



Market Analysis, Research & Education

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Can the Markets Weather the Oil Price Storm?

By Dirk Hofschire, CFA®

The sharp rise in crude-oil prices in recent months has increased the risks to investing in the global financial markets. Higher oil prices can both provoke inflation as well as inhibit economic growth, making their impact wide-ranging across the global economy.

The impact of higher oil prices on consumers

Energy expenditures account for slightly more than 5% of U.S. consumer spending, down from roughly 8% in the early 1980s (see Exhibit 1, page 2). With energy a smaller part of the consumer budget, an increase in oil and gasoline prices has less negative impact on consumer spending than it used to. More importantly, oil prices are rising at the same time that labor markets are seeing their most sustained improvement in years, with strengthening employment providing a hefty offset to rising energy costs.

However, other fixed costs for consumers have risen over time, including financial obligations (debt payments and rent) and particularly health care. As a result, total fixed costs represent just under 37% of consumer spending, implying 37 cents of every consumer dollar spent goes to pay those relatively fixed obligations. This level is up significantly from about 32% three decades ago, underscoring how the share

of consumer income available for discretionary spending has fallen (Exhibit 1).

More recently, the percentage of consumers' fixed costs had been declining from the nearly 39% peak reached in 2008, as low interest rates and the reduction of household debt that has occurred since the financial crisis reduced consumer financial obligations, leading to the lowest fixed-cost levels since 2004. The recent spike in oil prices threatens to reverse this trend by pushing up energy expenditures. As a result, higher energy prices in and of themselves may not be high enough to tip consumer spending into recession, but they have the potential to reverse some of the improvement in the consumer backdrop that has occurred during the past several quarters.

The potential impact of higher oil prices on the global economy

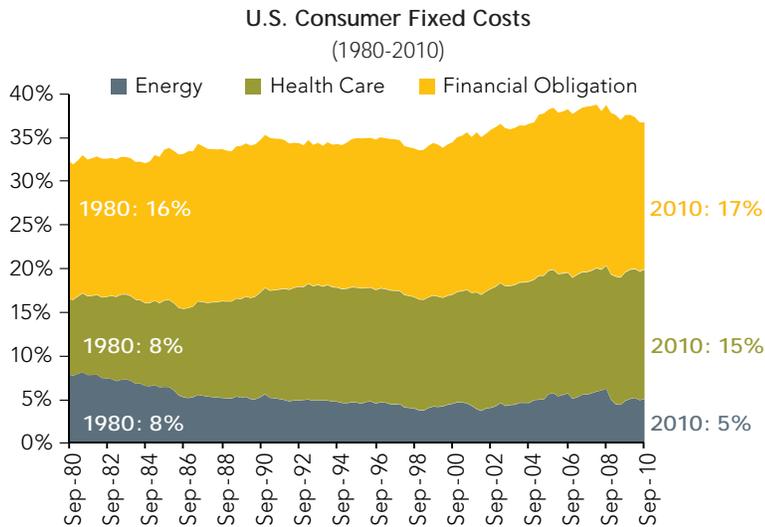
From a global standpoint, if oil remained at about \$100 per barrel in 2011, oil expenditures would represent about 5% of global economic activity, which appears to be manageable given the solid global expansion. However, if crude oil prices averaged \$120 per barrel this year, spending on oil would account for 6% of global GDP—a level not seen since the early 1980s. Above this price level, pressures on consumers and businesses would probably increase substantially; a \$150 per-barrel price would push the world closer to its historical peak level of oil spending that occurred during the global recession in 1980 (see Exhibit 2, page 2). It is also important to note that crude-oil prices have recently been substantially higher in markets outside the United States; for instance, Brent crude prices in London consistently traded above \$120 in early April.

An even more important consideration for many economies outside the United States is the inflationary impact of rising oil prices. Due to oil's importance as an input and transportation fuel in the costs of many other raw materials, rising crude oil prices

KEY TAKEAWAYS

- With a risk premium pushing up the price of crude oil due largely to political instability in the Middle East, supply-shock oil pressures stand as one of the major risks to the outlook for financial markets.
- However, the strength of the U.S. and global economic expansions make them better able to withstand the oil-price increases experienced so far, implying that absent additional supply shocks, oil prices by themselves should not disrupt the positive trajectory of the world economy and financial markets.

