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Rising Oil Prices are Stressing Consumers and Investors

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It wasn't so long ago — April 2020, in fact — that the spot price for a barrel of West Texas Intermediate (WTI) oil, the U.S. benchmark for oil prices, was briefly negative for the first time in history. At that time, there was so much excess supply in the face of cratering demand amid the pandemic-lockdowns that paying someone to take it off their hands was more economical for producers than paying the costs to store it. On April 21, 2020, when WTI moved back into positive territory, it closed at $8.91 per barrel. On March 8, a barrel traded at $123.70; 1,288% higher than it did less than two years ago! That meteoric rise has translated to a 53% increase in the energy component of the Consumer Price Index (CPI) over the same period[1].

Consumers are undoubtedly feeling it at the pump, where gas prices' highly visible nature — with prices posted outside every gas station — serve as a constant reminder of the impact on our bank accounts. Moreover, many are concerned about the impact of high energy prices on the broader economy, while investors have questioned what steps (if any) they should take to better position their portfolios to mitigate the deterioration of their purchasing power.

Macro Environment

Oil is a versatile commodity used to produce a wide range of goods, from hand lotion to golf balls to tires; yet it has directly contributed only 0.73% to the 11.0% increase in the broader CPI since April 2020. This is not to be dismissive of the dramatic increase in gas prices we're all experiencing at the pump. It's just that the broader economy has become less energy-intensive, so rising oil prices do not have as widespread of an impact on other goods as they once did. Over the past 60 years, the ongoing transition from a manufacturing-based to a more services-based economy has reduced U.S. dependance on oil and consequently lessened its impact on overall inflation (Figure 1). These dynamics, coupled with the U.S. emerging as the top producer worldwide, mean the U.S. economy is more insulated from oil price spikes.

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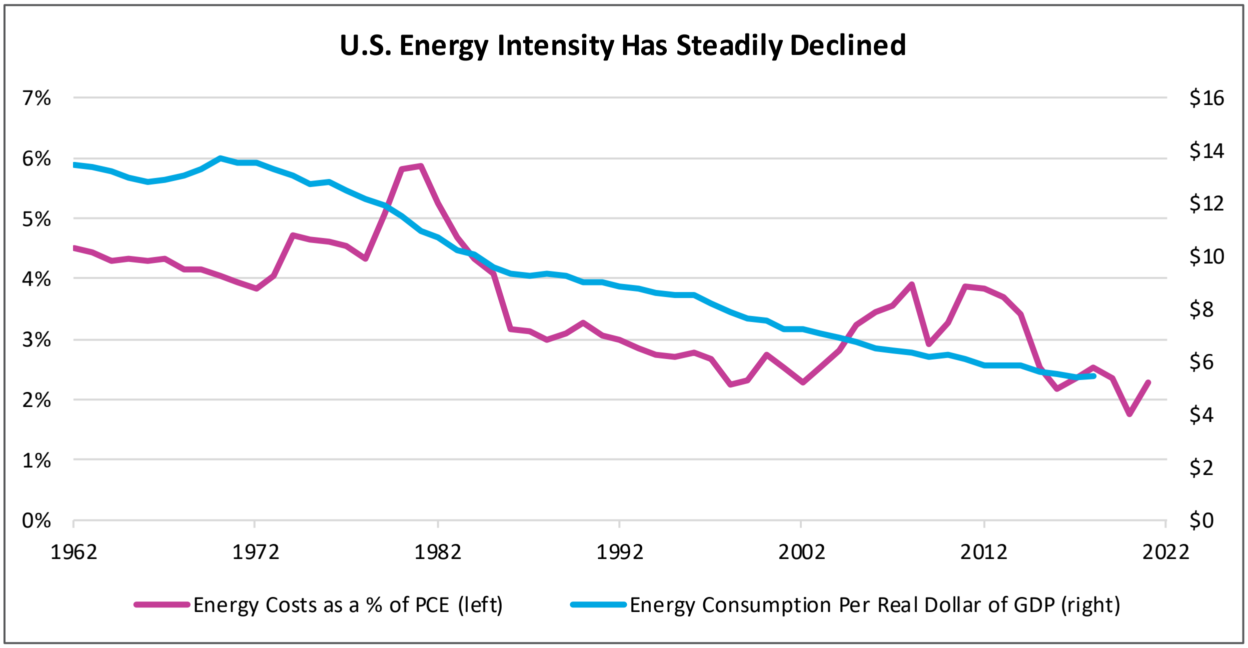
[1] Comparing the values from April 2020 and February 2022, the most recent data available

