Economic and Market Insights

December 10, 2014

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Who do we thank for low oil prices? Why China, of course

You may still be a little incredulous as you pull away from the pump – maybe even a bit giddy. You dreaded emptying your wallet into your vehicle's tank only six months ago, and now you wonder how long this discount energy bonanza will last.

How did we get to this collapse in oil prices in seemingly so short a time?   As investors, it's important for you to know the answer because oil prices could influence at least part of your portfolio sector allocations and financial planning in the near-term.

Many analysts believe that the drop in oil prices and other commodities has largely run its course. But for now, it's important to understand this pleasant turn of energy relief started in China and in other emerging economies. For those who still remember the laws of supply and demand, the story is not complicated.

The second-largest economic engine in the world has decided it wants to shift from an investment-oriented to a consumer-oriented economy, and it's a lot like turning a yacht around in a bathtub. China is reducing its previously insatiable demand for commodities (oil, concrete, steel, agricultural products, metals, etc.), and the course correction will be monumental, but painfully slow.

As China cuts back, the "feeder" countries (e.g., Australia, Malaysia, South Korea, and Brazil) exporting their home-grown commodities to China have slowed as a result. Whereas so much money was previously going into emerging markets to support that colossal resource production, the end-user has put up a "caution-slow" sign for a while.

As the demand side has fallen, the production capacity kept rising, creating a textbook overall commodity glut. Oil gets most of the headlines though as the global exporters on the planet slug it out. A stubborn OPEC recently voted not to cut production in an attempt to squeeze out the upstart shale-oil producers in North America, who have come on strong in six short years with oil-fracking technology. The United States went from producing 8 million barrels per day to 15 million barrels per day in six years. But, for a while at least, domestic production may be reduced in reaction to falling world oil prices.

What does all this mean for the economy? Simply put, oil and other commodity price reductions help keep inflation at bay, and in turn help keep the lid on low global interest rates, including ours.

So China kicked off this cycle of events, and as a result oil as a commodity is playing a role in keeping rates low everywhere. The question facing investors is how low oil prices will go during this temporary blip? American drivers are saving $630 million on gasoline a day compared with what they paid at early summer prices. This translates into a $230 billion windfall if prices were to stay this low for a year.

And the repercussions from collapsing oil have had other effects on your portfolio, too. If you have been an investor in the energy sector of late, you have suffered. Through November, the oil sector was down -8.2% year-to-date. Meanwhile, S&P 500 Sector Index Returns in Consumer Discretionary and Consumer Staples were up 8.6% and 17.2%, respectively. Consumers don't have to spend as much money filling up, and now they can make more consumer-related choices. Retail, restaurant, and entertainment sectors may get a boost. Not surprisingly, some hotel stocks are already up.

The price of oil has declined about 40 percent since its peak in mid-June, a development that might prompt investors to re-examine their portfolio sector allocations with their financial advisors to take advantage of any rebalancing opportunities that may exist as we head into the New Year.