Oil Wars

Heightened volatility in the final two quarters of 2015 left the stock market mostly flat for the year, with the Dow Jones Industrial Average and S&P 500 respectively down -2.23% and -0.73%. The technology-heavy NASDAQ Composite managed to eke out a 5.73% gain for 2015. Meanwhile, the composite of all equities under management at Osher Van de Voorde declined by -1.51% for the year. While we correctly predicted a "much wider trading range in 2015", our year-end price target of 2,200 for the S&P 500 proved elusive.

Indeed, the S&P 500 closed calendar 2015 at 2,044 or roughly 7.5% off our year-end prognostication. At that price, the S&P 500 traded at 17x and 18x expected earnings for 2016 and 2017 respectively. While these PE ratios are not bargain-basement by any means, the approximate 6% earnings yield and 2%+ growing dividend yield offered by stocks seems far superior to the approximate 2% yield of U.S. ten-year Treasury bonds. Relative valuation be damned, calendar 2016 greeted investors with renewed volatility and whiffs of panic as the S&P 500 traded down to 1,878 in the first 10 trading days of the year. Clearly, the market is in the process of testing the recent lows set in August of last year. At these depressed levels, the S&P 500 trades at 14.7x and 13.1x expected earnings for 2016 and 2017 respectively. Valuations have become much more reasonable in a very short period of time.

While we will analyze the potential causes behind today's unsettling volatility and offer prognostications for year-end 2016, it is important first to recognize just how normal this type of volatility is. Since 1980, the average intra-year price decline in the S&P 500 has been 14%, ranging between 3% at the low end (1995) and 49% at the very high end (2008). Despite such volatility, one of the worst single-day crashes in history (1987) and two of the three worst bear market cycles in nearly a century (2000-02 and 2008-09), the S&P 500 enjoyed 8.45% annual compounded growth over this 35-year span. Through disciplined portfolio management and diversification techniques and by focusing on high quality, valuation and growth of dividend income, we take all prudent measures to eliminate the risk of any permanent loss of capital. That said, volatility is a risk that cannot be eliminated. Volatility is the price we pay to own stocks in order to obtain such worthwhile long-term returns.

In analyzing the circumstances around today's pronounced volatility, we must start with an assessment of what lies behind the stunning decline in the price of oil. From its recent peak reached in 2014, crude oil prices have plummeted 70% and inflation-adjusted gasoline prices are approaching an all-time low. There are multiple factors to consider and each factor weaves its tentacles into the other, exacerbating oil's decline and compounding the complexity surrounding the issue. Let's peel back the onion:

The Federal Reserve

In the wake of the 2008 financial crisis, the Federal Reserve engineered a multi-year, multi-trillion-dollar Quantitative Easing (QE) campaign to reduce interest rates, flood the global financial system with excess liquidity and help stimulate the U.S. economy. With dollars in oversupply and interest rates repressed to historically low levels, speculators drove up the price of oil and other commodities to unsustainably high levels (a phenomenon we wrote about in 2008 even before the stock market collapsed that year). With QE in the rear view mirror and the Fed finally embarked on its first rate hike cycle since 2006, even as Europe, Japan and China remain entrenched in their own forms of manipulative monetary policy, the U.S. dollar has become especially strong over the last year. With oil priced in U.S. dollars worldwide, there is an inverse relationship between oil and the dollar. As the greenback strengthens, it takes fewer dollars to purchase oil resulting in a lower price. The Fed's easy money policy drove the price of the dollar lower and was directly linked to the bubble in oil prices. The end of QE, the Fed's telegraphed intention to continue hiking interest rates and the subsequently stronger dollar have all helped prick the oil bubble.

Oil Speculators

As mentioned above, speculators helped drive the price of oil and other commodities to unsustainably high prices. As the dollar has strengthened, speculative traders are prompted to sell oil futures and buy more dollars. This liquidation by hedge funds, speculators and "non-commercial" players has accelerated over the past 14 months. The impact of this liquidation is further heightened as these speculators must unwind highly leveraged positions. Speculators reduced their net long positions in oil futures contracts by 24% in the first week of January alone and now have the fewest bets on higher oil prices in over five years. With approximately 55% of all oil futures contracts driven by non-commercial buyers, the unwinding of the leveraged "long oil" trade has been painful for speculators.

"Fracking" Technology

Since the Great Recession of 2008, oil reserves have increased 75% in the United States and the Energy Information Administration estimates that the U.S. possesses 198 billion barrels of undiscovered, technically recoverable oil resources. All of this of course is the result of America's technological breakthroughs in hydraulic fracturing or "fracking". Yes, the United States is now the world's largest oil producer and the shale oil boom has increased U.S. oil production from eight million barrels a day to 12 million. Moreover, many U.S. shale producers have figured how to profit from oil production even at today's depressed levels. While this is enormously bullish for the U.S. over the long-term, there are unknown, potentially destabilizing repercussions in the short term that the market seems to be grappling with. Don Luskin recently opined in the Wall Street Journal that "fracking is to the global oil industry what Uber is to taxi medallion owners: great for consumers who enjoy the sudden abundance, deadly for incumbents whose business models were built on exploiting scarcity". The newfound abundance of oil in the U.S. has sent shockwaves throughout the incumbent world. OPEC is slowly disintegrating, while Russia and Saudi Arabia are fighting an economic war with oil as the weapon.

