Oil’s Slippery Slope

Executive summary
Over the course of 2014, the price of crude oil has declined 40 percent, dropping to the lowest price in five years. This has translated into lower gasoline pump prices for businesses and consumers. According to the U.S. Energy Information Administration (EIA), as of early December, the average price of regular gasoline in the United States was $2.68, down $0.59 from year-ago levels. The decline in oil prices has many investors wondering why prices are coming down, what the potential implications may be to economic growth and whether the pullbacks may present investment opportunities.

- Among the reasons for the decline in oil prices has been the strong supply from U.S. shale oil producers, as well as the return of production in the Middle East. In addition, Libya has resumed exports, there is rising production in Iraq and there is also the potential for the lifting of Iranian sanctions. Furthermore, weakening economic growth across China and Europe has weighed on energy prices.

- The fall in oil prices is benefiting consumers and harming producers, particularly in countries where the budgets have come to rely upon high oil prices. In the United States, the economy is likely to see some lift from this “windfall” for consumers, but less than in prior episodes due to our progress in fuel efficiency and the development of alternatives to oil.

- U.S. shale oil producers could face oil prices at or below $80 per barrel through 2015, which would likely reduce investments in the sector and ultimately reduce the volume of oil production. This may have a dampening effect on earnings of companies operating within and around the oil industry. Production outside the United States will likely slow as well, with producers adjusting to lower prices and more modest demand growth around the world.

- We anticipate oil prices will likely find a floor in 2015, with the market adjusting to these new supply and demand dynamics. We expect some lift above the $80 per barrel level in 2015 or 2016.

- The new role for the Organization of the Petroleum Exporting Countries (OPEC), as defender of their production volume rather than their prior role as producer of last resort, indicates to us that oil prices will likely be more volatile over the next couple of years. Prices may provide the primary signal for oil production rather than OPEC policy, with production adjustments potentially falling to private producers rather than the OPEC cartel.

- While the near-term visibility for oil prices remains largely uncertain, we are warming to the space for investors with time horizons of one year or longer, believing that the supply-demand imbalance will begin to correct itself by late 2015 and into 2016, with the broad equity market responding favorably in anticipation of this turnaround. Additionally, following the pullback, many energy-related companies have attractive dividend profiles, affording investors the potential for both income and appreciation.

We believe weak demand growth and a slow moderation in global production may keep oil prices relatively low for much of 2015.

- Oil consumers could benefit from the more than 40 percent decline in oil prices.

- U.S. drivers may save about $100 billion in gasoline purchases in 2015.

- Investors may wish to consider modest exposures to energy stocks or diversified commodity strategies.
Oil prices in the rearview mirror

Sustained oil prices above $80 per barrel made U.S. shale oil production cost effective, driving U.S. production volumes to the highest levels in 30 years. Prior to 2014, the oil market had been able to absorb this supply, with strong growth in emerging market nations, improving growth in the developed world and the curtailment of supplies from Libya, Iraq and Iran. In 2014, strikes in Libya ended allowing the return of Libyan oil to the market. At this time, Iraqi oil production expanded and economic growth across developing nations slowed. During 2014, economic growth in Europe and Japan has largely disappointed, with Japan slipping back into recession in the third quarter. The oil market was hit with rising supplies and weaker demand.

Out of the oil slick rises the U.S. consumer

As a major consumer of oil, the U.S. economy has historically benefitted from declines in energy prices. Based on recent U.S. EIA estimates, U.S. consumers will save $100 billion on gasoline purchases in 2015 compared to 2014, or about 0.6 percent of total U.S. gross domestic product (GDP). The estimated savings could be used elsewhere in the budgets of consumers.

Countering this benefit is the adjustment in activity that will likely be made by U.S. oil producers who must now adjust their investments relative to this new price environment. On balance, the lift to the U.S. economy will likely be modest in 2015. We expect U.S. GDP growth to average 2.5 percent to 3.0 percent for 2015, bolstered by lower energy prices and solid growth in employment. Conversely, business investment that has been supportive of growth will likely be moderated as energy producers cut their investments and exports, due to weaker growth outside the United States. This action will likely be a drag on economic activity. Low oil prices have the potential to be a disruptive force for adjacent enabling industries (steel, chemicals, pumps, rail cars, etc.), which could detract from GDP in 2015 and 2016.
Emerging from the crisis

Over the first half of 2015, oil producers will likely adjust their activity relative to the new price world. With the responsibility for balancing the oil market now falling to private enterprise rather than the OPEC cartel, the adjustment is expected to be more volatile than historical patterns. Prices are likely to stay low, on average, early in 2015, although daily volatility is likely to remain high, with prices potentially falling to the lows seen during the financial crisis. In fact, we are already seeing a slowing in oil rig investments in the United States. This should continue, and the resultant decline in production may mean oil prices stabilize in the second half of 2015 and then rise to more normal levels late in the year.

Production vs. consumption

For investors, the question of timing comes into play. The thematic appeal of U.S. energy independence remains intact, with overall production levels expected to stabilize sometime in 2015. For investors with longer-term time horizons, we recommend modestly increasing exposure to energy at current levels, with overall exposure increasing, along with improved visibility into supply-demand metrics.

Conclusions

The oil market is likely to remain well supplied in the coming year, with still slowing growth outside the United States and a slow adjustment by producers to new prices. The fall in oil prices has created significant benefits for oil consumers and should provide a modest lift to economic activity. With solid domestic economic growth, U.S. equities will likely see additional gains over the course of the next year.

- Consumer stocks may benefit since low energy prices are boosting confidence and adding to discretionary income. Additionally, companies where oil is a primary input, such as chemical and transportation companies, stand to benefit from the low price of oil.
- Prices for energy-related companies have fallen significantly and are resulting in seemingly improved risk/reward profiles. Mindful that low prices and the lower production needs suggest that it may still take some time to unlock the value, investors may wish to maintain modest exposures to energy stocks for now since the sector could begin to respond favorably as the supply/demand imbalance narrows, possibly beginning in late 2015.
- Direct commodity investments have suffered through much of 2014, and our outlook for oil prices indicates returns in 2015 will likely be modest. However, the commodity complex offers strong diversification potential to stock and bond portfolios. Also, commodities tend to perform well relative to stocks and bonds in supply shock or crisis scenarios. Such scenarios include drought, weather and conflict, particularly in the Middle East. At present, we continue to recommend, when appropriate, small allocations to the commodity complex.
- Given the difficult environment for oil prices, we would further suggest investors consider diversified commodity investments, which are lighter in their oil exposure. Not all commodities share the fate of the oil market. Supplies of base metals have been declining, leaving supply and demand in relative balance, indicating upticks in demand could lead to higher prices. Also, grain prices have fallen significantly over the past years due to strong harvests. Current prices will likely pressure plantings, which should support prices, and weather remains a difficult science.
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