EXHIBIT 1: U.S. consumers spent more on health care and financial obligations during the past three decades as the total fixed costs increased to 37%. Although energy costs have declined since 1980, higher oil prices pose a threat to the discretionary spending dollars available to consumers.



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 9/30/10.

have both accompanied and exacerbated the price increases experienced over the past several months in agricultural and other commodities. The sharp rise in commodity prices has stoked inflationary pressures in most economies, spurring monetary authorities around the world to hike interest rates. The impact is felt most acutely in developing economies, whose poorer consumers devote more of their budgets to food.ⁱ However, even the European Central Bank raised its policy interest rate this month to counter faster-than-expected inflation caused primarily by commodity-based increases, despite relatively weak inflationary pressures elsewhere in the euro-zone economy. This round of global monetary tightening, which is not yet over, will likely reduce global economic momentum over time.

What to watch: global demand and threats to supply

The absolute U.S. dollar level of crude-oil prices does not tell the entire story of the risk of petroleum spikes to the global economy. Just as important is whether higher oil prices are being caused more by unexpectedly strong demand or negative supply shocks.

Higher demand was expected

The past decade has experienced a sustained underlying trend of higher oil production costs and rising developing-country demand. Prior to 2000, crude-oil prices had been below \$25 for most of the

1990s, as production kept pace with demand that was driven in significant part by developed (OECD) economies.ⁱⁱ During the past decade, rapid growth in emerging-market demand for crude oil spurred a near quadrupling in prices, as production rose but struggled to keep up with demand. With the expectation that continued strong demand growth from emerging-markets would keep pressure on global production growth, the recovery in world oil demand was expected to reduce inventories and tighten the supply-demand balance throughout 2011.ⁱⁱⁱ

Perceived supply shocks were unexpected

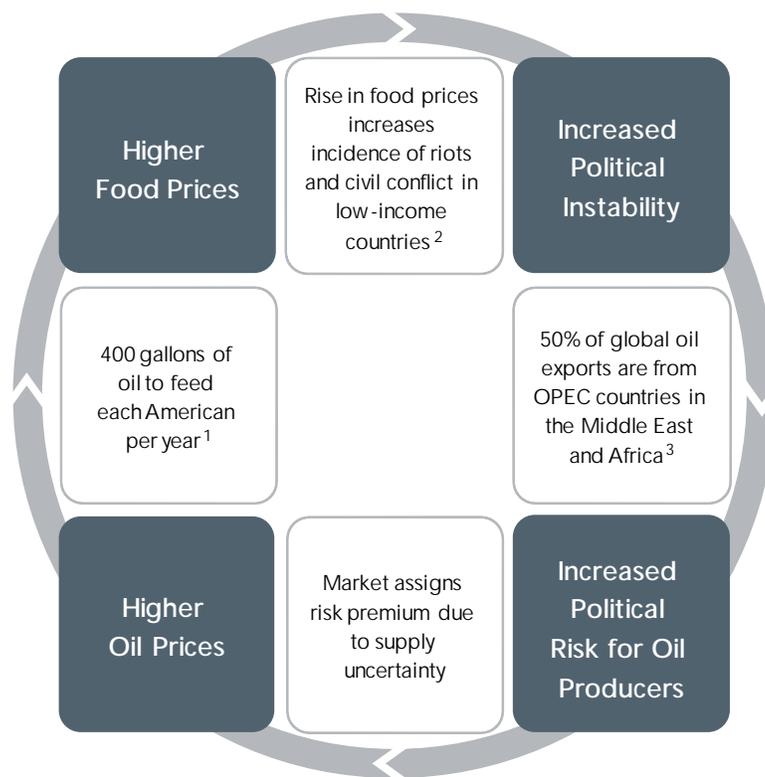
However, the abrupt upward move in the first few months of 2011 was clearly more the result of concerns about a supply shock due to increased instability in the Middle East and North Africa. With most of Libya's production coming off-line as a result of armed conflict, concerns grew that the world's dwindling spare production capacity may not be enough to make up for the potential loss if any unrest caused production losses to any other significant oil producer in the region. Oil's move at the beginning of the year from roughly \$90 per barrel to \$110 in early April was likely due in significant part to a higher risk premium being priced into the oil markets due to these supply concerns.^{iv}

