PILARSKI SAYS

Is there a relationship between oil price changes and the stock market?

Strange things happen when the price of oil falls, and sometimes it is difficult to understand why, writes Adam Pilarski, senior vice-president at Avitas.

Since the dramatic drop of oil prices there has been a curious relationship between the direction of oil price changes and the Dow Jones stock index. Any time oil prices fell, the markets responded counter intuitively by also falling. Journalists picked up the trend and produced headlines such as "US stocks fall as decline in oil prices fuels pessimism", or even the more surprising "Oil price pain starts to spread".

The latter headline is reminiscent of developments a few years back when high oil prices caused real economic pain with higher inflation, lower incomes and other factors associated with a tougher life. Why "oil price pain" can be associated with falling oil prices is difficult for me to fathom.

To be fair, oil price declines are mentioned as a major reason for the fall in the Dow Jones, but other reasons are also stressed. One is the bad economic news from China (which I will address in this column next month) and the others are strange political developments in a constantly changing world. The bizarre election campaign in the US, uncertainties in the Middle East, the constantly grotesque behaviour of the leader of North Korea and unpredictable future political leaders in the UK, France and other places raise the prospects of a future that is difficult to predict, which naturally causes the markets to retrench.

Theoretically, the human race should rejoice and benefit immensely as one of the major cost components in our production process goes down in price. Oil is used for energy, so average products should cost less as its input price declines. Oil is also used in transportation, so the cost of moving, say, agricultural products to markets should also decline. Overall, world GDP has to go up with lower oil prices, which increases demand for all products. This together with airlines being able to charge less for flights should also increase demand for flying and for additional aircraft. This is proven by realities in our industry: in 2015, air fares fell, traffic increased substantially and airlines made record profits.

Of course, often there are elements of industry that do not benefit from certain developments. Should scientists discover a cure for cancer, the morticians will suffer as may some hospitals and cancer specialists. The stock market should not, though, decline because of such localized suffering. Obviously, as oil prices fall major oil-producing countries make less money, oil companies record lower profits and banks which loaned them money have a harder time.

All this is overwhelmed by those who benefit. The estimates are that the average American consumer gained $700 because of lower oil prices in 2015, leaving them more money to spend on other goods. It is the same for consumers in western Europe and around the world. Countries such as Japan, India and most European countries benefited immensely from lower oil prices, as did agricultural producers who work in a heavily energy-intensive industry. There are winners and losers with any changes in prices but almost all economists agree that the world overall benefits from lower oil prices.

So how come Wall Street and the Dow Jones index react in an unpredictable way? There are various explanations offered. One is a simple tautology. With lower oil prices the retirement accounts are down. This does not explain anything except that as the Dow Jones is down people's accounts are down. But how oil prices are related to all this is not clear.

Another set of explanations is that low oil prices cause oil companies' stocks, and those of the banks which loaned heavily to them, to come down. That is true, but at the same time the stocks of industries that benefited from lower oil prices, such as airlines, should go up. On average the winners should in this case outnumber the losers.

Another line of reasoning is that emerging markets are getting crushed. This is probably true for some countries which are heavily dependent on oil revenue. For every Venezuela or Nigeria (which in addition to dependence on oil revenue have many of their own particular problems) there is an India which is doing better, spending substantially less on oil imports. Finally, arguments are made that weak oil prices may be a symptom of an underlying weak world economy. This argument has some possible validity, although I do not buy it. Oil prices did not drop because of weakening demand but rather because of supply factors. It is a fact, though, that, as of March, the US has entered the 81st month of its recovery. This makes this the fourth longest of the 34 economic cycles since 1854. The economy has been quite anaemic, although with enough room to continue expanding, and I do not see an imminent recession on the way.

High oil prices have changed our industry profoundly. Many of these changes will not be undone – although in hindsight we might have avoided making them. Some who invested in new technologies will not reap all the benefits they hoped for but this is life in a dynamic industry.