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What's Driving the Stock Market-Oil Connection?

While volatility is still the watchword for U.S. stocks, recently the turmoil has been triggered not by the "usual suspects," such as corporate earnings reports or the Federal Reserve's latest policy announcement. Instead, the market has been moving in near lockstep with oil prices.

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Thus far in 2016 oil prices and the S&P 500 have moved together 87% of the time. Through part of February that correlation surged to 96%.[1] On March 1, the S&P 500 and the Dow Jones Industrial Average both turned in their strongest gains in more than one month as oil prices turned sharply higher. The benchmark price of crude oil, for example, climbed to $34.40 a barrel, from a 13-year low of $26.05 a barrel set on February 11.[2,3]

Not only is this relationship between oil prices and the stock market historically unusual, for many observers it is also puzzling. After all, cheap oil has generally been considered a boon for the U.S. and global economies -- and by association -- the stock market. For instance, it is estimated that the drop in oil prices has saved U.S. consumers $190 billion dollars over the past 18 months. Further, a recent study conducted by the JPMorgan Chase Institute found that consumers have spent the majority of every dollar they have saved from lower gas prices.[4] And as we know, consumer spending is the fuel that feeds the economy.

In a broader economic context, lower oil prices should reduce manufacturers' costs of producing and transporting their goods, and airlines' costs of operating their aircraft, thereby improving profit margins and investor sentiment. Yet airline stocks have tracked the price of oil very closely even though lower energy costs saved the four major American carriers more than $11 billion last year.[4]

Then there is the question of timing -- why has this close relationship between oil and stocks come to light now, when oil prices have been declining since June of 2014?[5] Economists and industry experts generally consider the following factors to be among the most relevant to the discussion.

Uncertainty Over the Global Economy

When oil prices fall precipitously, investors fear that the underlying strength of the global economy is in peril and/or that a widespread economic slowdown may be imminent. Such fear is compounded when China enters the discussion. Recent disappointing economic data coupled with China's devaluation of its currency in the summer of 2015 have only heightened anxiety among investors, as well as industrial and commodity multinational corporations, which have pegged their corporate strategies and profit projections around aggressive growth forecasts for China's economy.

The Long-Term Impact

Should oil prices remain depressed indefinitely, the economy -- and investors -- could feel the negative repercussions in a number of ways. For instance, energy companies will likely slash research and development budgets, which could curtail innovation and stunt longer-term growth potential within the sector, particularly in the area of environmentally-friendly, alternative energy sources. Similarly, banks and other financial institutions that have helped finance America's energy boom have already been feeling the squeeze as prices have plummeted. Dozens of energy companies have gone bankrupt or slashed spending and cut jobs to stay afloat. Three of the nation's biggest banks have warned recently that Wall Street will continue to feel the effects, especially if prices fall further.[6]

A Global Glut

One of the key factors driving oil prices down is the vast oversupply coming from a number of sources, including the fairly recent boom in shale-oil production in the United States, the revitalization of Iraq's oil industry, and most recently, the lifting of sanctions on Iran.[4]

And, as the Paris-based International Energy Agency (IEA) forecast in February, oil supplies are expected to continue growing:

"Oil stocks should grow by 2 million barrels a day in the first quarter and 1.5 million barrels a day in the following three months. Stock building will continue in the second half, rising by 300,000 barrels per day. If these numbers prove to be accurate, and with the market already awash in oil, it is very hard to see how oil prices can rise significantly in the short term."[7]

Oil prices are traditionally volatile and much of that volatility can be driven by investor sentiment and factors internal to the industry as opposed to macroeconomic forces. So, for the time being at least, until something happens to break the investor mindset and/or a bottom is established for oil prices, prepare for more of the same.

Contact your financial advisor to learn more about oil price trends and the effect they may have on your financial situation.

[1]CNN Money, "Oil still has a chokehold on stocks," February 23, 2016.

[2]MarketWatch, "S&P, Dow close with best one-day gain since January as oil rallies," March 1, 2016.

[3]CNN Money, "Is the crash over? Prices soar 32% in 12 days," March 1, 2016.

[4]*The New Yorker,* "Tanking," February 8 & 15, 2016 issue.

[5]T*he New York Times*, "Oil Prices: What's Behind the Drop? Simple Economics," February 16, 2016.

[6]CNN Money, "Big banks brace for oil loams to implode," January 18, 2016.

[7]International Energy Agency, Oil Market Report, February 2016.