SHARPER GRANITE LLC

Letter on the Economy

Market Spotlight: Volatility and Oil

In February 2016, the U.S. stock market staged a second correction in six months, partly driven by plunging oil prices. Many warned investors to get out of the market. Human nature makes it hard to keep one's head when everyone else is losing theirs; however, a clear understanding of market behavior helps. Since then, oil prices and equities have recovered nicely.

When investments are in a correction mode as they were in early 2016, it may be tempting to move to cash. But according to academic leaders like 2013 Nobel Prize winner Eugen Fama and classic investors like Warren Buffett, an investor's best option is to stay the course, efficiently rebalancing a portfolio but never attempting to time the market.

From 1926 through July 2015 the market saw 28 corrections in the S&P 500 Index of 10% or more. Following those corrections, the average S&P 500 returns after one, three and five years were 23.6%, 8.9% and 13.3% respectively.[1]

A well-designed portfolio strategy expects and even embraces market volatility. Sound, long-term investors understand that market corrections will occur – they are part of the plan.

Embracing Market Volatility

Market volatility should be expected. How we react to the volatility is another matter. Watching a portfolio constantly and rooting like a cheerleader is not healthy investment behavior. Market dips convey useful information and can actually enhance after-tax profits for long-term investors.

In well-functioning capital markets, prices reflect the expectations of all market participants. Those expectations include investors' risk tolerance, future profit estimates, personal liquidity needs, etc. These factors and many others feed into the aggregate expectations each day. As new information appears, expectations change and the market adapts. Hence, we expect prices to fluctuate, and we accept that it is impossible to anticipate every market participant's views and needs.

As such, market fluctuations are completely unpredictable in the short-term. Studies asking experts to predict next-day market moves show that no one has the ability to consistently predict markets.[2] And how could they? The market may move due to an oil refinery breakdown in the Middle East, an unexpected interest rate change, or a sudden decision by a CEO to retire. Some view the stock market as a pre-built roller coaster, believing that somewhere there are experts who can see where it leads. But the next stage of the roller coaster is built each day – and by random, unpredictable events.

Sound investors align their time horizon and risk tolerance with portfolio strategy. Then they stick to the plan as a strategist, not a cheerleader. They take advantage of market dips through rebalancing, regular retirement contributions, and tax-loss harvesting.

> *"After nearly fifty years in this business, I do not know of anybody who has done it [market timing] successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently.*
>
> – Warren Buffett from his book, *Common Sense on Mutual Funds*

Understanding Oil

The primary drivers of the recent volatility have been interest rates, earnings, and oil prices. While the former two are nearly constant market movers, the oil price situation is unique. Oil prices are usually problematic when increasing, not decreasing as they have been over the past two years (see chart below). Historically, stock prices moved with little correlation to oil prices. However, for much of the past few years stock and oil prices moved in lock-step.[3]

But why? The U.S. economy is far from being a proxy for oil, with the mining and energy sectors making up less than 3% of the economy.[4] And the old rule of thumb was that every $10/bbl decrease in the price of oil boosted economic growth by about 0.2%.[5] So, why are oil prices having the opposite effect on the U.S. market?

U.S. No Longer a Heavy Oil Importer

In 2005, the U.S. imported a net 13.3 million bbl/day; in late 2015 it was a net 4.5 million bbl/day.[6] Thus, the benefit of cheap oil to the economy may not be as powerful as it once was. Regardless of the effect on the total economy, the effect of lower oil prices is devastating to energy producers and energy investors. Additionally, alternative-energy companies may not be viable competing with oil at today's low prices. This is a consequence of improved U.S. energy independence.

Black Swans Lurking?

A sudden oil price drop can also create "black swan" risks such as geopolitical risk. Low oil prices add to the economic challenges and instability of oil-producing nations.

A second black-swan risk surfaces because oil-producing companies borrow and invest hugely in equipment for drilling and transport. These investments are based on an oil price assumption. Some smaller energy companies are no longer profitable at low prices and could go out of business, defaulting on loans. Some analysts worry this could have a domino effect on banks. While this is a risk, banks are as strong as they have been in years based on capital reserves. Even a wave of oil-industry loan defaults should not be a problem for banks. Still, this threat has worried the markets in recent years.

Decade of Brent Crude Oil Prices [7]

Sovereign Wealth Fund Effect [4]

After the financial crisis, oil prices increased to over $100/bbl, inflating the coffers of oil producing countries by billions of dollars. This windfall grew sovereign wealth funds (SWFs) for oil-producing countries. SWFs are state-owned investment funds that typically invest in global stocks and corporate bonds. In the boom years of 2010-2014, oil-producing countries were investing $700-800 billion a year across the globe. For scale, that is equivalent to the U.S. Federal Reserve's Quantitative Easing (QE) program.

Now that oil prices have fallen by roughly 70%, economic growth in oil-producing countries has slowed. Inflows to SWFs have stalled, and several oil-producing countries expect to borrow from their SWFs to support their weakened economies. Norway is projecting to borrow $9 billion from their SWF this year. UAE, Russia, Qatar have all started liquidating investments in their SWFs to bridge the gap between low revenues and high fiscal spending. The powerful SWF market influence on global stocks and bonds has now turned from buyer to seller.

Conclusion

Due partly to some unusual oil price circumstances in recent years, we have faced significant market turbulence recently and may face more soon. Wise investors expect and even embrace volatility in healthy, efficient markets. The key to calm is having a strategy in place that matches your individual risk tolerance and allows you to not panic when others around you do. Fortunately, your advisor can use diversification and rebalancing techniques to set your portfolio to a comfortable level of risk. If you find the current turbulence too much to bear, reach out to your advisor and discuss your fears. They are ready to work with you to fine tune your portfolio strategy.

Notes and Acknowledgements:

1. Wes Wellington, Dimensional Fund Advisors, July, 2015
2. Multiple studies supporting this may be found in *The Quest for Alpha*, Larry Swedroe, 2011
3. "Time for Oil Stocks?" Fidelity, IEA, February 25, 2016
4. "Why Are Stocks and Oil Prices Moving in Tandem?", Sonu Varghese, February 25, 2016
5. The Leuthold Group, Charles Schwab, data March 31, 1926 to March 31, 2010
6. U.S. Energy Information Administration, December, 2015
7. Tradingview.com, price/bbl data March 23, 2006 to March 23, 2017

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