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BLOG POST
Oil as a Weapon
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The shocking attacks on Saudi Arabia's oil production a couple of weeks ago highlight that warfare today is targeting economic impact as much, if not more, than military impact. Houthi rebels from Yemen, backed and financed by Iran, carried out the drone attacks that took 50% of Saudi production offline, equaling 5% of global oil supply.

With bleak economic data out of China, Germany on the cusp of recession, and the UK increasingly looking like they could crash out of the European Union without a deal, the timing of an oil spike is conspicuous for the global economy. Oil is like oxygen for the world economy, causing some analysts to suggest the 15% spike in crude prices could tip economies into recession.

While a price spike might cause concern, I do not think we are any where near a price per barrel that would warrant recession concerns. First, adjusted for inflation, oil remains about 50% lower than the process achieved in the 1980's, 2008, or 2014. In 2019 dollars, oil reached a high of $158/barrel in 2008 before the Great Recession. The total amount consumers spend on energy today is roughly equivalent to what was spent during WWII.

Energy expert Steven Kopits of Princeton Energy Advisors suggests that crude prices would have to reach $110/barrel to cause a recession today. The primary reason an oil spike is not the same threat today is that the world's largest economy, the U.S., is now a net exporter of oil instead of the largest importer of oil (an honor that now belongs to China). The U.S. briefly overtook Saudi Arabia and Russia as the largest oil exporter in the world in 2019. U.S. production has risen the 15 million barrels per day (BPD), 25% higher then the Saudi's uninterrupted production and more than twice maximum production from just 10 years ago, thanks to technological breakthroughs in shale exploration.

OPEC had seen their influence fall dramatically with respect to oil prices. The top 7 producing countries account for 50 million BPD according to the Energy Information Administration, and OPEC represents just 16 million BPD of that total (excludes Iran because of sanctions). The lack of influence is forcing some members to try and create havoc or economic terrorism. At this point, it seems unlikely they will be able to succeed in that except in countries that are particularly vulnerable to oil price stocks like China.

There is, however, a strong economic impact being caused by instability of the energy markets; just not what the perpetrators have desired. With the surge in U.S. oil production to more than 15 million BPD and becoming a net exporter of oil, the U.S. does not send dollars overseas in the same quantities as in the past. There is a growing USD liquidity issue that is negatively impacting emerging market countries who rely on USD for their economic growth. Because much of emerging market debt is priced in USD, they need access to dollars to service the debt. With fewer dollars available in global markets, the dollar rises compared to the emerging market currencies making debt servicing onerous. Just recently the IMF (International Monetary Fund) reduced forecasts for global growth in 2019 and 2020 as a result of slower growth in emerging markets caused by a U.S. dollar squeeze.

The U.S. stock market shrugged off the attacks on Saudi oil and the corresponding 15% spike in oil prices as a non-event. Recent history has even shown that since the U.S. became a net exporter of oil, the markets are more vulnerable to a sudden price drop in oil more than increasing oil prices. The impact on corporate earnings for the S&P 500 of falling oil prices, particularly below $40/barrel, is much greater than the impact on earnings of oil prices above $60/barrel.

Consumers remain optimistic and their balance sheets on the whole support continued spending to keep U.S. economic growth in the 2.5%-3.0% range. The labor markets are unlikely to be negatively impacted by higher oil prices supporting continued domestic growth. The investment implications are most likely to be a pullback in allocations to China and emerging markets hurt by the dollar shortage and vulnerable European markets like Germany. New stimulus and quantitative easing by the ECB should soften the impact across Europe. Energy remains a critical component of economic growth, but the winners and losers have changed dramatically.

U.S. Crude Oil Export (Annual Average)