Falling Oil Prices

What's good for Disney is bad for Bakersfield

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As recently as June 2014, Crude Oil stood at $105/barrel, not far off its 2011 high. Today, the commodity hovers around $30/barrel – a precipitous drop of more than 70%. No doubt some of oil's tumultuous fall can be attributed to China's economic slowdown. The world's 2nd largest economy, China has been enjoying a sustained period of hyper urban growth that has buoyed the global demand for commodities in general, and oil in particular.

Yet even despite the slowdown in China, the demand for oil is holding steady and actually projected to increase over the next couple of years. The problem today is not a demand problem but rather a supply problem. The game has changed – the world is awash in too much oil – and it's due in large part to the U.S. Shale Oil revolution.

The U.S. currently produces more than 9 million barrels per day, nearly double the 5 million barrels we were producing as recently as 2008. According to Goldman Sachs, over the last seven years we've morphed from a country that imported a net 13 million barrels per day to one that imports only around 5 million. For decades now, OPEC has possessed both the desire and the ability to balance global oil supply and demand by initiating production cuts. But the playing field has clearly changed, and OPEC (namely Saudi Arabia) has recently shown a reluctance to cut-back on supply.

Why the change of heart? History may offer a clue. In the past, OPEC production cuts to sustain high prices have driven increased investment in alternative energy sources (e.g., Solar, Wind, Tesla) and development of new oil fields in the North Sea, Alaska and the Gulf of Mexico – all of which have now come back to weaken their control. Perhaps this time around, OPEC believes the short-term pain of lower prices is preferable to lessening demand. They may also expect cheaper oil prices to help stem the U.S fracking revolution, as lower prices drive down profitability.

What cheaper oil means for investors

Whatever the underlying impetus, it appears as though relatively low oil prices are here to stay for the foreseeable future. But what does that mean to investors, particularly those of us in Southern California?

For equity investors in general, lower oil prices bode well for those industries that are high energy consumers such as airlines, cruise lines and traditional auto makers. Consumer discretionary stocks (e.g., retailers, restaurants, lodging and entertainment) may also benefit, as consumers will likely have more money in their collective pockets. Discount stores and mass retailers may also get a lift, as lower socio-

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economic classes (who spend a higher percentage of their after-tax incomes directly at the gas station) should have more discretionary spending.

All those potential positives, however, come at the likely expense of oil producer stocks. California-based Chevron is down 36% from its mid-2014 high. Similar losses are reflected across the industry. And diminishing profits in the industry inevitably have a trickle-down effect. As the nation's third largest oil-producer, California's oil and gas industry employees consist of nearly 200,000 people (the majority in Kern and Los Angeles counties) and directly contribute more than $10 billion in state and local tax revenue. Industry layoffs began in 2015 and are expected to intensify. Ultimately, some scaling-back of government services to reflect decreasing tax revenues and a possible dampening of real estate prices as sellers outnumber buyers may come to fruition – especially in those cities and counties where oil is a major industry.

As a result of being one of the states at the vanguard of the nation's clean energy initiatives, we in California are doubly susceptible to the adverse economic impact of low oil prices. One needs look no further than Tesla Motors and SolarCity to understand how cheaper oil prices can quickly dampen the interest in alternative sources. Tesla shares have tumbled close to 50% from their June 2015 high, while SolarCity stock is down almost 80% since May 2015. Even the perennial favorite Toyota Prius saw its first ever decline in sales in 2015, due in large part to significantly lower gas prices. Even if OPEC should decide to tighten the oil supply, the likelihood of that effort driving prices significantly higher over the long-term seems remote, as the U.S. is well positioned to substantially grow production and gain market share at the expense of other higher cost producers, and for many years into the future.

So, perhaps the best thing to do is simply enjoy the extra money in your wallet, fill up the gas tank, and take your family to Space Mountain for the afternoon.

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