warned that oil would rise to $200 per barrel, or higher, in expectation of skyrocketing global demand and a lack of new, substantial oil deposits. These pundits failed to realize the old adage, "the best cure for high oil prices is high oil prices," as high prices eventually encourage more supply to enter the market, pushing prices down again. And that's just what happened.

Today, fracking in the U.S. and continued production in countries like Mexico and Russia are adding to the surplus. Thus, global oil supply has outstripped global demand growth, which inevitably led to a fall in oil prices. This new supply/demand dynamic has made the relationship between oil prices, the economy and the stock market more complex. It is imperative that we dig deeper to understand how $60 per barrel oil price will ultimately impact the global economy.

The Numbers—the Bad and the Good

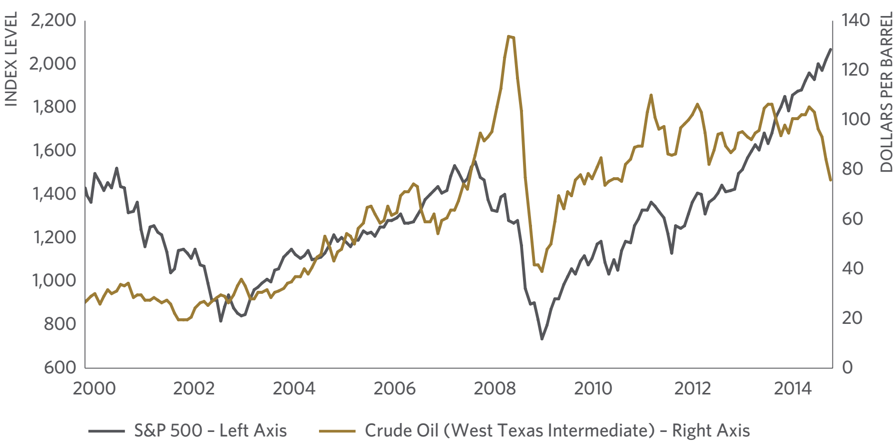
Sharply lower oil prices have already begun to affect oil production in the U.S. After recently peaking at nearly 9.5 million barrels per day, current production has been reduced by an estimated 500,000 barrels per day, as lower oil prices make some fracking production less economically viable. Estimates are still being compiled, but this lower output, and that which might follow if oil prices remain low, could subtract up to 0.25% to 0.5% from annual GDP figures.

On the flipside, the drop in price at the gas pump has been a welcome development. Early estimates show that nearly $1.2 trillion has been saved at the pumps and put into consumers' pockets. These savings have a direct correlation to consumer confidence, which recently moved to its highest level since the financial crisis ended in 2009. With consumers accounting for 70% of GDP, this holiday shopping season should be an early indicator of the potential impact of energy-related savings.

The stock market looks to be sorting out the impact of lower oil prices. We've seen clear winners and losers from this trend, with oil producers and exploration companies suffering and consumer-oriented companies benefiting. But, overall the market is signaling a net positive. As illustrated in Exhibit 1, the historically positive correlation between the S&P 500 and oil prices has diverged with domestic indices hitting new highs even after oil has fallen over 40%. We believe this breakdown in positive correlation is evidence that something has changed and we think the changing role of oil supply is at the heart of the matter.

Exhibit 1—S&P 500 and Price of Oil Diverging

S&P 500 Index Level vs. West Texas Intermediate Spot Price



Source: FactSet. As of 11/30/14.

New, More Balanced Paradigm

While there are pluses and minuses to lower oil prices, the real winner in all of this may be the U.S. economy and stock market. In my travels throughout the country, I'm often asked how to play this country's potential energy independence. My answers over the past two years have been simple: you should invest in those industries and markets that will benefit from this new global paradigm. Our recommended positioning in client portfolios reflects this belief with an overweight to U.S. stocks and an underweight to commodities.

As the world adjusts to this new, more balanced order, expect higher near-term volatility in the price of oil, pressure on currencies of oil-producing countries such as Russia, and greater demand for safe haven investments. In addition, companies that produce oil from fracking are experiencing higher borrowing costs, as a result of widening high yield spreads within the sector.

Oil supply is often difficult to change in the short run and therefore can drive oil price volatility on nothing more than a perceived change in short-term demand. But over time, we expect something different—more price stability, as no one cartel will have the ability to constrict supply. This should remove price spikes—the real culprit in many of our past deep recessions—from our future. Oil prices should eventually become range bound, with the low end defined by when fracking no longer makes economic sense, and the high end being where substitute energy products (solar, natural gas, more expensive fracking, deep water drilling) make economic sense. We will continue to monitor developments on this front as the market awaits an eventual stabilization of oil prices. In the meantime, we remind investors to look beyond the day-to-day headlines and instead try to take advantage of longer term trends.

Jeff Mortimer, CFA
Director of Investment Strategy

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