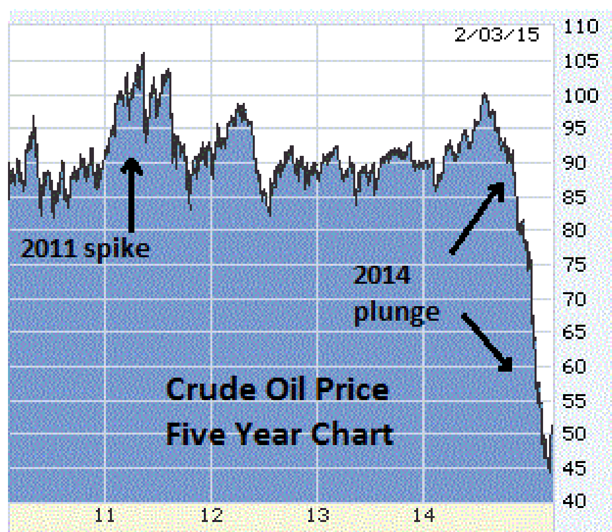
American Heritage Financial

February Update February 3, 2015

Boil, Boil, Oil and Trouble!

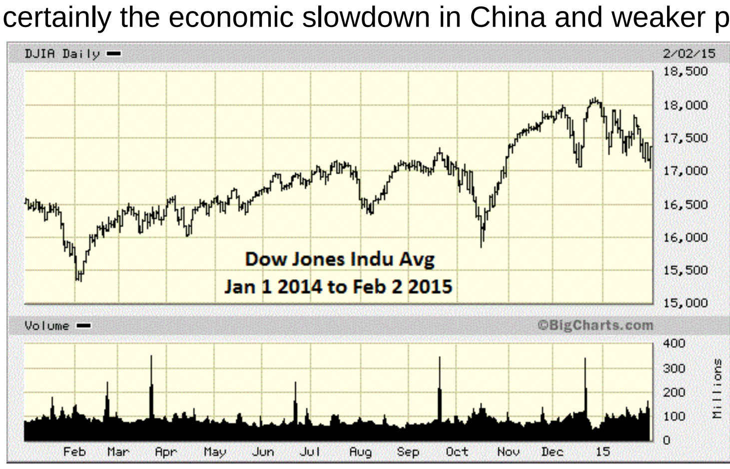
Our title this month begs two apologies. First, for seriously trashing Shakespeare's famous quote* and second, for repeating a title we originally used in March 2011 referring to turmoil which ultimately became known as the Arab Spring. In early 2011, oil prices had moved dramatically higher in response to escalating social and political upheaval in the Mid-East. The price of the world's most critical commodity had surged to over $100 per barrel; with concerns that it could go much higher. It was another example of the delicate supply-demand balance which governs all commodity prices. The 2011 oil price surge was in *anticipation* of a potential supply disruption; oil peaked at about $110 before settling into the $90-$100 range which it maintained until mid-2014. (See the accompanying chart.) Our March 2011 comment also touched on the doubling of oil to $140 in late 2007, a key factor in bringing on the global financial crisis of 2008. The 2007 price spike was caused by global oil ***demand*** growing faster than ***supply*** and is more relevant to our current discussion.



Of course, oil prices today are ***declining*** rather the ***appreciating*** and lower oil prices are, for the most part, a huge positive for the global economy. But, the rapid decline, along with the uncertainty of just where prices might ultimately settle and the implications of those lower oil prices, is causing pain and disruption for vast areas of the global economy; including producing countries and companies alike. Crude oil has tumbled 60% since June to below $50 per barrel, claiming several high-profile victims in the process.

Russia, highly dependent on oil earnings (and also suffering from sanctions and political disarray), has seen its currency and stock market tumble. High-yield bonds, a sector with a heavy concentration of speculative oil companies, have experienced dramatically lower prices and higher yields. Sagging energy prices have also contributed to lower global interest rates, put downward pressure on inflation and may be influencing central banks to keep money conditions easier than they might otherwise. Oil prices are also the **major reason for a huge increase in volatility in the stock** market since October and contributed to the 3% plus drop in the market during January.

The concern is that the tumble in oil presages a broad downturn in the global economy–and certainly the economic slowdown in China and weaker parts of the euro zone have contributed to lower demand for all commodities. Still, other factors argue against interpreting the energy tumble as an economic warning sign. For one thing, broader commodity prices, while retreating, have fallen only about half as much as oil, a point not consistent with a generalized economic downturn.



Along with flagging demand, oil prices have been affected by increasing supplies over recent years made possible by new technology, plus the Saudi decision (notably in November) not to tighten, or balance, supply. The International Monetary Fund estimates that the fall in energy prices is 60 percent attributable to supply issues.

Lower oil prices have quickly caused disruption and market turmoil but the longer term benefits are yet to be truly realized…but they will occur. Both the IMF and World Bank agree that cheaper gas at the pump and energy for factories will give a boost of nearly one full percent to global growth—although that adjustment applies to 2016. Both organizations recently lowered their forecasts for growth in 2015. A report from Barclays Bank found that declines in the price of oil tend to coincide with slowing global growth but that benefits result six to nine months later. The simulative affect of lower oil prices may be particularly true in the United States, where due to lower energy taxes, more of the impact of cheaper energy will drop directly into consumers' pockets.

Think of the fall in energy prices as being like quantitative easing for Main Street. Cheaper gasoline and lower utility costs are a great benefit to the middle class who have seen meager income growth in recent years and who are likely to spend any windfall. Yes, the losers from lower oil, from Russia to Venezuela to the Dakotas, will continue to suffer. Certainly marginal companies may be gone permanently and capital investment and spending hurt will be hit selectively. But we should soon start to see significant economic benefits: better non-energy spending and investment in major economies and lower interest rates. Finally, the improving economies and reduced production will result in a rebound in the price of oil, but don't expect a significant price rise until mid-2016, or later.

* The correct quote from Macbeth is "double, double, toil and trouble; fire burn and caldron bubble."

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?
Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us atwww.EGIFinancial.com