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"Markets Shudder at Dropping Oil Prices!"

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Do you think the guy in Peoria who's filling his tank right now with $1.80/gallon gas -50% cheaper than it was last summer- is worried about the Taco John's waitress in Williston, North Dakota who may be facing a cut in her $15/hour starting wage? He's probably not. But folks who work in Williston, a boom town in the Bakken oil fields, rely on higher oil prices to keep the local economy flush. It's an area with some of the country's highest starting service sector wages, an area that stands out as a North American arc lamp when seen from space, due to all the wells burning off natural gas that they just have no use for right now.

These days, with oil prices down about 55% from their June 2014 highs, workers at that local Taco John's are looking at an economic slowdown, and possibly lower wages as a result. This is the collateral damage of a profit slowdown in the energy sector that will rock the markets for a while.

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But it's a fair question to ask –even though we don't wish ill for the staff at Taco John's- "Why do I care about Exxon and Halliburton making less money? I can fill my SUV for $40 instead of $75 now, and it's about time!"

Well, we'll tell you why you should care, but maybe not worry too much. And why the folks in Williston should be just fine, as should Halliburton and Exxon.

First, why should lower oil prices be of concern at all, and why did the Wall Street Journal (WSJ) report in January "Oil's steep drop sent shudders through the financial markets. It's driving all financial markets right now." The simple answer is that any time the price at which you can sell a product drops by 50%, it will drag your profits down dramatically, too. You'll think, "Do I still want to produce this stuff, and pay all those costs, or just sell what's left on the shelves and wait it out?" Or something to that affect. Those are the questions that business people ask themselves, and this is what the energy industry is pondering.

As we enter the meat of the earnings reporting season, we will see the effect that these lower oil prices have had on the energy companies. It is expected that energy company profits will be off by close to 20%, while telecom and healthcare are projecting much higher profits (WSJ 1/9/2015). If this plays out, markets will react. According to Leo Grohowsky, BNY Melon Wealth Management, oil companies and those that supply them, represent about 25% of the earnings of the big companies that dominate the stock market. Expect volatility to continue to escalate.

While there are theories that the price of oil is being kept low by certain governments hoping to exert further economic pressures on Russia (and in so doing Nigeria and Venezuela), the fact is that global demand has not kept pace with production. Basic economics tells us that when supply goes up, and demand does not . . . prices decline on any commodity. In 2013, total global production was 90.2 million barrels per day (mbpd) and consumption was 90.5 mbpd (JP Morgan; Energy Information Agency). These same sources estimate that global production in 2015 will be 92.8 mbpd and consumption 92.3 mbpd . . . a surplus of 0.4% per day. Doesn't sound like much, but supplies could build up considerably over a period of months. Interestingly, almost all of the global production increase from 2013 to 2015 is attributed to the U.S., which is expected to have increased production by 20% (12.3 mbpd to almost 15 mbpd).

In the face of this, most energy companies will rein in exploration and reduce some production (although the production of shale oil wells- where fracking is used- declines by 60-90% in the first three years anyway, according to a Post Carbon Institute study). Over the short haul, wages may decline in the industry, there may be layoffs (even at U.S. Steel which makes pipes and tubing for the energy industry), and profits will be off. There could be some loan defaults from smaller producers. States in which oil is a major revenue source (think Alaska, where over 80% of the budget is funded by oil) will be forced to consider spending cuts.

The concern isn't so much that oil is down from $100/barrel, but how far down. After all, we've been talking about an energy renaissance in this country for over 3 years now, with increasing production, exporting oil and natural gas, and declining dependency on imports (in 2008 we imported 66% of the crude oil we use, and now that number is 39%, states Jerry Webman of Oppenheimer). Did anyone really think that the price of oil *would not decline* when this scenario began to play out?

Yet, the positive aspects of lower oil are obvious. Families in the lowest 1/5 of earnings spend 13% of income on gasoline and motor oil (Bureau of Economic Analysis), as opposed to 3% for the highest quintile. These lowest wage earners are now getting a 50% reduction on those costs, and they'll spend most of that money (studies have shown). This is a boon to restaurants and retailers. Delta airlines recently reported that they expect a $1.7 billion savings in fuel this year, and shipping companies of all types will save further billions.

In the long run, oil below $80/barrel is good for the U.S. There will be a period of retrenchment in the energy sector for sure, but seasoned oil operators do not want to be idle. Already they're finding ways to become leaner and more efficient; the "breakeven price" will drop, and exploration/drilling will pick up steam again. Maybe within months. Demand will rise again, because consumers will spend more of this savings, and it will stimulate the economy (all products that use oil will cost less to make), people will drive more, they will buy more SUVs. And because the productivity of shale wells declines so rapidly, new wells will need to be drilled to keep pace with this *increasing demand.* This is a classic supply and demand cycle.

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We don't know when oil will top $100/barrel, but we do think it's unlikely for it to stay below $50/barrel. The more probable case is that it will end 2015 closer to $70 than $50, and that's something everyone can live with. For the U.S. economy, we think things will be just fine, albeit with some pain in the energy sector for the time being.

For the investor, things are not so clear. Lower oil also signals that global growth is not anticipated to be robust, and that demand might remain muted. It will help countries that import, such as India and China, but will hurt the oil exporting countries. So the global picture is mixed. The domestic stock markets will continue to wobble with each price shift, and most investors will see this reflected in their account values. Not surprisingly, some money managers are making the case that this is an opportunity: this is "the best time in years to invest in energy" states Blackstone Group Chairman, Steve Schwarzman.

Our view, as usual, is don't overreact to these events. Stay the course and look for opportunities. Talk to us about how to navigate the increased volatility. And, as Fed Chairwoman Janet Yellen stated in December, 2014, "the recent declines in oil are transitory." Meaning, the waitress at that Taco John's in Williston will probably be ok.

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