Conversations with Commerce Trust

Beyond the Oil Spike: Economic Impacts and Market Outlook

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David Hagee, Chief Investment Officer: Hello and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we're discussing the energy markets with Scott Colbert, our Chief Economist and Director of Fixed Income. Welcome back to the podcast, Scott.

Scott Colbert, Chief Economist: Hi David.

David: Excited to have you here. This is a topic that we've wanted to talk about for some time. I think it's always in the background, but certainly with the Iran conflict, there's been a lot more discussion surrounding energy. I think it'd be helpful maybe to take one step back and talk about energy's relationship with the U.S. economy, and certainly we'll get into the markets later on. But Scott, as you're thinking about energy, I mean, it's pervasive. But what are the key components that you think about when we're approaching that from an economic input?

Scott: Well, you know, this country has become much more energy independent, not only from being able to produce as much oil as we consume. But as we've grown from a manufacturing economy to more service-oriented economy, we actually use a lot less energy per unit of GDP than we used to. We're down to only consuming about 4.2%, energy per unit of GDP compared to nearly 10% 30 or 40 years ago.

So, the good news is, is, while nobody likes higher oil prices, we can absorb it a little bit better. About half of that energy consumption is transportation fuel, a euphemism for oil. So only about 2% of GDP is affected. Now, at the household level, it's a little more. The average household prior to the war was spending about 6.3% of their income on all energy consumption. About half of that's electricity, and the rest of that is either natural gas or transportation fuels, gasoline or diesel.

So it's impacting the average household a little bit more than it is the overall economy, but it's still not terribly egregious, but that certainly doesn't diminish the fact that it impacts the lower-income households a lot more.

David: And certainly, I think you bring up a great point. We've become significantly more fuel efficient, and we've become more efficient in our energy use, especially over the past 50 years. But if you look at global oil consumption and demand, it stayed around 105 million barrels per day, over the past you know, 40 years.

And the reason being is that as we've become leaner in terms of our energy consumption, the rest of the world has become, you know, has started to use significantly more, especially in Asia and, you know, emerging economies out there.

So, as we think about the supply-demand picture, you know, what inputs are you thinking about in terms of where that's going?

Scott: Well, most of our clients are asking us. How is it that energy prices haven't spiked even higher, right? How is it that gasoline and oil prices haven't spiked even higher with, as we all know by now, about one-fifth of the world's oil supply disrupted that goes through the Strait of Hormuz?

So, the answer to that is fairly simple. With the higher prices, we've destroyed some demand around the planet. S&P estimates that we've, that we've destroyed about 4.6 million barrels per day, so let's call it 5, right? That's 5. The straight was giving us 20 a day, so we've destroyed 5 in demand. That leaves 15 to pick up. The Arab countries have managed to divert some of the oil that was going through the Strait into pipelines and other vessels and trucks and trying to get the oil out any way they can. The world approximate that at about 5 million barrels. So now that leaves 10 shortage, and how have we made that up? Well, about half of it, 6 million barrels a day, has been the strategic petroleum reserve release. Not here only, but around the planet. So, we've been providing about, you know, 6 million barrels of additional oil, so that leaves about 4 million to make up, and that happens to be about exactly the exact excess capacity that we had to produce oil, before we went to war with Iran.

So oddly enough, we've made up about 15 million barrels of oil already, and we've lost about 5 million in demand from the higher prices. That's how we are squeaking by with, you know, $80 to $85 a barrel of oil instead of what some probably thought to begin with, you know, well over 100 expectations. Of course, the high tick in energy was about $122 for Brent crude, the spot prices for overseas crude, and then here in our country, it was about a hundred and $15, $16, $17 a barrel.

David: Yeah, we have seen prices after the quick pop when the Iran conflict really sort of flared. And when we're looking in March and April, prices were well into the hundreds. You've seen them crawl back quite a bit more recently. I guess there's one thing that's surprising to me. One is how much the strategic petroleum reserves were built up and gave the ability for countries to be able to have reserve releases that were very meaningful.

Additionally, is that how demand has been somewhat elastic around oil consumption. If you look at oil's role or energy's role in terms of both oil and energy byproduct in, you know, food packaging, whatever it might be, there were some catastrophic projections out there, but really those haven't come to pass. The market's been able to work through it.

Scott: Yeah, on a day-to-day basis, of course, it's fairly inelastic, but given a little bit of time, people do try and adjust. The overall impact to our economy, though, is still likely to be what? Higher inflation that we've already received and a slowdown in growth, which probably occurred in the second quarter. Our estimate for the first quarter growth, of course, is already in at about 2.1% annualized. Our estimate for the second quarter is closer to 1.5%. So, there's clearly some slowdown.