Russia v. Saudi Arabia

With Syria as the battleground theater, the true war between Russia and Saudi Arabia has been waged around the price of oil. In spite of the plunge in price, Saudi Arabia recently increased production to 10.5 million barrels per day and Russia set a new post-Soviet record by upping production in December to 10.8 million barrels per day. Both countries are highly dependent on oil production at higher prices to maintain economic stability and both countries are fighting for global market share in a high-stakes game of chicken. With the U.S. self-sufficient and Chinese demand having slowed dramatically, there are reports of Saudi Arabia offering oil to Eastern European countries at steep discounts to undermine the Russians. Both countries are hemorrhaging through their respective reserves to make up for budget shortfalls. It is estimated that Moscow's budget for 2015 was based on expectations for oil at $80 to $90 per barrel. To buffer itself in the short-term, Saudi Arabia is raising debt and there is speculation that the Kingdom may issue a massive IPO of some portion of its prized Saudi Aramco, estimated in total to be worth more than $10 trillion. Saudi Arabia's budget surplus was turned into a 21.6% deficit in 2015 and it is estimated that the Kingdom's public debt will rise from 2% of GDP in 2014 to over 33% by 2020. While it is difficult and highly speculative to predict how these oil powerhouses will handle a new paradigm of oil priced lower for longer, it seems safe to assume that this source of geopolitical instability will persist.

Iran- Syria

In lifting years of sanctions after the Obama administration's historical agreement with Tehran, it is estimated that Iranian oil production will reach 3.6 million barrels per day by the end of 2016. Russia has been a major ally of Iran and together Russia and Iran are backing the Assad regime in Syria. Saudi Arabia sees Iranian oil production as a threat and is intent on maintaining its market share at Iran and Russia's expense. That there are religious overtones and radical Islamist/Jihadist elements to the ongoing quagmire in Syria does not give us confidence in the potential for any short-term resolution to this conflict.

China

Demand for oil from China has slowed markedly as the Chinese economy has reached a more moderate level of growth. With China slowing and the U.S. now a net-exporter of energy, the oil incumbents can no longer rely on demand for their oil from the world's two largest economies.

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Taken together, we expect that oil will remain at depressed levels for an extended period. We further expect there will be significant oil price volatility as well as the potential for heightened geopolitical instability. Geopolitical risk notwithstanding, the windfall to consumers worldwide is estimated at $7.8 billion per day or $2.9 trillion over a full year. This windfall is equivalent to a massive worldwide tax cut that will benefit all consumers, especially in the United States which derives 70% of GDP from consumer spending. While extraordinarily bullish in the long-term, there are unintended consequences that may weigh on markets in the short term.

First, with energy companies comprising 15% of the asset class, the high yield corporate bond market is in distress. Bond yields of high risk energy concerns have spiked and junk-bond spreads generally have widened considerably. Since 2009, fueled by the Fed's easy money policies, the U.S. junk bond market increased by 80% to $1.3 trillion while energy junk bonds increased over 180%. It is estimated that U.S. banks have $276 billion exposure to leveraged loans for the oil and gas industry. According to Wolfe Research, as much as one-third of American oil and gas producers could go bankrupt. While it appears that the largest U.S. banks have relatively small exposure to energy, the ripple effects of this energy boom-gone-bust are being felt throughout the industrial economy of the U.S.
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Next, the estimated $2.9 trillion gain for consumers is a net loss for all of the aforementioned oil incumbents that depend on oil at higher prices to maintain economic stability. As oil plummets, these incumbents have been forced to dip into reserves and sovereign wealth funds to meet budgetary demands. It is estimated that over $5 trillion is invested in global capital markets from sovereign wealth funds of oil-producing nations. Mass liquidation by sovereign wealth funds as oil remains stubbornly low is an overhang that may keep a lid on equity prices, despite attractive valuations.

Finally, the inverse relationship between the dollar and price of oil has left China prone to policy error as Beijing grapples with the appropriate level of its currency which is pegged to the dollar. As the dollar has climbed, China's central bank has cut the yuan's peg in order to remain competitive. Beijing would like to find equilibrium for the yuan without further dwindling its currency reserves, having declined from $4 trillion to just over $3 trillion in the past year. A higher-than-warranted value of the yuan leaves China in a potentially uncompetitive position, while any sharp, lower adjustment to the yuan could prove destabilizing for other emerging market economies. It is at least encouraging that Chinese President Xi Jinping has adopted "supply-side structural reforms" similar to the Reagan reforms enacted to revive the U.S. economy in the 1980s.

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With U.S. and global GDP expected to grow only moderately (2-3%) at best in the midst of a U.S. Presidential election year as the Federal Reserve openly debates the prospects for higher interest rates, we now believe that upside will be muted by persistent geopolitical noise and subsequent volatility. Further, it's hard to imagine that the markets would view Donald Trump's potential nomination as the Republican candidate favorably. Until there is more clarity around the aforementioned geopolitical concerns and around the U.S. Presidential election, or until valuations become even more compelling, it seems appropriate to maintain a higher than usual investment in cash. We view upside in the current environment to be a limited range between 2,100 to 2,150 for the S&P 500, offering 3% to 5% upside from year-end prices and a more respectable 12% to 15% gain from current levels of the S&P 500. While the upside presently seems restrained, risks for a sharper, albeit short-lived, correction have increased. We are confident that our focus on high quality growth companies that have demonstrated the ability to grow earnings and consistently raise dividends will serve our clients well, especially in this uncertain environment.

In the technology stock bubble of 2000-02 and real estate bubble of 2008-09, unintended consequences and contagion spilled over to multiple asset classes. In theory, one might expect the aftermath of a bubble to be more contained and localized to that particular asset class. in practice, however, this has never been the case. Over the longer term, there are distinctly positive implications resulting from oil's new normal that will be felt by U.S. consumers and enjoyed by the U.S. economy for years to come. In the immediate short run, we need more time for the dust to settle and will carefully review the potential aftermath of this ongoing unwind of the oil bubble. As the oil wars continue to play themselves out on the world's stage, even as the markets grapple with short-term ripple effects, the United States can observe from its distant shores that this is a war we have already won.
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