LPL RESEARCH

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OIL BOUNCES BUT STILL IN BALANCE

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KEY TAKEAWAYS

Oil prices rose in anticipation of the U.S. withdrawing from the Iran deal.

Spare OPEC capacity and rising U.S. production should largely compensate for lost supply from Iran.

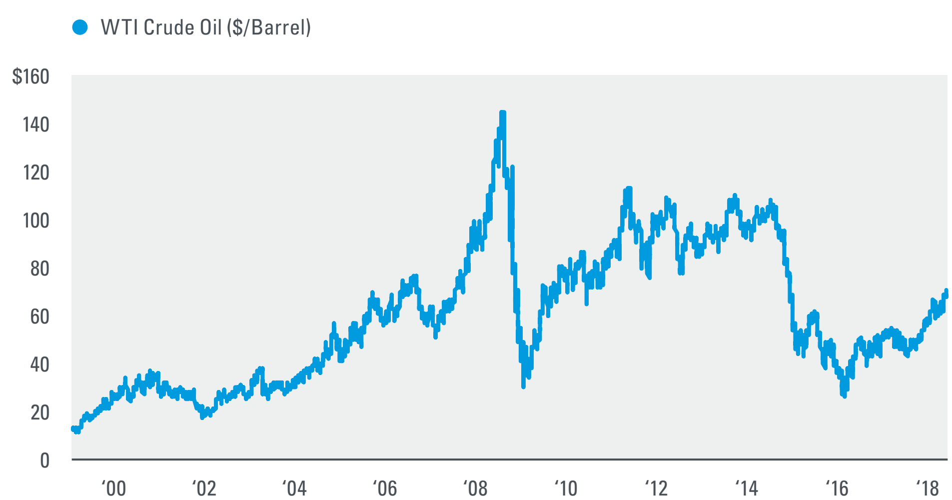
Consumers will feel the impact of higher oil prices, but the effect may be small compared to the benefits of a strong job market and the new tax law.

Last June, oil hit an interim low of about $42.50 and started to climb. By May 7, 2018, it had crossed $70 for the first time since 2014. President Trump announced the U.S. would be withdrawing from the Iran nuclear deal the next day. We view rising oil prices as largely a result of rebalancing supply and demand, and believe prices will stabilize as markets digest the recent news. The Organization of the Petroleum Exporting Countries (OPEC), its partners, and U.S. production growth should be able to compensate for reduced Iranian supply. Even if prices stabilize at current levels, it will be a modest hit for consumers, especially those at lower income levels, and it may temporarily push headline inflation higher; however, we believe the impact may be small compared to economic support from a strong job market and the new tax law.

OIL SWINGS NORMAL, BUT EXPECTING INCREASED BALANCE

Oil prices are naturally volatile, even more than equity markets, and recent experience has only reinforced the fact. In early 1999, oil sat near $11 per barrel, but by 2008 it had peaked at over $140 [Figure 1]. During the recession we saw oil fall to just over $30 before once again topping $110 as late as 2013.

1 OIL VOLATILITY IS NORMAL



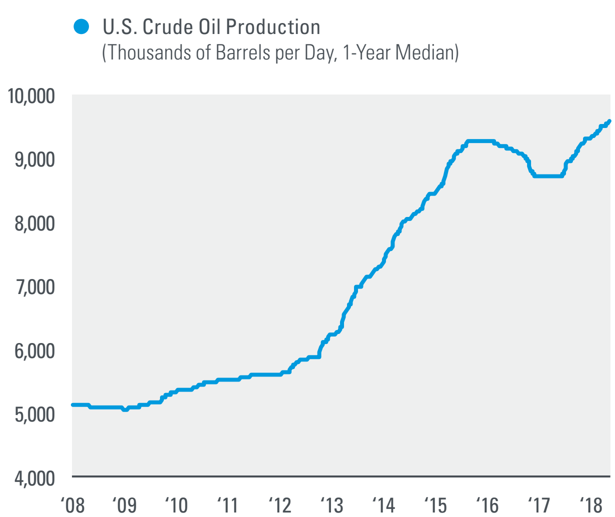
Sources: LPL Research, U.S. Energy Information Administration 05/11/18

Illustration is historical and no guarantee of future results.

Since then we have seen oil crash to the mid-$20s, but now it sits at over $70. Such swings are normal over time, but they can be punctuated by periods of relative balance. Oil, as a hard asset, is driven by the basic law of supply and demand, but given the capital-intensive nature of the industry and its sensitivity to geopolitics, price cannot always adjust quickly and therefore can be very sensitive to shocks, sentiment, and shifting imbalances. But, assuming no new disruptions, over time a new balance should take hold.

