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Oil Prices in Free Fall: How Low Can They Go?

As crude oil prices hit their lowest point in more than four years, a production war is gathering steam among global oil exporters. What are the potential benefits and downside of lower oil prices -- and do analysts believe there is a floor in sight?

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Oil prices, which are down nearly 30% since June, have come under pressure this year due in large part to new energy supplies -- notably from the United States -- that are tipping the balance of supply and demand. Over the past several years U.S. oil production has increased more than 70%, while the Organization of Petroleum Exporting Countries (OPEC) has seen its imports to the United States cut by more than half.[1]

A New Market

In a recent announcement, OPEC stunned the world by failing to reduce its petroleum production target -- a move that would almost certainly put a stop to the plummeting prices. Many have interpreted OPEC's inaction as it ceding its position of dominance in the global oil arena. According to *The New York Times*, "The outcome of the OPEC meeting is a clear indication that the oil exporters now recognize that this is a new market, and suddenly the United States is poised to surpass Saudi Arabia as the world's top producer, possibly in a matter of months."[2]

What lies ahead, some contend, will be a production war among Saudi Arabia, Russia, and other oil exporting countries that will attempt to fill the gap once occupied by sales to the United States with sales to China and other Asian markets. This, in turn, analysts say, could keep prices low for an extended period of time.

Cheap Oil: Good Medicine or Economic Malaise?

Do lower oil prices have a positive or negative effect on the global economy? The answer is "yes."

Generally, cheaper oil is good for the American economy. It is estimated that savings to date from tumbling gas prices represent the equivalent of a $75 billion tax cut for U.S. consumers -- or roughly $1,100 per family on an annual basis if prices remain at current levels.[3] More disposable income in the hands of consumers is likely to boost consumer spending, which, in turn, feeds economic growth. Case in point: Automakers reported total sales for the month of November were up 4.6% to 1.3 million, the best monthly finish since 2001.[4]

In a broader economic context, lower oil prices reduce the cost to manufacturers of producing and transporting their goods, and to airlines of operating their aircraft, thereby improving profit margins and investor sentiment.

On a global scale, lower oil prices should boost consumption and lower manufacturing costs in oil-importing economies, particularly in Europe, where sluggish economic growth has much of the continent teetering on the brink of recession. Yet the immediate positive effects of lower oil prices in Europe need to be tempered by longer-term realities -- namely, weak economic fundamentals and the specter of deflation (an extended period of falling prices).

The Deflation Factor

Low oil prices are currently helping to keep the inflation rate at near-zero, which in turn removes the pressure on central banks to raise interest rates. In an otherwise healthy economy, this scenario could be seen as fairly benign and contributing to an improved outlook for stocks over bonds. Yet in a weakened economic environment like that present in Europe, the economy is more likely to get caught in a deflationary trap. When prices fall across the board, consumers put off making major purchases in the hope that prices will fall even further. When spending stalls, companies' revenues suffer and pressure mounts to cut costs by laying off workers, freezing or reducing wages, or raising the price of the goods they produce -- all of which can further stymie consumer spending and deepen the deflationary cycle.

The good news/bad news nature of deflation has everything to do with what is driving the drop in prices of goods and services. For instance, if it is a lack of demand -- as many economists say is currently the case in the Eurozone -- deflation could be damaging. If, however, it is due to a boost in supply -- such as the oil and gas boom in the United States -- it can prove beneficial to economic growth.[5]

Takeaways for Investors

Similarly, from an investment perspective, lower oil prices present a double-edged sword. On the positive side:

- Low-priced oil should help to buoy U.S. stocks by strengthening the economy and extending the period of extraordinary monetary policy established by the Federal Reserve.[6]
- The revelation that the United States may be poised to eclipse Saudi Arabia as the world's leading oil producer may spell good news for U.S. equities in general -- and strengthen the dollar against other world currencies.

On the downside:

- In the short term, investors in the energy sector -- and commodities markets in general -- should prepare to see the plunge in oil prices reflected in the price of the securities they own.
- Should oil prices remain depressed indefinitely, 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.
- The Russian wildcard -- With energy exports accounting for a major portion of the country's economy, the Russian ruble recently hit a record low against

> the U.S. dollar. This latest in a long line of economic woes facing the country creates uncertainty about how President Putin will handle the situation. Europe is uniquely vulnerable to the government's actions as Russia supplies about one-third of the oil and gas imported into the European Union. Further, the EU's exports to Russia are valued at $170 billion annually, with Germany standing alone as Russia's largest trading partner in Europe.[7]

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

[1] *The New York Times*, "Morning Agenda: Oil Prices in Free Fall," December 1, 2014.

[2] *The New York Times*, "Free Fall in Oil Price Underscores Shift Away From OPEC," November 28, 2014.

[3] *MarketWatch*, "U.S. households could save $1,100 from falling gas prices," December 2, 2014.

[4] *USA Today*, "SUVs hot in best November auto sales since 2001," December 2, 2014.

[5] *Bloomberg,* "U.S. Gains From Good Deflation as Europe Faces the Bad Kind," October 26, 2014.

[6] *Reuters,* "Low oil prices boost stocks, deflation risk: James Saft," November 25, 2014.

[7] *CNN Money,* "3 risks from the Ukraine crisis," April 28, 2014.