



Economic and Market Insights

August 17, 2015

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Spring's Brief Oil Price Rally Fades As Stockpiles of Global Crude Continue to Build

Commerce Trust Senior Portfolio Manager Chuck Freedman, CFA, CAIA, takes a moment to update his energy overview from the first quarter to assess where we are now and where we might be headed this fall.

- Q. The decline in global oil prices leveled off in April and even recovered slight upward momentum. By mid-summer, however, the price of crude was trending downward again. Why is this happening?**
- A. It's true the markets gave us a "head fake" on the direction of oil in April when the price per barrel increased to the \$60 range, but the fundamentals in place now point toward a continuing decline of oil prices. It looked like the bottom had been reached, but apparently we have more to go. The U.S. Energy Information Agency forecast has lowered its pricing projections for West Texas and Brent crude, two key benchmarks in oil pricing.
- Q. What is causing the downward pressure on oil?**
- A. The Organization of Petroleum Exporting Countries' (OPEC) effort to flood the market with crude and drive the U.S. oil fracking industry out of business is viewed by some to have backfired. The ingenuity and resilience of U.S. producers has allowed them to sustain very efficient production, some calling the break-even price as low as \$25 per barrel.* Just recently the United States reached a volume of 9.6 million barrels per day. Add those influences to China's economic slowdown, which reduced oil demand considerably, and the strong dollar, and you have a recipe for a classic glut.



Q. How does a strong dollar affect oil pricing?

A. A unique feature of this drama is that international oil is priced in dollars, and our currency has significantly appreciated compared to other currencies. Oil is priced to compensate for the strong dollar, which tugs the price downward.

Q. How long could this oil pricing last?

A. It could go on for a while. Some experts have estimated that the global crude market is currently oversupplied by 2 million barrels per day. We are now in the \$40 to \$45 range for West Texas crude and some have predicted a barrel of oil in the \$30s later this year. More oil will likely enter the pipeline with the prospect of Iran bringing its reserves back on line after sanctions are lifted. Some estimates say Iran could add 1 to 2.5 million barrels a day in 6 to 12 months' time, not counting what Iran intends to do with significant floating stockpiles it currently has parked in oil tankers off their coast.

Q. How does this translate to gas pump prices?

A. The correlation is not always direct. However, the national average price of gasoline is about \$2.62 a gallon, the lowest for this time of year since 2009. Labor Day could see some prices well under \$2.25 as the U.S. vacation driving season winds down and demand diminishes. Some have ventured that the price could break the \$2 mark in some states before year-end. And prices have fallen nonstop for the past three weeks.

Q. Aside from the benefits at the pump, how much should the average investor care?

A. If oil prices continue their fall, the impact is certainly unfavorable for the earnings of energy stocks and petroleum-related companies, suppliers and drillers. As investors, it's important to follow the unfolding drama because oil prices could influence at least part of your portfolio sector allocations. The S&P energy sector is down almost 30 percent in the past year. On the bright side, the background effect of all this is that lower oil prices have helped keep inflation low, and to some extent interest rates. They have also acted as an income boost, particularly for middle income consumers. The key during these downturns, however, is to remain focused on your long-term goals regardless of the market environment.

*U.S. Energy Information Administration



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