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WEEKLY INVESTMENT COMMENTARY

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Oil Causes Stocks to Slide

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Stocks Slip as Energy Prices Rise

U.S. stocks slipped last week as escalating violence in Iraq pushed oil prices sharply higher. The Dow Jones Industrial Average lost 0.88% to close the week at 16,776, the S&P 500 Index fell 0.68% to 1,936 and the tech-heavy Nasdaq Composite Index declined a more modest 0.25% to 4,311. Meanwhile, fixed income markets were fairly calm, with the yield on the 10-year Treasury little changed at 2.60%.

Rising energy prices, if sustained, would represent a headwind for the global economy, including U.S. consumers. This reinforces our previously stated sector view, which is favorable toward energy stocks and much less constructive on retailers and other consumer discretionary positions.

Oil Spikes ...

Overall, the week was relatively quiet outside of the Middle East unrest and oil price spike. Specifically, West Texas Intermediate (WTI), the oil benchmark in the U.S., traded above $107 per barrel while Brent Crude, the global benchmark, hit approximately $114 per barrel. The sudden price spike is attributed primarily to an escalation of sectarian violence in Iraq, a country producing more than 3 million barrels of oil per day. While the violence is unlikely to impact southern oil production, which represents the vast majority of exports, the attacks call into question production in the northern part of the country and also threaten to undermine new investments in the energy sector.

The crisis in Iraq is symptomatic of a broader trend. We're seeing declining production out of Libya, another country on the verge of collapse, as well as falling production in many other parts of the Middle East, including Nigeria and South Sudan. A telling case in point is Libyan production, which has fallen from roughly 1.5 million barrels per day to virtually nothing. The recent military success of the Islamic State of Iraq and al Sham (ISIS) threatens to exacerbate the situation and further destabilize an already volatile region. To some extent, all of this is neutralizing the benefit of surging oil production in the United States and Canada.

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... Investors and Consumers Notice

For investors, the prospect of an oil shock not only nudged stocks down, but it pushed volatility up. Indeed, volatility rose last week from its lowest level since 2007. This is something we had warned about in prior weeks—specifically, that low volatility suggested a level of investor complacency that could be rattled by an outside shock.

While a short-term spike in oil prices is not a major threat, a prolonged price rise would put additional pressure on the global economy, including U.S. consumers, who are still operating in a mode of caution. More evidence of that came last week. While April retail sales were revised higher, U.S. retail sales in May were well below expectations. Outside of autos, overall sales rose by a scant 0.1%.

Energy Stocks Poised to Benefit; Consumer Sectors at Risk

The recent unrest in the Middle East and the potential for higher oil prices confirms our views on two sectors: positive on energy while negative on U.S. retailers and other consumer stocks. Year-to-date, energy has been one of the best-performing sectors while consumer discretionary has trailed the broader market.

Given that the crisis in the Middle East is not likely to be resolved quickly, and oil prices are likely to remain elevated, we would stick with these themes. Higher oil prices, coupled with still reasonable valuations in the sector, support a continued overweight to energy stocks. At the same time, higher oil and gas prices represent yet another headwind for a consumer already struggling with slow wage growth and high personal debt. In a world of modest growth and a strapped consumer, we believe a cautious view toward consumer discretionary companies is warranted.

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