And the Fed would suggest that basically for every 10% higher average oil price per year, you lose 1/10 to 2/10 of percent of GDP. So far this year, oil prices have averaged 26% higher than last year's oil prices. Oil averaged $65 a barrel last year, about $80 a barrel so far this year here in this country. So, we would have lowered our GDP estimate if oil stays about $80 a barrel to $85 a barrel. We'd have to subtract about 3 tenths of a percent off of our GDP estimate. You'll recall that we were thinking we could probably grow at least 2% this year once again, so we took our estimates down to something less than 2%. But if they can come to some type of negotiated peace, you can see that prices can drop pretty quickly. Now, I don't think we know what the odds of that are, but to the extent that it occurs, you saw prices come down probably quicker than most people thought.

David: Yeah, and at the start of the conflict, we were at a supply glut. We had, you know, a tremendous amount of supply, which is remarkable. Given that, you know, you had mostly Russian oil fall off the world trading stage, in, 2022, and then on top of that, you've had these disruptions coming out of the Strait of Hormuz. If we're thinking about this. I think the big difference, you know, the question I get from clients is around, okay, we had these oil shocks and the energy shocks in the 70s with the Arab oil embargoes. What's different this time? What are your thoughts?

Scott: Well, you mentioned the inventories around the planet. We had approximately, and you know who knows how they actually keep track of all these numbers, but approximately there were 8 plus billion dollars of excess inventory out there, either through strategic petroleum reserves or in the commercial pipelines.

So that was a record for the last five years. So, in other words, we went in with a lot of inventory.

Second, we talked about the elasticity, that there has been that demand destruction. The third, of course, was the ability of the Arab nations to perhaps move some oil around. But you know, there are some other factors, probably at work here. The other thing that people forget about was, and I don't think this was part of the Israeli or American timing for the war, but February 28th is about the low seasonal tick for our need for energy consumption, for oil consumption around the world. Now, of course, we're into the summer months, and that's not helping any at all. But at least at the start of the war, it was the lower end of the demand for oil around the planet.

David: That's right. The summer driving season still plays a role inside global energy markets. You know, I'm struck that, you know, as we highlight these differences here, what's sort of gone unnoticed or maybe, maybe not as recognized as it should be is that the U.S. is the largest producer of oil at this moment. Doesn't mean we have the largest oil reserves. But with fracking and the byproduct that we get from that natural gas, has really sort of been a game changer, right, is given the ability, like you say, to for us to increase exports dramatically, not necessarily on refined product, but on unrefined product.

And then on top of that, as you mentioned, the Saudi Arabia and the Persian Gulf states have been able to reroute oil around the Strait of Hormuz, either to the Red Sea or to the Gulf of Oman. You know, for me, I think it's significantly different, even though it feels the same that oil shocks that you experienced in the 70s.

Scott: Well, of course, in the 70s, the OPEC nations specifically boycotted just the United States. So it was very impactful to us, but they let the oil go to everybody else, so it raised our, you know, oil prices a lot, but the rest of the world's actually declined just a touch. So that was targeted straight at the United States, and of course, back then we were dependent, you know, almost half of our, you know, oil consumption was coming from the Middle East. Now we really don't need it, you know, specifically, so it's been a generic price rise, you know, across the world for energy prices. So, it's been a huge boon to be semi, you know, independent.

Now, you've probably noticed that gas prices haven't come down tick for tick with the oil prices, and that has to do with the refining capacity, and actually, oddly enough, a lot to do with the Ukraine and Russian war, because the Ukrainians are taking out the Russian refining capacity with their drones and their ability to attack deeper into Russia, so we don't have as much refining capacity as we had prior to the war. So that's what's keeping gas prices a little more elevated than the actual drop in oil prices. You might have hoped to have seen lower gas prices sooner, given the sharp drop in the price of a barrel of oil. But gas prices are still averaging about $3.85 to $3.90 per gallon in this country per AAA.

David: So, yeah, as we avoid that $5 handle on the gallon of gas, I think that's the psychological point where people get very concerned about impact. As we talk about energy prices coming down, we just had a CPI print on Tuesday of 3.5%, down from 4.3% for the May print. You know, what do you see the path moving forward for inflation, given this sort of reprieve we've had in the energy markets?

Scott: Well, it certainly helps. And you saw it quickly pull the top line down from its high for the year. The surprise was that the core didn't continue to increase, because there was the thought that basically the higher energy prices were slowly bleeding into the core with a lag, and would continue to push up, even with top-line inflation coming down. But across the board, we actually saw kind of inflation just generally retreat just a little bit across the board. It was the first negative core print we've had in five years. So, our thoughts are this. That we're probably pretty close to getting peak inflation. It's likely to be, you know, in excess of 3%, whether you want to look on a core basis or a top line basis. It's still 50%, 60% higher than the Fed's 2% target. And this is what brings the Fed into play eventually during the year. Unless we get these energy prices to roll over fairly quickly and some type of peace deal signed, I think it's very likely that the Fed is bound to tap on the brake, not necessarily just from the energy side, but we all have to talk about the AI build-out, and of course, the demand for electricity, which is, you know, another form of energy, and the push that we're seeing there. There's certainly a price push coming from the AI data center build-out, the price of copper, the price of steel. Just the big push for the data center build out.

