Will Rising Fuel Prices Crush the Bull Market?

Oil prices have been marching higher for months, a fact that many readers likely know based on recent trips to the pump. The cost of a barrel of West Texas Intermediate oil has soared from the low teens in April 2020 to over $90 a barrel today, as surging demand continues to be met with constrained supply. Many economic forecasters and energy analysts are calling for $100 per barrel and soon.[1]

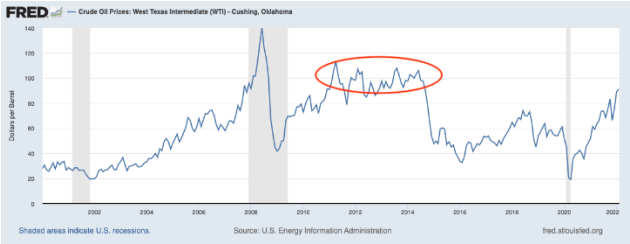
If oil prices continue to move higher, costs for businesses and consumers will continue to go up as well, which could sap margins and spending, respectively. This begs the question: will high oil and gas prices crush this bull market?

I think the answer is no. The first reason I'll give is based purely on history, and the second reason is based on a supply and demand imbalance I think should correct later this year.

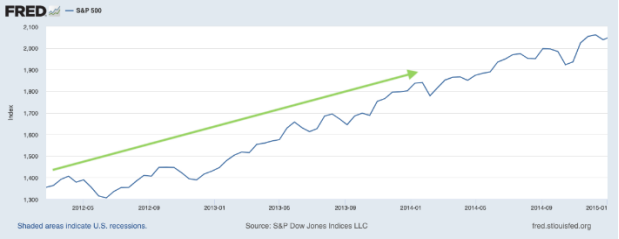
Let's start with the history. Many readers may not remember, but there was a period from mid-2011 to 2014 when oil prices hovered around $100 a barrel pretty consistently (circled in red on the chart below). Gas prices were quite high then, too, even higher than they are in parts of the country today.

The stock market did not seem to mind – during the period from 2011 to 2014 when a barrel of oil cost more than $100, the S&P 500 went up +65.1%.[2] The U.S. economy grew throughout that period as well, albeit at modest rates. Modest GDP growth was more due to the economic 'hangover' from the Global Financial Crisis than high oil prices, in my view.

The first chart below shows the period when oil was above $100 a barrel, and the second chart shows the S&P 500 from 2012 onward. As you can see, higher oil prices may not have necessarily helped the economy and markets, but they certainly did not hurt.



Source: Federal Reserve Bank of St. Louis[3]



Source: Federal Reserve Bank of St. Louis[4]

The second reason I do not think higher oil prices will kill the economic expansion and/or bull market is because of supply forces.

The period of high oil prices from 2011 to 2014 gave way to a shale boom in the U.S., which, coupled with OPEC also increasing supply, caused oil prices to plummet (readers can see the drop-off in prices around 2015). The well-remembered U.S. shale boom was heavily financed with debt, which ultimately led to a wave of bankruptcies and failed companies when oil prices crashed. Some analysts believe the lessons learned in that period will result in broad reluctance for shale producers to take advantage of high oil prices this time around, meaning supply will remain constrained in 2022. But the data so far suggests otherwise.

In the U.S. Permian basin, shale exploration and development rig activity are back to about 70% of pre-pandemic levels, and oil production is close to crossing all-time highs above 5 million barrels per day. In the gas-rich Haynesville close to the U.S. Gulf Coast, activity is just about at its highest level in a decade. U.S. oil production in February is expected to rise to 8.54 million barrels per day, which is only 730,000 barrels less than the record set in November 2019. Back then, oil prices were $20 *lower* than they are today.

At the end of the day, U.S. shale producers are very wary of taking on big debt and overproducing as they have in the past. But they are not wary of ramping up production to take advantage of higher prices. As of late last year, the break-even cost for shale producers was $37 per barrel. With oil trading above $90 per barrel, the incentive to come back online is high.

The other side of the supply equation is, of course, OPEC. The organization has indicated on a few occasions its intention to increase production and most recently announced a 400,000 barrel-per-day increase in March. But figures from OPEC are not always reliable, and to date, OPEC production remains about 5 million barrels per day below peak levels. Market-watchers are understandably worried about the impact of a Russian invasion of Ukraine, given Russia's status as a significant oil and commodities producer, particularly for Europe. This possibility remains a wildcard, and could give way to more choppiness and even higher prices in the near term – an outcome I think would simply shift supply elsewhere, and bring even more producers online.

Bottom Line for Investors

Higher oil prices are not ideal for energy-intensive businesses or consumers, but they are also not a death knell for earnings or an economic expansion. The U.S. economy was notably weaker in the 2011 to 2014 period than it is today, in my view, and the economy and markets managed to do just fine during that period of $100+ oil.

