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For the United States, 2014 was unquestionably a year of continued recovery. The economy gained traction as consumer and business confidence both improved. U.S. stock prices recorded new highs, aided by loose monetary policy and the recognition that the economic recovery had become self-sustaining. Many other regions, however, continued to struggle.

This divergence in growth prospects and the potential feedback to our shores may be one of the big story lines in 2015. For it will also prompt a divergence in policy prescriptions. While the Federal Reserve is transitioning to a less accommodating stage, other central banks, namely the ECB, Bank of Japan, and Peoples Bank of China, will likely be turning their spigots on. There has already been an impact on currency rates and yields. It should make for an interesting brew.

Spot market jolts stock market

Of course, the big news spilling into the New Year involves the precipitous drop in oil prices and the corresponding turmoil in the stock market. Since June, spot prices for the benchmark Brent crude have plunged from $112/bbl (barrel) to under $50/bbl.

The speed and size of the decline have unnerved investors — and not just those in the energy patch. For 3½ years, crude oil had been trading consistently in a $100-$125/bbl range. Observers of the energy markets certainly had not anticipated the latest turn of events. This environment brings to mind economist Rudi Dornbusch's classic observation that "In economics, things take longer to happen than you think they will, and then happen faster than you thought they could."

Incremental changes provide decision makers and market participants with the opportunity to adapt smoothly to a changing environment. Rapid, violent disruptions to the status quo are much more problematic. This phenomenon partially explains the concern over the drop in oil prices. There will be both financial and geopolitical implications to the swoon, and everyone is trying to work out what they will be.

Canary in the oil well

Furthermore, oil prices have generally been pro-cyclical: Higher prices tend to correspond with greater economic activity, while falling prices have often pointed toward a global economic slowdown. Hence the fear that has enveloped stock markets around the world.

But are low oil prices really the *canary in the coal mine* for global growth prospects? A closer look at the dynamics driving the current cycle suggests that pundits are misinterpreting the signals.

The demand for oil has indeed receded a bit, mostly as a result of China's downshift into a lower gear. Europe's malaise has not helped either. Nevertheless, the International Energy Agency still expects worldwide consumption to *increase* modestly in 2015. The imbalance stems primarily from a supply shock. Surging oil output, particularly from U.S. shale fields, has changed the math. Production has grown faster than consumption, leading to a buildup in inventories and pressure on prices.

Gusher in the Gulf

During past periods of excess supply, Saudi Arabia has typically acted as swing producer, curtailing its own output to restore balance to the market. This time around, the Desert Kingdom has so far elected not to alter its production profile. No other OPEC member has stepped back, either; most are pumping oil all-out.

Naturally, conspiracy theories abound. Some postulate that Saudi inaction is aimed at driving U.S. shale oil producers out of business. Lower prices *are* causing some stress in that industry, particularly for smaller firms that need the cash flow to service high debt loads. Fortunately, the typical cost of finding and extracting a barrel of shale has dropped to under $60.

Others speculate that in a passive-aggressive way, Saudi leaders are seeking to punish their regional rival and troublemaker, Iran. That nation depends on petrodollars to fund large subsidies to its citizens. By some estimates, Iran requires oil prices of over $130/bbl to cover government spending.

Low prices — the bad news

Or perhaps the motive is as simple as the desire to maintain market share; a bit of brinkmanship to pressure other OPEC members (and large non-OPEC producers like Russia and Mexico) to agree to cut output and share the pain. But regardless of the actual reasons, investors must focus on the outcome — low prices.

And the oil price collapse will indeed have some negative consequences. The first involves the potential shakeout in the shale oil industry and the flow-through to the broader economy. Bears suggest that U.S. oil and gas activity will slump, leading to stressed balance sheets, debt defaults, and job cuts; capital spending will collapse.

The energy renaissance has been one of the leading domestic themes over the past five years. Increased capital investment led to job growth within the sector itself and among its suppliers in areas like manufacturing and transportation. As energy firms cut back on production and capital spending, some of these jobs will be in peril. Certain industries and regions will bear a disproportionate amount of pain. But in the scheme of things, the overall economy should be able to absorb much of this stress. Jobs in the oil and gas and related industries account for a very small share of total employment. In contrast, the sector's capital spending has been very meaningful and accounts for 10% of total capex. A pullback will present a headwind but probably not a death knell for overall capital spending.