Oil's volatility creates challenges for consumers, but also to businesses and even the producers. Over the last several years, oil markets have had to adjust to the growth of U.S. shale, changes in global demand, and the constant potential for supply disruptions. Under normal conditions, these fundamentals create a range where oil prices should approximately settle, and, given healthy global demand, we believe we are near that range right now. But when markets perceive even potential disruptions, there can be an impact on producer, consumer, and even speculator behavior as markets prepare for different potential outcomes.

2 U.S. PRODUCTION ACCELERATING AGAIN



Sources: LPL Research, U.S. Energy Information Administration 05/11/18

IRAN IN FOCUS

Recent concern has focused on Iran and the U.S. withdrawal from the 2015 nuclear deal. Iran is the world's fifth largest oil producer and the renewal of U.S. sanctions will certainly have some impact on supply from Iran. Even so, Iranian oil will continue to help meet some international demand if the Iran deal remains in place for some countries outside the U.S. Currently, China, Russia, France, Germany, and Iran itself all remain in the nuclear accord, making the impact of the U.S. withdrawal on Iranian crude exports uncertain. Analysts estimate that Iranian exports could fall by anywhere from 200,000 to 1 million barrels per day, a significant but likely manageable amount. Some of the lost supply, however, could be met by OPEC nations and partners outside of OPEC who had agreed to lower supply to help stabilize oil prices.

In addition, the U.S. continues to expand its production capacity as well as its ability to bring more oil on line quicker as technology improves. U.S. production has nearly doubled since 2008 [Figure 2], and according to Baker Hughes data, the oil rig count still sits at only about half the level of its peak of near 1,600 rigs in 2014. Even before the potential for reduced supply due to restrictions on Iran's exports, the U.S. Energy Information Administration estimated that U.S. production would increase at an average of about 13% a year over the next two years. Based on these factors, while the lost supply from sanctions may be significant, we believe there is sufficient capacity to offset it.

MIDDLE EAST POLITICAL UNCERTAINTY REMAINS A WILD CARD

In addition to concerns about changes in global supply, markets are focused on the potential for increased regional tensions as nations adjust to a changing political backdrop. Saudi Arabia and Iran remain bitter geopolitical rivals and continue to battle for influence throughout the Middle East in countries such as Iraq, Syria, Lebanon, and Yemen. Israel remains an Iranian target, and while it's hard to say that the U.S. withdrawal from the nuclear deal intensified already elevated tensions, it did make de-escalation less likely. Markets dislike uncertainty, especially when it comes to an already volatile commodity that plays such a large role in the global economy. If concerns turn out to be unfounded or the changing environment normalizes, some of the risk premium may come out of oil prices, especially given the level of concern that is likely already priced in.

CONSUMER IMPACT MANAGEABLE

Higher oil prices have wide-ranging consequences, but consumers bear much of the impact, especially at the lower end of the income spectrum. For businesses, the results are mixed. Energy companies themselves, and energy-producing regions, benefit, as do companies that support the energy industry. The impact on transportation companies is complicated, in part due to the possibility of fuel surcharges, but even if those surcharges make higher prices more manageable, they do get passed on to consumers and businesses. If oil prices stabilize at current levels, we expect the consumer impact to be easily offset by the new tax law and a strong job market, but it will eat into some of the prospective consumer gains. The larger concern would be if prices start to move significantly higher and start to pressure inflation, and in turn, the Federal Reserve (Fed). But until the Fed views the changes as structural rather than temporary, it should take the inflation impact of a short-lived increase in oil prices in stride.

CONCLUSION

We believe oil markets will largely be able to compensate for decreased supply due to new sanctions on Iran. Regional geopolitical uncertainty remains a concern, but may normalize over time. Even at current levels, consumers may feel some impact from higher oil prices, potentially offsetting some of the benefits of the new tax law but leaving the bulk of the benefits in place. We do have some concerns about the growing number of secondary effects each taking small bites from the positive impact of the legislation: oil prices, tariffs and trade, rising rates, tightening financial conditions, and deficit concerns. But for now, the dominant theme for the economy remains the growth potential of a fiscally and investment-driven business cycle to extend the expansion, increase productivity, and lift economic growth to close to 3%. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risk including loss of principal.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

The Organization of Petroleum Exporting Countries (OPEC) is an organization consisting of the world's major oil-exporting nations. It was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries.

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