EXHIBIT 2: At current price levels, global spending on crude oil appears to be at a manageable pace given the global economic expansion underway, but higher prices pose a significantly greater risk to the global economy.



Oil prices above reflect the average per-barrel price of crude oil for the entire calendar year. Source: FMRCo as of 3/31/11.

EXHIBIT 3: As the markets place a higher risk premium on crude-oil prices due to the potential for political instability, the higher oil prices bolster the trend toward higher food prices, thus reinforcing the cycle of rising risks.



(1) Richard Heinberg, "Threats of Peak Oil to the Global Food Supply"; (2) IMF working paper "Food Prices and Political Instability"; (3) Energy Information Administration. Source: FMRCo (MARE) as of 2/28/11.

The geopolitical risks associated with crude-oil producers in the Middle East are further exacerbated by the outsized influence that oil has as an input in the production costs of so many other commodities. Spiking crude-oil prices exacerbate the increase in the prices of food commodities, which in turn contributes to greater political instability in lower-income countries, whose citizens feel the impact the most. Oil producers of lower-income nations in the Middle East and North Africa account for roughly half of the world's oil exports, leading markets to place a higher risk premium on crude-oil prices due to the potential for political instability. The higher oil prices bolster the trend toward higher food prices, thus reinforcing the cycle of rising risks (see Exhibit 3, above).

Historically, demand-driven increases in oil prices have been more sustainable and less disruptive to economies and asset prices, mostly because higher oil prices have a natural self-correcting tendency to curb demand. On the other hand, supply shocks have tended to be more unsettling, with notable examples including the OPEC embargo and Iran revolution during the 1970s, which created shortages

that contributed to the stagflationary environment. As a result, an additional supply shock or a higher risk premium as a result of additional turmoil in the Middle East remains a significant risk to the global economy.

Investment implications

Rising crude-oil prices, particularly when they result from supply shocks or perceived political instability, are one of the biggest threats to the global economic expansion and to the prices of stocks and many other riskier assets. However, the recent spike in oil prices has arrived at a relatively healthy phase of the economic cycle, where the U.S. and global economies have entered into full expansion and are thus more able to withstand higher oil prices. The possibility of some demand destruction occurring at these higher price levels, in addition to recent interest rate hikes in many countries, may combine in future months to slow the pace of economic growth and release some pressure on world oil markets. If this occurs in a relatively gradual fashion, oil prices by themselves should not disrupt the positive trajectory of the world economy and financial markets. ■

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.

The Organization for Economic Co-operation and Development (OECD) countries include: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

[i] The weight of food in the consumer price indices of the United States, Europe, Brazil, China, and India is 8%, 15%, 30%, 32% and 47%, respectively. Source: Country statistical organizations, ISI Group, Haver Analytics, FMRCo. (MARE) as of 12/31/10.

[ii] The average price of Light Sweet Crude Oil Futures (1st Expiring Contract) was \$19.70 from 1/1/1990 to 12/31/1999. Source: Wall Street Journal, Haver Analytics, FMRCo. (MARE) as of 12/31/1999.

[iii] World oil consumption is expected to be about 88 million barrels per day (bpd) while production is expected to be 87 million bpd. Source: Energy Information Administration, Oil and Gas Journal, Haver Analytics, FMRCo. (MARE) as of 4/12/11.

[iv] The price of Light Sweet Crude Oil Futures (1st Expiring Contract) went from \$91.55 a barrel on 1/3/11 to \$110.30 on 4/7/11. Source: Wall Street Journal, Haver Analytics, FMRCo. (MARE) as of 4/7/11.

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