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CAPITAL MANAGEMENT

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SPRING IS IN THE AIR

April, 2016

April is the cruelest month, breeding
Lilacs out of the dead land, mixing
Memory and desire, stirring
Dull roots with spring rain.

"The Waste Land"
T.S. Eliot

Most of us have emerged once again from winter's cold embrace. The azaleas and dogwoods have bloomed and previously austere tree branches are now showing signs of green life. Of course, spring also ushers in some unwelcome events, most notably that yellow sea of pollen that coats every surface in its wake — causing discomfort to many. The annual filing of federal tax returns marks another source of mild unpleasantness.

But this time of year is commonly viewed as a season of renewal and hope, notwithstanding the sentiment of Eliot. Perhaps his dim view relates to the possibility of false or unfulfilled hope. For a while, the financial markets have been similarly unsure about the basis for any optimism.

Taking a cue from oil

Between early November and mid-February, the Dow shed 2,250 points, a 13% drop. The broader S&P 500 Index retreated by the same proportion. Both stock market measures have since rallied into the spring, largely recouping those losses. The low point in stock prices occurred the *same day* that prices for West Texas Intermediate (WTI) crude oil bottomed out. Hopefully, this date — February 11th — marked the winter solstice for financial markets this year.

For a number of months, stock prices have been moving in lockstep with oil prices. It seemed as if traders would come into their offices, observe the daily change in oil, and buy or sell equities accordingly. Such close tracking has been curious given their historical relationship — which has been all over the place.

From the February low, the spot price of WTI crude has moved up from $26/barrel to around $40. That does not seem like much of a rebound considering how far oil prices have fallen. Yet the mere "stabilization" of oil prices seems to have mollified stock investors, at least for now.

Bad news is good news

But for much of the fall and winter, as oil prices slid, so too did stocks. In other words, cheaper oil has been viewed as unwelcome news. Two factors help explain this phenomenon. First, falling oil prices are being interpreted as a signal for slipping global growth, particularly in China. A byproduct of economic activity, the demand for oil must be receding, the meme goes, causing prices to plummet. In fact, global oil consumption has continued to *increase*, albeit at a slower pace. The imbalance — and resulting price drop — stems instead from excess supply: The U.S. shale oil revolution has brought millions of new barrels of oil to the market each day. And OPEC is still pumping all out to preserve market share.

Oil prices are notoriously volatile and subject to their own boom-and-bust cycles. It is a folly to read too much into them. Rising prices do not necessary foretell economic expansion nor do falling ones always imply contraction. For instance, in 1986, oil prices tumbled, yet the U.S. economy kept humming along for years. More recently, in 2008, prices surged, giving no hint that the global economy was about to enter the worst recession in generations.

No contagion

Secondly, many observers have been concerned that the spillover effect from cheap oil could turn viral and harm other industries. This too has caused stock prices to react negatively to falling crude prices. The energy complex accounts for a considerable amount of overall capital spending. *Oil & Gas Journal* estimates that the sector's U.S. capex dropped from $286 billion in 2014 to $182 billion last year. The publication forecasts that 2016 spending will decline another 25% to $136 billion. Meanwhile, as producers cut output, spending on current operations has also been trimmed. So businesses that directly or indirectly supply the oil and gas industry have seen pressure on their bottom lines.

It may be that the ripple effect most troubling to investors relates to the potential impact on the financial system. The shale boom has been led by small and mid-sized companies that generally borrowed to fund their growth. They collectively issued approximately $250 billion in bonds from 2007-15. These bonds are now trading at very high yields, reflecting concerns for the credit quality. Fitch Ratings recently indicated that 60% of unrated and below-investment grade energy companies could be classified as being in danger of default.

Banks also lent aggressively to the industry. According to Bloomberg, the largest U.S. banks collectively have $125 billion of loans to the energy sector on their books. And another $150 billion of unfunded credit lines could possibly be drawn down.

