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RIVERPOINT
CAPITAL MANAGEMENT
INVESTMENT ADVISORS

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COULD RISING OIL PRICES RAIN ON STOCK MARKET'S PARADE?

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Stocks have gotten off to their best start to a new year since 1998. The S&P 500 is up nearly 6% through the end of February, continuing the bull market that began last summer. Many of the concerns that weighed on investors in early 2010 have begun to disappear. The domestic economy has shifted from "stabilizing" to "expanding," with recent readings on industrial activity, consumer sentiment, and even employment painting a brighter picture than what was expected. The domestic economy grew about 3% in the fourth quarter, which is about average over the past 40 years.

Corporate profits have remained strong, putting to bed the notion of a "double dip" recession. Over 90% of S&P 500 companies have reported quarterly earnings, and roughly ¾ of those reporting have topped analyst expectations. While cost cutting efforts fueled the initial stage of the rebound in corporate profitability, top-line revenue growth has also begun to push profits higher.

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State and local governments across the country have made headlines by taking a tough stance on the overarching issues of declining tax receipts and outsized pension liabilities. While there are still a lot of issues to address, these stories are defusing some of the concern that the municipal bond market is on the verge of a crisis.

Even the issues in Europe have been settling down. The region's healthier economies – notably France and Germany – continue to perform well, and the weaker countries – Greece, Ireland, Portugal – are stabilizing. Decisive policy action has allayed some investor fears as well. The European Central Bank (ECB) and International Monetary Fund (IMF) have increased the size of their rescue funds, lowering the odds that a financial crisis will sink the region and threaten the global economic recovery.

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Of course, just when the concerns of 2010 are fading into the background, the turmoil in the Middle East opens up a whole new can of worms. Aside from general instability and uncertainty, the wave of unrest has caused oil prices to rise. The threat of supply disruptions in the oil-rich Middle East has spooked investors, driving up the price of crude. The countries that have seen the most turbulence so far – Tunisia, Egypt, Yemen, and Libya – are all minor oil producers.

On the other hand, Saudi Arabia, Iran and Kuwait represent 20% of global oil production and have yet to feel the same type of social pressure. A spillover of political upheaval into those countries would cause oil prices to rise further – we estimate that these concerns have added $10-$15 per barrel to the price of oil. So, even though there is some excess capacity in the oil supply chain (current global excess production capacity totals approximately 5% of global demand) the mere threat of issues in these larger oil-producing countries has caused traders to bid up the price of oil. We are confident in our energy stocks, which reflect our strategy of diversifying our exposure both geographically and across commodity type (oil and natural gas).

Our concern is that rising oil prices could have a larger impact on economic growth. For every $10 rise in the price of oil, economic growth falls by an estimated 0.2%-0.4%. Higher oil prices impact the cost of transportation and power generation, driving up the cost of doing business. Oil is an important input for the production of plastics and resins, so a rise in oil also drives up the costs of many other industrial operations.

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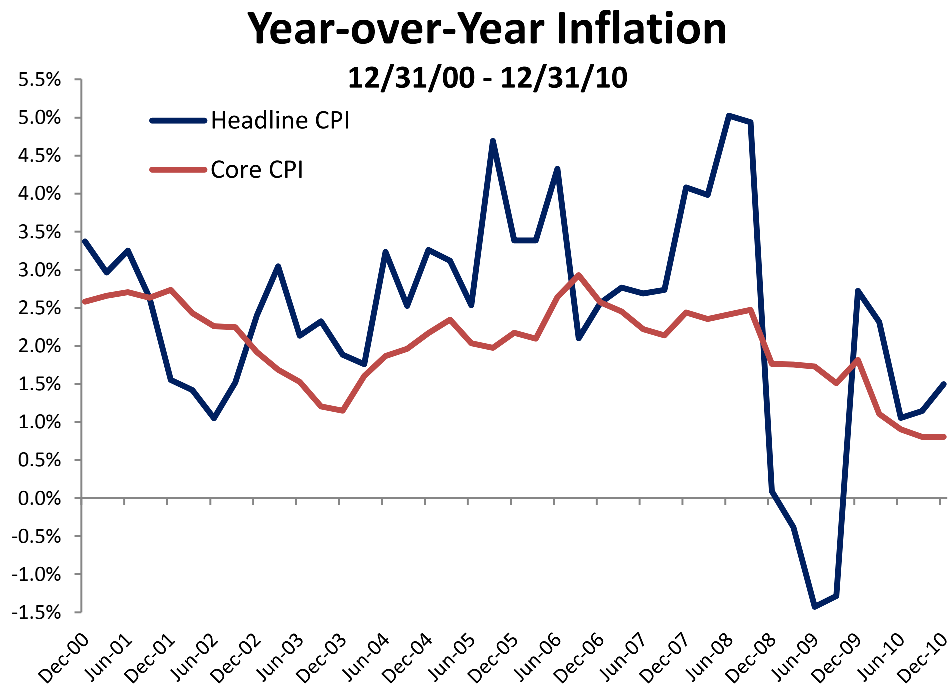
Last, but not least, is the impact of higher oil prices on the consumer. Consumer confidence has been rising over the past several months, but higher prices at the pump could dampen spirits pretty quickly. With consumer spending accounting for over half of the US economy, a dramatic rise in oil prices would have a very real impact on US economic growth. Because of this potential, we are continuing our balanced stance in our asset allocation, continuing our holdings of high quality bonds as well as stocks, depending on client guidelines.

Rising energy prices can also lead to higher inflation. When inflation data is reported in the press, there is a “headline” number and a “core” number. The difference between the two is that the “core” number strips out food and energy prices, smoothing out monthly volatility (see chart below). Focusing on the "core" figure can make it easier to identify longer-term trends in overall prices, but we all know that people need to eat, heat their homes, drive to work, etc.

Economists focus on Headline CPI, which eliminates some of the volatility of food & energy prices.



Most of the time, stripping out food and energy costs doesn't make a big difference when assessing the current state of inflation. In fact, the average American spends roughly 12% of their budget on food and energy. This means that a rise in food and energy prices doesn't have a huge impact on most American budgets. Our concern is that rapid increases in the prices of food and energy - which can give consumers a case of "sticker shock" and affect their behavior - can have a big impact on economic activity. The situation in the Middle East has the world on notice that we may be entering one of those periods where food and energy costs weigh on consumers' psyches and slow economic growth.

We see it already - increasing energy costs are beginning to impact consumers at the gas pump, and higher oil prices are impacting the costs of other goods. Food prices have been rising around the world, too. In the US, rising food prices haven't had a major impact on economic growth yet, mainly because food costs represent a small fraction of the average American's budget. Food inflation is also less of an issue in America due to the fact that we are mostly self-sufficient in terms of our food production. However, in less developed economies that import a large proportion of their food supply, food costs can represent over half of an individual's budget, so any food inflation there can cause serious hardship.

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Overall, we view the recent rise in oil prices as a temporary phenomenon resulting from the unrest in the Middle East. While old fashioned economic growth and increased demand have caused oil prices to rise since early 2010, speculators appear to have added $10-$15 per barrel in case there is a major supply disruption in the Middle East. Our client portfolios are well guarded against a temporary spike in oil prices – while stocks in economically sensitive sectors (Industrials, Consumer Discretionary) may fall, our Energy stocks should provide an offsetting rise. Our outlook is that the global economic recovery should continue, as business investment continues apace and the employment situation continues to stabilize. We are, however, prepared to adapt to other possible outcomes and are keeping a prudent and protective asset allocation to buffer against the potential for future geo-political events.