HBKS Wealth Advisors

Does the Low Price of Crude Oil Help or Hurt the U.S. Economy?

The conflicting effects of the drop in oil prices on the U.S. economy is a big reason for the increase in stock price volatility this year.

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As Director of Asset Management for HBKS® Wealth Advisors (HBKS®), Brian Sommers oversees the firm's investment management processes for a distinguished group of nearly 30 investment advisory representatives. Mr. Sommers chairs the Investment Policy Committee of the firm and is instrumental in the identification, evaluation and recommendation of the investments that make up HBK's portfolios. He brings HBKS clients the expertise of more than 20 years managing a wide range of portfolios for both high net worth individuals and institutional clients.

Over his career, Mr. Sommers has managed an impressive array of investments, including Taft-Hartley plans and endowments, and plans for foundations, corporations, individuals and public entities. He has held positions in investment consulting and client service for both institutional and high net worth clients.

After the financial crisis of 2008, the recovery of economic growth in many countries around the world, especially China, fueled a seemingly insatiable appetite for oil. Producers struggled to keep up with the demand, and the price of crude oil soared, peaking around $120 a barrel in 2011.

Since then, gas and oil production has surged in North America. Hydraulic fracturing, or "fracking," combined with new methods of horizontal well drilling, has allowed an enormous amount of previously inaccessible oil and gas to be pumped from the ground.

Meanwhile, the growth rate of global demand for oil and gas slowed as the economic recovery decelerated. In particular, economic growth in China, a major source of demand for oil, experienced a severe downturn. With the supply of oil and gas rising much faster than the demand, oil prices plummeted to below $30 per barrel in mid-February of this year.

Although prices have rebounded somewhat, there is still a surplus of oil, rather than a shortage. According to an article in *The Economist* magazine, last year, the world produced approximately 1.8 million barrels of oil per day more than was consumed.

Over time, a drop in the price of oil should have a positive impact on the global economy, especially in the United States. U.S. consumers benefit from an increase in purchasing power thanks to lower gasoline and utility costs. U.S. manufacturers also benefit from the lower cost of the inputs into their products and from the lower cost of shipping their goods.

Steven Franckhauser, Director of HBK Energy Advisors, says that "a drop in the cost of energy is a good thing for U.S. manufacturers because energy costs are about one-third of their expenses."

But what is a boon to some is a bust to others. Plummeting energy prices has led to stark reductions in plant and equipment investments by companies involved in the exploration, production, distribution or sale of oil, as well as many other companies that sell products to energy-related industries. The drop-off in spending has damaged broader industrial activity.

For companies involved in oil and natural gas production in the shale regions of the United States, including the Appalachian Basin, lower margins translate to substantially reduced profits, Franckhauser says. That means fewer jobs in the energy upstream.

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Financial institutions also are suffering. Numerous oil-related companies that have relied on debt to grow their business have been forced into bankruptcy. Banks that made loans to these companies will see a rise in their nonperforming loans, which lowers the overall profitability of the bank.

This has created a lot of uncertainty for investors and caused an increase in the volatility of global stock markets. Many investors fear that global economic growth is so anemic that even oil prices near $30 per barrel won't be enough to spur growth. Many consumers have become nervous about their future job prospects, causing them to pay back debt and build up precautionary savings with the extra cash in their pockets rather than spend it on goods and services, further endangering economic growth.

Whether the low price of oil continues to harm the economy or spur additional growth as we move through the rest of 2016 is dependent on the stabilization of oil prices. The United States is a net importer of oil, and the benefits of cheaper energy prices within consuming nations typically begin to outweigh the negative consequences as we move through the business cycle. We believe that if the price of oil settles into a trading range around current levels the economic headwinds will turn into economic tailwinds.

Fortunately, recent data suggest the negative effects from falling oil prices are already receding. The price of oil rebounded in early April, but remains low by historical standards. The drop in capital spending by energy-related corporations appears to have bottomed and is starting to bounce back. Also, the profits of companies in industries that use oil as an input are likely to receive a boost in 2016.

The consumer accounts for roughly 67 percent of GDP in the United States, and we believe there is good news here as well. The labor market continues to improve, and many individuals are in better financial shape after paying down their debt. Housing prices also continue to improve. As consumers become more optimistic regarding their financial condition, we believe they will begin to increase their spending once summer arrives.

As 2016 progresses, the domestic energy outlook remains unclear. This will likely cause the uncertainty in the global economy to continue. But while some are predicting the United States economy will fall into a recession, we believe these fears are overblown. Though economic growth is weak, the combination of lower energy costs, historically low interest rates, and moderate inflation should allow the economic recovery to continue.

One thing that is certain, however, is the United States is much closer to energy independence than it has been for a long time. The abundance of natural gas and oil from shale formations has allowed the U.S. to successfully meet the energy challenges posed by the demise of coal. While the output from renewable energy sources such as solar and wind are increasing, according to the U.S. Energy Information Administration (EIA), they provide only 10 percent of total U.S. energy consumption and 13 percent of electricity generation.

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Franckhauser says that "the key to U.S. energy independence is greater domestic utilization of all energy resources in an environmentally responsible manner and which satisfies basic economic principles." The EIA reports that in 2015, the United States imported only 24 percent of the petroleum it uses, down from 60 percent in 2005. It would be difficult to argue that this is not a positive for the long-term safety and health of the country.