Figure 1



Source: FactSet as of 3/11/2022

Oil Price Shocks Don't Derail Stocks

Consequently, stocks have become more resilient to energy price shocks. Figure 2 shows years in which oil prices increased by 40% or more since 1970, when energy consumption as a percentage of gross domestic product (GDP) peaked. The average annual return of U.S. stocks for those years, as represented by the S&P 500 Index, has been 2.9%, while performance in the subsequent year has been even better on average, at 12.8%. It's also important to note that stocks experienced above-average, intra-year market drawdowns in years when oil rose more than 40% (-20.7% on average). The following year has historically seen similar drawdowns; however, performance has tended to be much better (12.8%).

Figure 2

Year	Oil Price Change	S&P 500 Index Return	Maximum Drawdown	S&P 500 Index Next Year Return	Maximum Drawdown Next Year
1974	76.6%	-25.9%	-37.6%	37.0%	-14.1%
1979	40.4%	18.5%	-10.2%	31.7%	-17.1%
1980	70.8%	31.7%	-17.1%	-4.7%	-18.4%
1981	47.2%	-4.7%	-18.4%	20.4%	-16.6%
1999	43.1%	20.9%	-12.1%	-9.0%	-17.2%
2000	71.7%	-9.0%	-17.2%	-11.9%	-29.7%
2008	41.4%	-36.6%	-48.0%	25.9%	-27.6%
2021	78.8%	28.5%	-5.2%	?	?
Average	**58.8%**	**2.9%**	**-20.7%**	**12.8%**	**-20.1%**
Average*	**1.3%**	**14.0%**	**-13.4%**	**12.4%**	**-13.7%**

