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By Chuck Freedman, CFA, CAIA
Senior Vice President
The Commerce Trust Company

Why would falling oil prices have a *negative* impact on the stock market?

Many analysts would say the economy is too complex today to expect one commodity like oil to drive all business activity in a predictable way.

But that hasn't stopped some from recalibrating their analysis to find out if there remains or if there ever was a reliable correlation between the price of oil and the performance of the overall stock market.

In most of the preceding two decades, when oil prices were high and big oil companies prospered, the overall impact to the general stock market was usually in the opposite direction. In other words, oil company stocks rose when petroleum prices spiked, but the overall equity market would generally suffer. This is referred to as a negative correlation. It was a steady 20-year inverse relationship we could all understand and rely on.

Predictability in its own way can bring comfort, but what happens when the tables are turned? What has changed in our "new normal" relationship with oil when plummeting prices seem to only pull the stock market downward?

One explanation of the tendency for stocks and oil prices to move together, up or down, is that both are reacting to a weakening of global aggregate demand, which hurts both corporate profits and demand for oil. As a recent *Wall Street Journal* article put it: "Oil and stock markets have moved in lockstep this year, a rare coupling that highlights fears about global economic growth."*

So the lockstep effect has actually intensified, yet it may be a short-term condition. The conundrum facing investors now is whether to root for higher oil prices to prop up stocks in their personal investment portfolio, or to simply enjoy the consumer benefits of low prices at the gas pump.

In reality, worldwide supplies simply exceed demand, and that spells glut. The surprise collapse of oil prices that started in July of 2014 increasingly hit investors' confidence in the overall economy each time it broke another price barrier on the way down. Once oil got below $40 in December and the $30s this year, the unfavorable correlation with the overall stock market became really pronounced. And the longer we are mired in low oil prices, the longer market sentiment adapts to these lows as the baseline condition.

On the international stage, OPEC's decision to fiercely maintain production levels to hold world market share hurt member countries and other oil-exporting nations. Developing economies like Russia, Venezuela, and Brazil are crippled, creating the impression that there could be another emerging debt crisis. Given that global oil is priced in dollars, the relatively strong U.S. dollar also complicates exchange rates in international oil trade.

Glut, global economic weakness, or slowing energy demand in China? A correlation between oil prices and the stock market exists, but the logic behind it keeps changing. That is often a sign that a correlation itself is about to shift. So while this market flip is in place, be aware of the correlation between oil prices and stock prices -- because it may not last forever.

<u>Takeaways:</u>

- Low oil prices have signaled a slowdown in the economy, which translates as a brake on the stock market.
- For now, watch oil prices ebb and flow, and you can pretty much get a reading on the overall stock market's direction
- The strange tango between oil and the overall stock market may only be short-term.

*Ben Bernanke's Blog, Feb. 19, 2016