And not subprime

Some debt that companies could comfortably service with cash flows from $60-$100/barrel oil looks onerous at prevailing price levels. But despite the claims of some pundits, this is not the subprime mortgage crisis all over again. The amount of outstanding debt is significantly lower and, for the vast majority of banks, comprises a small portion of loans. In 2007, mortgages and mortgage securities accounted for one-third of all U.S. bank loans. Today, commercial loans to the energy sector total only 2.5% of bank lending. And in many cases, borrowers have pledged their oil and gas reserves as collateral.

To be sure, many banks have had to add to their loan-loss provisions to protect against problem credits in the energy area. This has pressured earnings and partially explains the weakness by bank stocks this year. Before all is said and done, the top banks could end up writing off billions of dollars of bad debts. But even in the most extreme scenario, the stress should be manageable, not a systematic threat to the financial system.

Low oil prices a tailwind

On balance, cheaper oil should actually benefit households and businesses. The United States still imports 5 million barrels of oil per day (net of exports). In essence, the price decline represents a huge wealth transfer from producing to consuming nations. But judging from the stock market's reaction, one would infer that an environment with gasoline at $4.00/gallon is preferable to one with gas selling for under $2.00.

The negative impact of cheap oil has been front-end loaded and visible: lower investment spending, job cuts, bankruptcies, etc. Hence, all the chatter on the financial news channels. The positive offsets have been more diffused but still consequential. Unless one buys into the "contagion" premise, low oil prices will pose a tailwind for the U.S. economy.

In the current era of sluggish worldwide growth, falling oil prices have combined with negligible interest rates to help boost fragile economies. They have also provided central banks with more leeway to maneuver since inflation is generally being kept tame.

That policy flexibility is critical given the uncertain and unsteady backdrop. The International Monetary Fund just cut its global growth forecast for the fourth time in the past year, citing China's slowdown and chronic weakness in advanced economies. The IMF now expects that the global economy will expand by 3.2% in 2016.

As goes China

China remains the biggest factor affecting the over/under on that growth rate. As the country has reigned in infrastructure spending in favor of a larger role for consumption and services, its expansion has slowed. This shift has meaningfully impacted its trading partners, particularly those exporting raw materials and commodities to China. Unexpected and erratic moves by policymakers have caused angst in financial markets. Another misstep, such as a large devaluation of the yuan, could disrupt the global economy.

At this point, the odds favor China muddling through its transition but the process will continue to be bumpy and drawn out. Central authorities have plenty of ammunition to deploy. They also have much to lose — namely, credibility and control — if they fail to shepherd the economy forward.

Simply put, we live in a world today with less room for error. The weak growth environment leaves the global economy vulnerable to shocks. Rising political and geopolitical tensions also contribute to the risks. The

U.S. presidential primaries must be a comical, if not frightening, spectacle to overseas observers who count on us to exhibit some reasoned leadership in the world. Meanwhile, rising populism, Britain's potential exit from the E.U., and the refugee crisis have created a bit of turmoil in Europe. Fallout from political events could dampen consumer and business confidence.

Reason to hope

But U.S. investors need not despair. The macro environment has been cloudy since the financial crisis. Allowing the big picture to dictate investment decisions would have kept one mostly out of the market — and with a lot of money left on the table. Since 2009, the economy has grudgingly recovered, corporate cash flows have surged, and stocks have generally moved higher.

The United States economy remains one of the better positioned ones on the world stage. Some worry that our expansion seems rather long-lived. But as the old adage goes, "expansions don't die of old age." They tend to end when an overheating economy leads to a series of excesses, which in turn prompt the Fed to significantly tighten policy. That is certainly not the backdrop today.

The likelihood of a global recession also seems fairly low, particularly given the strong resolve of the world's central banks. Yet for equity prices to experience a *sustained* uptrend from here, investors will need more confidence that global growth, while muted, will persist. They will also need to see a rebound in corporate profits which have been under pressure. As for the latter, the impact of two headwinds to earnings — a strong dollar and worsening energy sector — should wane as the year progresses.

— Christopher J. Singleton, CFA, Managing Director

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