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Why We Should Care About Oil Prices

Over the past few weeks there has been a lot of news about oil prices dropping. West Texas Intermediate (WTI), one of the major oils tracked worldwide, has dropped from almost $110 per barrel in June to $57.45, as of the December 12th closing price.

1 Year Chart of WTI Crude Oil

WTI Crude oil is down more than 40% from its highs

Brent crude has dropped in line with WTI. Prices haven't been this low since the great recession. Why is it happening? What impact does it have on us as investors? First, let's discuss why it's happening, and then we'll address the impact to all of us.

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Why are oil prices dropping so rapidly?

1. **U.S. Oil Production –** Shale oil extraction has helped push the United States to become the second largest producer of oil, according to the International Energy Agency. The U.S. produces 11.1 million barrels of oil a day, just behind Saudi Arabia's 11.7 million barrels a day. This represents 13% of the world's oil supply. In addition, a recent Bank of America report indicated that the annual investment in oil extraction in the United States is over $200 billion. This means we will continue to extract oil at an increased pace for years to come. Most experts forecast the United States will soon become the world's largest producer of oil in the coming months.

2. **Libyan Increased Production –** Most analysts predicted that Libya would be producing 150,000 to 200,000 barrels of oil a day due to political unrest. According to a Wall Street Journal article on October 14th, members of the Libyan government say they are now producing over 800,000 barrels a day and forecast an increase in production of up to 1.5 million barrels by next year.

3. **OPEC Infighting –** The Saudis and the Kuwaitis have been in a price war for months. In days past, when oil prices dropped too much, OPEC would simply cut production which would hold prices steady or drive them back up. There are many theories about why OPEC hasn't cut production. One interesting theory is that low oil prices hurt the ISIS uprising, as ISIS funds its war effort by selling oil on the black market. Low oil prices hurt ISIS more than them. Most of the Middle East is very concerned about this uprising, making this a very interesting theory.

4. **European & Asian Economic slowdown –** This is simple economics. Both regions have seen economic slowdowns. Some of the larger countries, like China and Germany are reporting a slowdown in their economies. Slower economies translate directly into lower demand for oil.

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What impact does lower oil prices have on us as investors?

While lower oil prices do translate into lower gas prices at the pumps, which may be saving you some money, the immediate impact of lower oil prices aren't all good. Let's break it down.

The Good

1. A fall in oil prices will also benefit countries that are net importers. The United States is a net importer of oil. Lower oil price directly translates into lower gas prices. Lower gas prices are good for the average American. Lower gas prices mean that they can save that money (and invest it), pay down debts, or spend it on other discretionary items. Lower oil prices could have even a larger positive impact in poorer countries that import oil, as energy costs represent a larger percentage of their total disposable income.
2. Countries that import oil should also see lower manufacturing costs and transportation costs. This could drop the cost of goods made in net-importing countries. Most western nations are net importers. Lower oil prices could boost profits for some companies in western economies.

The Bad

1. The net impact may not be positive for GDP growth in the United States. While many people will spend all of the money they save at the pump, any money used to invest or pay down debt does not directly filter back into our economy. Lower oil prices may mean slightly slower U.S. economic growth.
2. If oil prices stay low for any significant amount of time, there will be less money spent on oil exploration and infrastructure because it will be less profitable for oil companies such as Chevron and Exxon to extract oil from the ground.
3. If oil prices continue to drop, it will significantly impact companies extracting oil through "fracking." Fracking is typically a more expensive way of extracting oil from the ground. The cost varies from basin to basin, but at some point it may not be profitable for companies to extract oil from the ground. The ripple effect of this could be substantial.
4. Lower energy prices will also mean less money invested in alternative energy because there will be lower demand for these types of energy.
5. Lower oil prices could fuel (no pun intended) more geopolitical unrest with Russia. The Russian economy has felt the sting of western sanctions. To date, Putin has been able to deflect popular Russian dissatisfaction with their domestic economy with regional military distractions like Ukraine. Low oil prices over an extended period of time might encourage more such actions. The markets have reacted negatively to prior Russian aggressions, although these drops where short lived and fairly shallow.
6. Falling oil prices may cause financial instability in "highly leveraged" countries that produce oil, like Russia and Venezuela. Both countries have borrowed significantly to be significant oil producers. While neither country is a friend to the United States, lower oil prices will make it harder for them to pay for their debt and increase the possibility of them defaulting on their loans. The impact from either country defaulting on their debt would be felt well beyond their borders.

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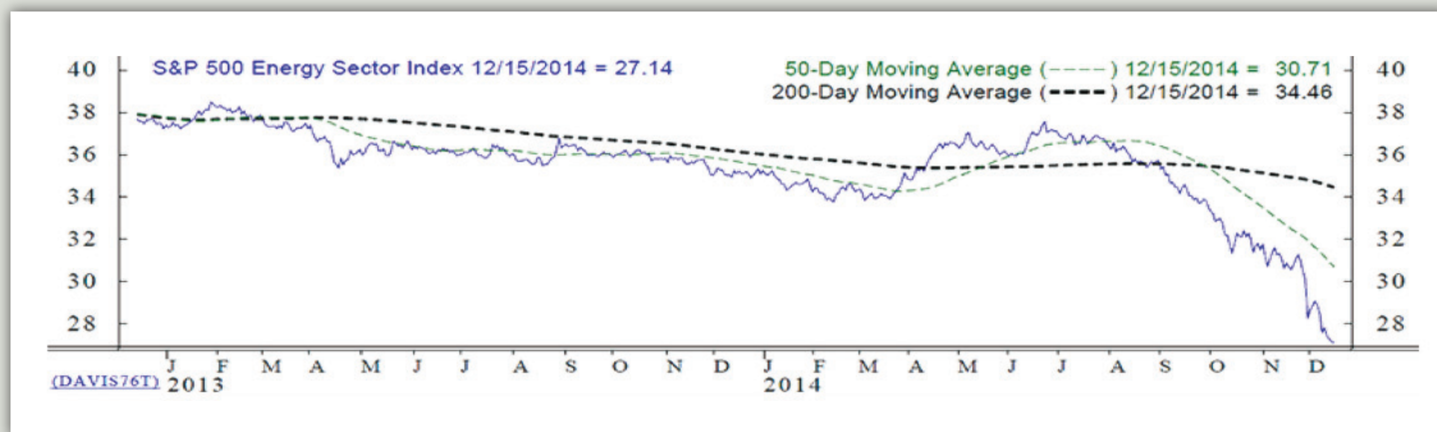
What Polaris Is Doing…

Polaris cut its exposure to energy in July from an overweight to a market weight. As we got more confirmation of the sector's movement, we cut our exposure from market weight to underweight in September, and eliminated our last holding several weeks ago to avoid the sector altogether.



As you can see from the above chart, the energy sector price broke below its 50 & 200 day moving averages in the late summer. The 50 day moving average broke below the 200 day moving average in early October. All of these are bad signs for this segment of the markets, which is why we pared back our exposure and eventually eliminated it.

I hope this helps shed a little light on this very complex subject. As always, I welcome your questions and comments.

Sincerely,

Jeff