It may not happen immediately but eventually sustained higher prices will encourage more production, particularly from U.S. shale companies. We are starting to see signs of that now. As production ramps up and more supply comes online, price pressures will eventually ease, in my view. I do not necessarily see this as a multi-year process as we saw in the previous cycle – U.S. shale companies can bring production online relatively quickly and efficiently, and with oil close to $100 per barrel, I believe they will.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Bloomberg. February 8, 2022. https://www.bloomberg.com/opinion/articles/2022-02-08/america-s-frackers-are-back-and-they-re-now-a-threat-to-opec

[2] Fishers Investments. February 2, 2022. https://www.fisherinvestments.com/en-us/marketminder/our-perspective-on-those-100-oil-forecasts

[34] Fred Economic Data. February 9, 2022. https://fred.stlouisfed.org/series/DCOILWTICO

[4] Fred Economic Data. February 15, 2022. https://fred.stlouisfed.org/series/SP500#0

Weekly Market Update

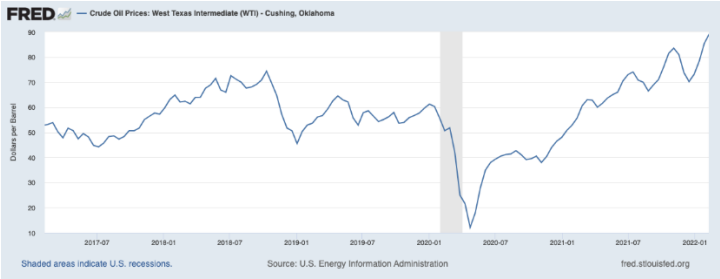
Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **Russia's invasion of Ukraine and its possible effect on oil prices**
- **U.S. government's budget surplus**
- **More retirees in the U.S.**
- **Update on retail sales**

Oil Prices are High – Will a Russian Invasion of Ukraine Send Them Higher?

Oil prices have been moving steadily higher since spring 2020 (see chart below) when the global economy started to reopen following the pandemic-induced lockdown. OPEC and U.S. shale producers slashed supply in response to the lockdowns, but over time demand for oil returned to the economy far faster than supply came back online. Global oil production is still below pre-pandemic highs. That has given way to high and rising oil prices, which many readers likely know given recent trips to the gas station. U.S. shale producers are steadily ramping production and OPEC has made 'commitments' to increase output, but it could take months before additional supply starts to put downward pressure on prices. And then there's Russia, the world's third-largest oil producer. An invasion of Ukraine could result in dented production, which could result in a short-term hit to already tight oil supplies. How the situation between Russia and Ukraine plays out is unknown today, but oil traders appear to be pricing in a significant "geopolitical risk premium," with oil approaching $100 a barrel.[1]



Source: Federal Reserve Bank of St. Louis[2]

U.S. Government Runs a Budget Surplus for First Time in Years

Did readers see that correctly? Did the U.S. government run a budget *surplus?* Indeed – in January, the U.S. government ran a monthly surplus for the first time since September 2019, of $119 billion. The monthly surplus comes from the expiration of fiscal stimulus programs like the child tax credit, aid to workers and small businesses, and other Covid-19 spending programs, coupled with an increase in tax revenue triggered by higher wages (which increases taxable earnings), more workers in the economy, and higher corporate revenues. Spending from the infrastructure bill has not yet been deployed, so the budget surplus seen in January may be more of a one-off event than part of a larger trend.[3]

More Retirees in the U.S.

The number of retirees in the U.S. increased over the past year, with the percentage of the U.S. population in retirement at close to 20% – up from 18.3% in early 2020. According to the Federal Reserve Bank of St. Louis, approximately 4.2 million people left the workforce during the pandemic, with a meaningful percentage of them planning never to return. There are a few reasons more people entered retirement. For one, the stock market and housing market have both delivered robust

gains over the past two years, meaning that many retirees and would-be retirees have seen their net worth rise to record levels. But there was also a recalibration of people's perception of work once the lockdowns took hold and the 'remote work' movement gained traction.[4]

Retail Spending Bounces Back Firmly, But…

January was a strong month for retail sales, which rose 3.8% from December – the biggest monthly gain since March 2021. Sales fell in December as the Omicron variant spread quickly, so the rebound in January was likely attributed to waning pandemic risk coupled with accumulated savings from the previous month. There's a "but," however – retail sales figures are not adjusted for inflation, meaning that higher prices will push sales figures higher. As such, the strong January performance is arguably just as much inflation-driven as it is purchase-driven. The upshot is that retail sales figures also do not account for spending on services, which are poised to see a rebound in Q1 (and hopefully beyond) and pandemic restrictions fade. In fact, there are already early signs this transition from goods to services may be taking hold – spending on services increased 12% year-over-year for the week ended February 5, as consumers dished out more for airfares, hotels, entertainment, and dining out.[5]

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[1] Wall Street Journal. February 14, 2022. https://www.wsj.com/articles/why-russian-invasion-peril-is-driving-oil-prices-near-100-11644790004?mod=djemRTE_h

[2] Fred Economic Data. February 16, 2022. https://fred.stlouisfed.org/series/DCOILWTICO#0

[3] Wall Street Journal. February 10, 2022. https://www.wsj.com/articles/u-s-government-recorded-119-billion-budget-surplus-its-first-since-before-pandemic-11644519768?mod=djemRTE_h

[4] Wall Street Journal. February 11, 2022. https://www.wsj.com/articles/you-got-richer-during-the-pandemic-early-retirement-is-still-risky-11644575419?mod=djemRTE_h

[5] Wall Street Journal. February 16, 2022. https://www.wsj.com/articles/us-economy-january-2022-retail-sales-11644963650?mod=hp_lead_pos1

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