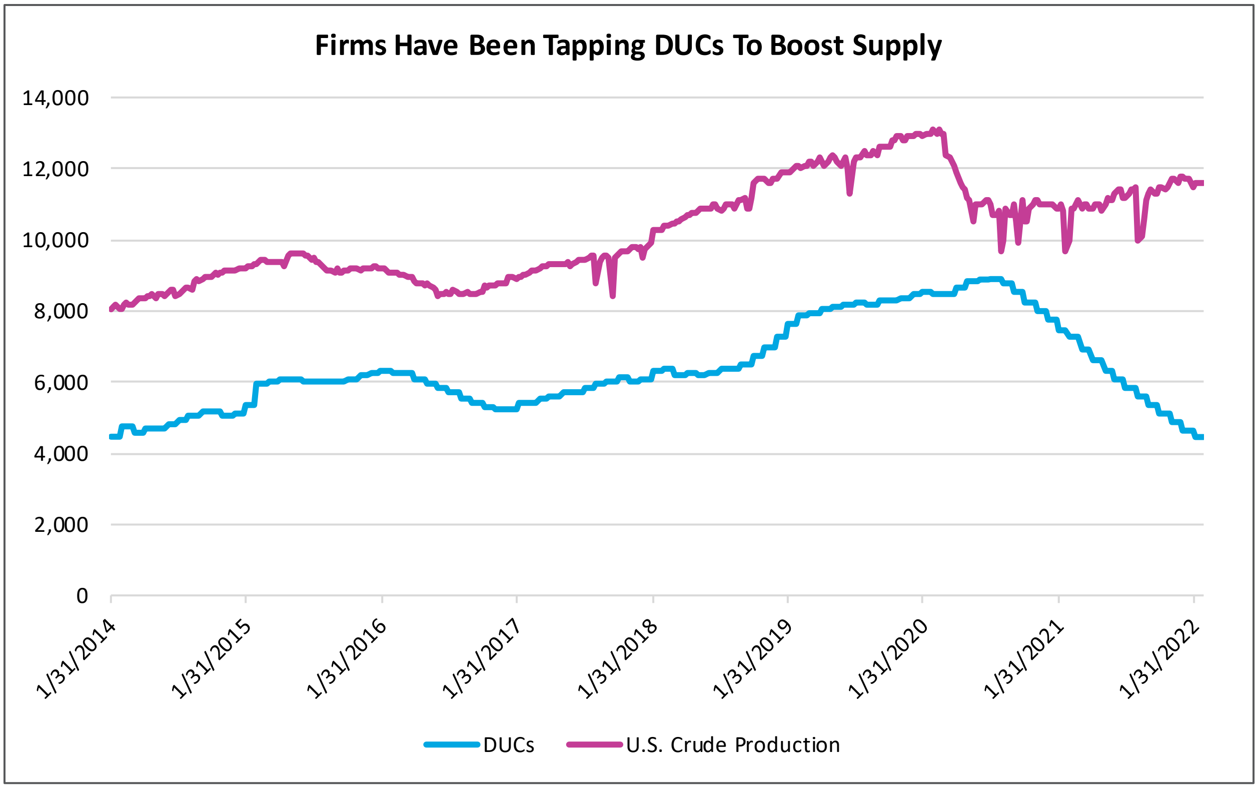
*Oil up < 40%

Source: FactSet, Stern.NYU, Choreo as of 12/31/2021

DUC Hunting

Despite the short-term windfall some companies have experienced as a result of the price surge, longer-term prospects may be less rosy. Over the past several years, U.S. energy firms have tended to favor returning cash to shareholders in lieu of investing in infrastructure, exploration and drilling new wells. Consequently, many have been relying on drilled-but-uncompleted wells (known as DUCs*) for supply, but even those sources have been rapidly declining since August 2020 and now stand near decade-lows (Figure 3).

Figure 3



** A DUC is a well that has been drilled but is not yet ready to produce oil. Well completion is a phase of the well lifecycle between drilling and production, essentially preparing a drilled and cased well for production.*

Source: FactSet, Choreo as of 12/31/2021

Consequently, energy producers will need to increase capital expenditures over the next few years to replenish production capacity, which may leave them in a bind. From a political perspective, regulatory focus will likely continue to lean toward renewables over fossil fuels, making it difficult to boost activities that would meaningfully add to supply. Should the political climate become more favorable for exploration and production, supply may have already increased (and/or demand may have fallen) enough to put sufficient downward pressure on prices to make once-profitable investments less attractive. In addition, companies would have to pivot from their more shareholder-friendly dividend payouts to which investors have grown accustomed, which could negatively impact stock prices.

Should We Bet on Oil Prices in Portfolios?

Aside from energy company stocks, investors may be contemplating other ways they might adjust their portfolios to capture potential additional upside should oil strength persist. We should first note that as long-term strategic investors, we do not advocate short-term, market-timing changes, especially in energy and other commodity markets where price movements often detach from long-term fundamentals. Even as we write this, oil prices have retraced more than 30% from the $130+ highs seen during the first week of the Russia-Ukraine war. Also of note, our strategic allocation to broad real assets provides diversified flexible, exposure to energy and commodity markets.

Most investment vehicles that seek to track the price of oil are not well-suited to long-term investors. Exchange-traded vehicles utilize derivative contracts to gain exposure to the underlying price of oil. Over time, the security's performance can diverge from the underlying asset depending on the shape of the futures curve and the investor's holding period. Currently, the term structure of the futures curve for WTI oil is in backwardation[2], which has generally helped oil-linked ETFs to outperform spot oil prices since futures prices are lower than the spot price. However, if the futures curve is in contango — the most common term structure characterized by near-term prices being lower than longer-term prices — the fund will incur excess costs to roll the security's exposure from the current contract to the next, more expensive contract as it nears expiration, creating a performance drag (akin to walking up the down escalator).

Conclusion

The surge in oil prices is front and center for consumers and investors alike. High visibility of rising gasoline prices, the relatively large outlay during each trip to the pump, and the isolated nature of the purchase make it easy to see exactly how much more we spend filling up the family roadster compared to the loaf of bread that goes from $3 to $4 and is buried among all the others items we buy at the grocery store. Investors, meanwhile, are looking either to take advantage of higher oil prices within their portfolio or defend their assets from the potential ravages of its inflationary impact. Investors whose asset allocation includes diversified equity exposure, broad real assets and/or U.S. high yield bonds likely already have meaningful exposure to the energy sector. We do not advocate tactically adding to that exposure, as the risk-reward is unclear and likely asymmetrical (to the negative), especially in many of the common investment vehicles. Instead, we continue to recommend a well-diversified portfolio that may better withstand bouts of higher volatility.

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[2] Downward-sloping term structure characterized by near-term prices being higher than longer-dated prices