David: And that's been the big change for us across 2026, has been just the strength and size of this AI build-out.

If we're looking at projections across the board, we're looking for ‘27, that projected CapEx spend to be right around $1 trillion. Think of that about 3.5% of the U.S. economy, somewhere in there.

Scott: You know, the interesting thing is, while the data centers are roaring, a lot of other sectors are weak. Nobody's building downtown office properties, the apartment sectors are slightly overbuilt, Amazon doesn't need as many warehouses as they used to, so we've seen some pullback in other parts. Commercial construction spend, the spend in commercial construction, actually peaked over a year ago. So, the good news is, while the AI is pulling the economy along, there were some other weak spots that were, that are helping out and basically helping keep inflation at bay as much as it is.

David: As we look at this, we have an economy that's sort of balancing off this, higher energy prices with this AI build out. You mentioned earlier that we might see the Fed actually raise rates rather than lower rates in terms of how the Fed is positioning themselves. We've looked at this neutral rate before. It would seem to be somewhat accretive for us right now that this rate should be an accelerant. So, is that what you're thinking in terms of the genesis for getting this rate up?

Scott: Right, I think the Fed, you know, having held rates steady through this inflationary rise, have actually done what? They've actually accommodated the oil price increase as well as the data center build-out and the pricing pressure that were coming from that. In general, the tech sector, those chips and everything, are up, on average, 10% in price year over year, and many people would suggest that seems to be understated. So the Fed has a very blunt tool to raise interest rates. They lowered them four times in 2024. They lowered them three times in 2025. So they've taken 1.75% out of the short-term rate. I think they're likely to put some back.

The weird thing is, though, I don't think a quarter point or even a half a point rate hike is likely to slow the AI build-out, right. I don't think there's a data center in the world that's sitting there worried about that. And of course, this is going to do nothing to help Iran and the U.S. come to some type of negotiated peace either. But it certainly does push down the rest of the cyclical economy. It's going to make car prices higher. It's going to make homes less affordable. So, while it won't directly dent the two things that are pushing up on inflation, it will dent the other parts of the economy perhaps enough to slow overall aggregate inflation down some.

David: So, as we think about this in the context of how we're positioning our fixed income portfolios at this moment, how are you trying to play these two areas?

Scott: Yeah, you know, you'd think, wouldn't you be short the market? Wouldn't you be short maturity because they're pushing up on rates? But oddly enough, we think by taking this assertive, aggressive stance on long-term inflation, we think that's likely to anchor the lower end or longer end of the market.

Secondly, of course, we still believe that bonds are a bit of a diversifier away from stocks. And of course, I think everyone agrees that stocks are semi-expensive. It's backed by a lot of earnings right now. The worry, of course, is will the earnings continue?

David: So, with that, as we're thinking about the second half of the year, as you mentioned, we do expect oil prices to continue to be somewhat moderate here and not be in that triple-digit range that we saw before. Inflation continued to flirt above 3%. As you work through this, energy spike that we experienced and transition over to this, AI build-out, and I think that's a very important point, that when AI started, it was mostly people just buying chips. That's where all the CapEx was. Now it's pouring concrete and getting data centers built, which is a much more broad-based lift out there. So, with that, maybe we see rates actually tick up over the course of the second half of 2026.

Scott: I think the long end stays anchored, but I wouldn't doubt that we'll see a slightly higher short-term rate as the year progresses. We still might get the full coupon, though, out of the bond market by the end of the year. I think you'll see some progress on inflation in the back half of the year that will at least assuage the bond market that they're not going to have to keep pushing rates higher and higher.

David: As we see this blending of AI and energy out there, look at this global AI race. It's not just us built. It's not just the U.S. building out this AI complex. My stat is 63%. As we look at global token share by the model developer's country. China now has 63% of all tokens spent. This is the currency of AI. As opposed to before where the U.S. almost had a hammer lock on everything. Just 18 months ago. So, 63% of all tokens spent are not U.S.-based, they're Chinese-based tokens.

Scott: The average Fed funds rate, which is 3 and 3/8%, historically from 1970 till today, has averaged about 1% over trailing inflation.

And so, if trailing inflation right now is measured by the CPI as 3.5%, that would argue for more like a 4.5% short-term rate, not 3.7%. So, I'm compromising, if you will, by saying maybe there's a couple rate hikes coming. I don't think we have to take it all the way up to the 4.5%, which would be more of a normal rate given today's inflationary environment. But I think this is why you can feel like there's some push upward in short-term interest rates.

David: And I think complicating that is a new Fed chair that, I think is staying the course around traditional Fed chairs but is less transparent.

Scott: Yeah, we really don't know what he thinks. He's certainly acting like an inflationary hawk, but we do know that he was rather dovish on the thought that AI is likely in the long run to bring prices down. The problem is the build-out of AI seems to be pushing prices up.

David: Well, Scott, thanks for the interesting discussion today. For more on this topic, please visit www.commercetrustcompany.com for our mid-year outlook, as well as additional commentary on this subject. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

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