Barrels of bonds

Secondly, the sharp drop-off in crude prices could introduce financial and geopolitical stress; specifically, via the high-yield corporate bond market as well as certain emerging bond and currency markets. Energy companies account for 20% of the U.S. high-yield debt space. Those yields have increased substantially over the past few months, implying more credit risk. Downgrades and even some defaults are quite possible but should be contained.

Meanwhile, yields have also surged on public and private debt in petro-states such as Venezuela and Russia. Lower oil prices represent a massive wealth transfer. Currently, approximately 90 million barrels/day of oil are consumed. The difference between oil at $100/bbl and $50/bbl represents a shift of $1.6 trillion on an annual basis. That is a pretty big number, and some producing countries are feeling the fiscal pinch. The Russians had already been pressured by western sanctions and are now unable to access new capital to refinance their maturing debt. The ruble has tumbled 50% against the dollar.

Tanks for the tax cut

But absent fallout from some global shock, the net impact of lower oil prices should be positive for the United States. The country is simultaneously the world's largest producer and consumer of oil. Our voracious appetite also makes us the leading importer as well. So the U.S. ultimately benefits from a wealth transfer from producing to consuming nations.

The real benefit flows to individual Americans. The fall in gasoline prices is equivalent to a sizable tax cut. If sustained, the current price drop is consistent with a 1.5% increase in consumer cash flows. And because of consumers' higher propensity to spend than save, the multiplier effect from lower gas prices will outweigh the corresponding loss to domestic producers. Or viewed another way, almost 70% of GDP is driven by consumer spending; oil and gas sector capital spending accounts for 1% of GDP. Globally, the International Monetary Fund estimates that every 10% change in the price of oil corresponds to a 0.2% movement in GDP.

There are obviously many cross currents, but oil's impact on the U.S. stock market should be bullish. That's because the price drop will stimulate growth while further dimming inflation expectations. It will keep pressure off long-term interest rates and thus bodes well for stocks. A benign inflation outlook also provides the Federal Reserve with flexibility to continue to delay a short-term rate hike as it sees fit.

Top dollar store

So when will the Fed start to allow short-term rates to rise? Consensus seems to be mid-2015, but the crowd has been wrong on this issue for a few years. The strong dollar could join oil as another mitigating factor. The rising greenback, a product of our trading partners' stagnant growth, represents a *de facto* tightening of monetary policy. With our exports more expensive, the dollar's move up could hamper economic growth. It also serves to drive down inflation, as the imports we buy become cheaper.

Fed board members continue to focus on labor market trends to help determine policy. The trend strengthened considerably last year, with an average of 250,000 jobs created each month. That added up to an increase of almost 3 million. Unless the pace trails off, the job picture should give the board confidence in the economy's resilience.

In any event, Fed policy will remain one of the issues at the forefront of investors' minds this year. The question will no doubt add to stock market volatility. During the current cycle, stocks have reacted sharply to each incremental policy change. The initial reaction to a rate increase will be negative but likely temporary — as long as yields do not spike up and inflation expectations remain well-anchored. Higher interest rates that result from stronger economic growth are ultimately a healthy sign.

Steering through it

No doubt, business trends in the energy sector will worsen if low prices persist. But it has always been a cyclical industry, and stronger firms will weather the storm, ultimately grabbing market share. Low prices will eventually prompt production cutbacks and remove excess supply. For the broader U.S. economy — and the stock market — the net impact of significantly lower oil and gasoline prices should be positive.

There's lots of noise as we kick off another year, but isn't that usually the case? One could reasonably argue that a short-term correction is overdue, particularly given the run-up in stock prices over the last several years. But the underlying U.S. economy appears to be in decent shape; indeed, it has been strengthening. Major stock market declines are typically associated with recessions induced by tight monetary policy. At this point, that scenario seems unlikely.

— Christopher J. Singleton, CFA, Managing Director

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