Key Questions

Bubbling Over: What Does the Recent Rise in Oil Mean for Investors?

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President Trump's decision to withdraw the U.S. from the 2015 Iran nuclear deal added uncertainty to the global oil market and helped push prices to $72/barrel, its highest level in four years. While geopolitical tensions and supply concerns have dominated the recent discourse, lost among the headlines has been the steady but significant rise in the demand for oil as a result of synchronous global economic growth. Over the past five years, global oil demand has increased by 10% to 100 million barrels per day and is projected to keep growing at 2-3% per annum for the foreseeable future.

Oil is a significant input for most companies and investors are concerned that higher prices may lead to increased input costs, declining consumer spending and compressed profit margins. However, historically, the overall impact has tended to be limited largely because both corporations and individuals have been able to shift costs. In fact, higher oil price has traditionally proven to be a boon for business investment, both energy and non-energy related. It's no different for the current cycle where business spending on building, equipment and intellectual property has risen six straight quarters. The multiplier effect of increased spending has helped drive U.S. corporate earnings up by 12% last year and expectations are for another 22% increase in 2018. We maintain our positive outlook for equities and recommend an overweight to stocks accordingly.

As oil prices rose the past few years, domestic inflation remained low due to the declining energy intensity of the U.S. economy. As a result, we continue to believe the increase in inflation will likely be modest and the rise in crude oil prices is unlikely to materially influence the Federal Reserve's (Fed) interest rate decisions. Still, with wage inflation likely to rise, we remain cautious on the fixed income market and recommend underweighting portfolio duration and favoring high-quality corporate bonds.

While investors are becoming concerned over the impact of higher oil and other commodity prices, history shows that the recent increases are unlikely to meaningfully impact consumer spending or inflation, and are likely to support investment. At the same time, considering low cross-asset correlations, developing inflationary risks and further potential for supply disruptions, we maintain the case for owning real assets.

In particular, we advocate fixed income investors include TIPS within their bond portfolio, and we favor certain cyclical industries within an equity portfolio. Investors interested in direct exposure to real assets should consider Master Limited Partnerships (MLPs), which offer exposure to the growing U.S. energy industry and total return growth opportunity.

For questions, please contact your Key Private Bank Portfolio Manager.

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