March| 2015

*At a Glance...*

*Page 1*



# A Drop in Oil

## *What does it mean for stock prices?*

A more than 50 percent drop in oil prices over the last six months has equity investors scared. But should they be? Whenever we see economic events that can create market turmoil, investors tend to revert back to 2008 and prepare for the worst. This time the outcome for the financial markets will likely be different. The six-month drop in oil and energy prices will eventually prove to be a net positive event for the United States economy and financial markets. The losers over the short-term are small oil and gas exploration companies, investments in debt of these companies (17-18 percent of high yield bonds) and some of the companies who supply equipment to the larger energy service companies. In addition, exploration work will likely decline over the short-term. Longer-term energy needs and demand will return, and many of the energy related companies which are today trading at or near 52-week lows, will undoubtedly recover.

One reassuring aspect of the impact of lower oil prices on the macro-economic environment is that in 2008 and 2009, earnings from the financial sector made up more than 40 percent of the annual earnings in the S&P 500 index. When the banks were on the verge of collapse because of the leverage in the financial system, bank earnings went to zero and in essence S&P 500 earnings declined precipitously. With the decline in earnings came the collapse in U.S. equities markets and the Great Recession. The S&P 500 lost 25 percent of its value in just 10 trading days.

Unlike the impact from the decline in financial profits from the big financial institutions and the related counter party risk from subprime mortgages, which resulted in the biggest decline in stock prices since the Great Depression, the decline in energy prices is actually a net positive for the financial markets and S&P 500 earnings. Here is the math: Oil and gas companies generate an estimated 11 to 12 percent of S&P earnings, significantly less than the financial sector which accounted for more than 40 percent in 2008, and the drop in oil prices will reduce their contribution to 8 to 9 percent. In other words, the impact to S&P 500 earnings from the drop in oil prices, while troublesome, is rather insignificant. The decline in S&P earnings is minimal. Taking into account lower oil, S&P 500 earnings for 2015 are likely to decline from $128 to $123.

The math makes the decline in oil a lot less painful for the financial markets. In addition, the silver lining is that lower oil prices translate into the U.S. consumer paying less at the pump. Consumers make up over two thirds of the economic activity in the United States, and lower oil prices provides them more discretionary spending power. There

# Perspective



***At a Glance...***

***Page 1***

- A Drop in Oil

are offsetting or favorable impacts from lower oil prices. During the financial crisis there were zero favorable or offsetting factors that were positive to the economy and that is why the financial markets experienced one of the worst bear market declines of our lifetime.

Where the above math begins to break down is if lower oil prices are telling us something much more ominous about the future, like a sharp drop in economic activity lies ahead. Again the signals seem to indicate no. United States economic activity is very strong and business investment is picking up with third quarter GDP jumping over 5 percent and fourth quarter GDP is likely pushing 4 percent. Other parts of the world are less fortunate. Both Japan and developed Europe are working to improve their economic activity. Both countries are embarking on additional liquidity measures to lower interest rates and reinvigorate economic growth. The upside to the United States of weaker activity abroad is the Federal Reserve will likely need to stay on the sidelines longer in their quest to begin to increase U.S. interest rates, another net positive for the equity markets.

2014 was a challenging year for investors given the negative undertone of the financial markets. International markets were negative and yet the US equity market generated surprisingly strong numbers. In addition, the fixed income market rallied as investors sought the safety of US treasuries and higher relative interest rates versus their global counterpart. The rise in the dollar also motivated overseas investors to hold more US paper further driving down US interest rates. Many on Wall Street were predicting higher interest rates in 2014, as the Federal Reserve wound down their quantitative easing campaign, only to be surprised by the further decline in interest rates. Oil and energy were the worst performing sectors in 2014 and REITs (Real Estate Investment Trusts) were the best. Small company stocks and developed international also performed poorly in 2014 on a relative basis. Going forward, we remain cautiously optimistic that the 6-year-old bull market will continue for at least a couple more years as low oil and record low interest rates will keep a floor under US equity prices.

At HighTower Bellevue, we help balance our client portfolios with their risk profiles. In addition, we take a cautious approach, given that most of our clients already have generated significant wealth for retirement. We are proud of our ability to deliver asset allocation strategies that preserve client wealth in both good and bad markets. If you are already a client, it might be time to check in. If you are considering HighTower Bellevue, let us show you how we can help you reach your financial goals.