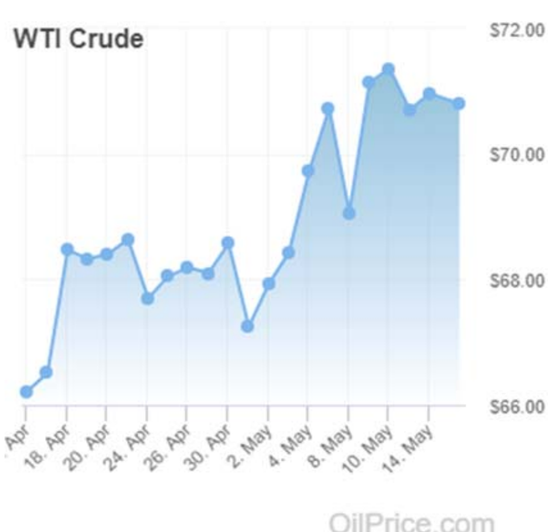
Crude Sense or Crude Nonsense?

- In the past, rising oil prices typically had an adverse effect on the economy as consumers and corporations reined in spending to cover the increased cost of fuel. However, the recent steady rise in oil prices is not having the same impact on U.S. and global economies as it has in the past.
- The U.S. economy's overall sensitivity to oil prices has evolved as the United States has developed to become the world's second-largest oil producer.
- Charles Schwab's Chief Global Investment Strategist, Jeffrey Kleintop, said: "The doubling of U.S. oil production over the past decade means U.S. energy businesses stand to benefit from higher oil prices, and the tax cut in the U.S. is helping offset the higher prices at the pump for U.S. consumers."

Why are oil prices rising?

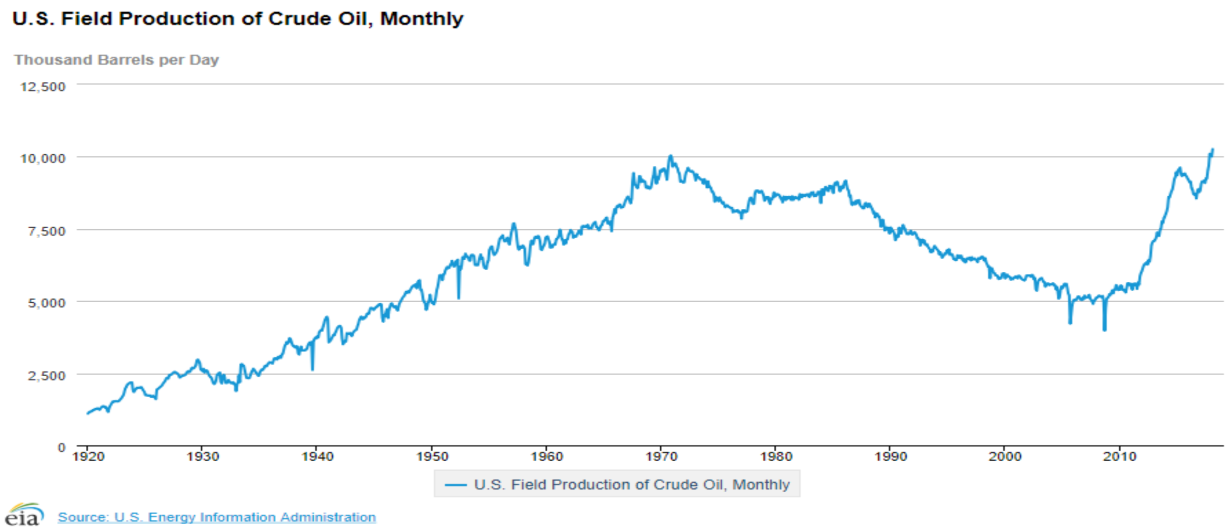
The price of U.S. oil, as measured by the WTI Crude benchmark, rose above $70 for the first time since 2014 in May. The European benchmark, Brent Crude, rose above $75 per barrel. These higher prices are largely the result of a drawdown in oil reserves, meaning there is less oil in storage, according to the International Energy Agency (IEA) and the Organization of Petroleum Exporting Countries (OPEC). In addition, geopolitical factors such as heightened tensions in Syria, unrest in Venezuelan oil fields and the most recent decision by President Trump to exit the Iran nuclear deal, have all sent oil prices soaring higher.

Are rising oil prices good or bad for the economy?

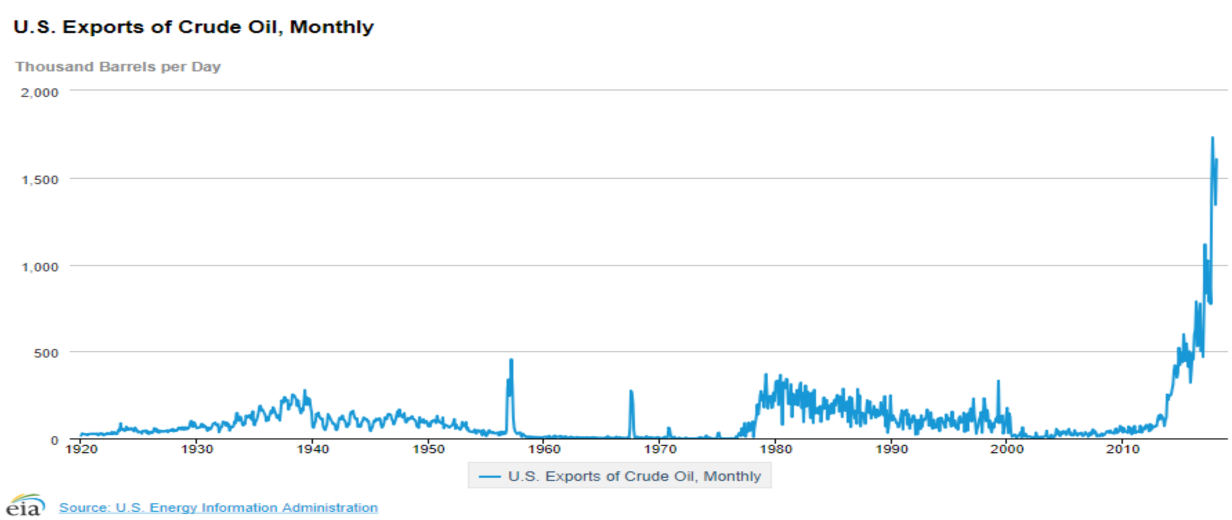


The impact of rising oil prices can be confusing. On the one hand, economists have historically argued that consumers are hurt by higher oil prices as it leaves them with less discretionary money to spend on other items, thus triggering an economic slowdown. On the other hand, rising oil prices have given the stock market a boost. Given all the benefits of lower gasoline prices, why are stocks reacting positively to rising oil prices? Is the U.S. economy actually better off with higher oil prices? Several economists now believe a rise in oil prices may not have the same adverse impact as once thought.

The shift stems from the rise of the United States as a competitive global oil producer. In January 2018, the International Energy Agency announced that the United States is set to overtake Saudi Arabia as the world's second-largest oil producer. U.S. oil production has surged from a low of fewer than 5 million barrels a day in 2005 to a new record of 10 million barrels per day in 2018.



The increase in U.S. oil production has caused a sharp decline in imports, which have fallen by 42% in real dollars since 2005, while exports are up 318%, according to Steve Leisman at CNBC. This shift in the landscape has enabled greater investment and spending by U.S. oil producers, helping to make up for some of the pain that consumers typically feel from rising prices at the gas pump.



According to Michael Feroli, chief U.S. economist with JPMorgan Chase, the effect of rising oil prices on consumption and increased spending by U.S. oil companies will be a wash going forward. Mr. Feroli said, “Our prior modeling would likely have produced a slightly more adverse impact, perhaps annualizing to a quarter point off growth for two consecutive quarters.” Jeffrey Kleintop, Charles Schwab’s Chief Global Investment Strategist, states: “The doubling of U.S. oil production over the last decade means U.S. energy businesses stand to benefit from higher oil prices, and the tax cut in the U.S. is helping offset the higher prices for U.S. consumers.” Kleintop also noted that robust global economic growth tends to absorb some of the impact of higher oil prices.

Bottom Line

The U.S. economy’s overall sensitivity to oil prices has evolved. Historically, higher oil prices have been beneficial to oil-producing regions outside the U.S. The recent energy renaissance within the United States will allow for more of that money to stay within American borders, thus providing a potential benefit to the economy. Still, if oil prices continue to rise at the current pace, it could eventually impact the bottom line for consumers, resulting in higher inflation and ultimately slower economic growth. But for now, as Kleintop states, “most economists would rather see oil prices climbing over $70 than dropping back down to $30.”

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