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MARKET SIGHTLINES

Crude Awakening:
Higher Oil Prices vs. a Resilient Consumer

By Michael O'Keeffe, *Chief Investment Officer*

I am sitting on a flight from California back to the East Coast. The plane is full, as was the plane on my flight out, and during my visit to the San Francisco Bay area, I saw fewer masks at restaurants and on the streets than at any time since before the pandemic. I experienced firsthand the effect of various mandates being lifted as the virus continues to dissipate. Of course, the news cycle has shifted from the pandemic to the war in Ukraine. Appropriately so, given the seriousness of Russia's actions and our focus on how the people of Ukraine, and the world more generally, might get through this crisis.

With worries about countries' dependence on energy from Russia, prices are up. Brent crude recently peaked at $127 per barrel, and people are worried about the impact of higher energy prices on inflation and economic growth. At the end of this trip, I filled the rental car at $6.50 a gallon, the most I've ever paid for gas.

In the week's Sight|Lines, we discuss higher energy prices and how they might, or might not, impact consumer behavior and increase the risk a recession.

Cutting Off Russian Energy…and Products

As discussed before, Russia represents just about 3% of global GDP, with an economy highly dependent on the export of commodities. It is the world's third-largest producer of oil and the second-largest producer of natural gas. Europe has so far been unwilling to sanction Russian energy products given its greater reliance on Russia, but this week the U.S. banned oil imports from Russia, which account for approximately 8% of our energy imports. This comes after numerous companies, asset managers, and individuals had already begun self-sanctioning Russian-made products and securities.

The Pandemic and Muted Demand Translates to a Bigger Shock

For much of the pandemic, people were less active and staying home to avoid risk of infection. Travel plummeted, commuters worked remotely, and even local trips to the store or to drop the kids at school were greatly reduced. As a result, gas consumption fell. Decreased demand has masked the world's under-investment in the carbon energy sector, as government policies and climate change activists encouraged a path to sustainable and renewable energy. So, as the risks increase that some countries will discontinue buying Russia's oil, prices have climbed with both the rate of change and higher levels shocking consumers.

Can the U.S. Find Additional Oil Supply in the Near Term?

The U.S. started the Strategic Petroleum Reserve (SPR) following the 1973-1974 oil embargo. Four sites with deep underground storage caverns can hold an emergency supply of up to 714 million barrels of oil. At the end of

2021, the SPR had over 593 million barrels in inventory. For reference, the U.S. imported an average of 672,000 barrels a day from Russia. So, replacing the Russian oil shouldn't be a major issue for the U.S. in the near term. However, should other countries or companies, especially in Europe, impose sanctions, then oil prices will continue to move higher and remain elevated until demand for oil falls or oil production from OPEC, Canada, and the U.S. increases.

A More Resilient Consumer

The price of a barrel of oil nearly quadrupled in 1974 and more than doubled in 2008, and recessions followed in each case. But when we look deeper, we see that consumers were spending, on average, more of their "wallets" on gasoline and other energy products, totaling 4.6% in 1974 and 3.9% in 2008. At the end of January this year, oil was at $91.21 a barrel, with related gasoline consumption representing approximately 2.5% of consumers' wallets, well below the 4.6% and 3.9% levels. At today's price, gasoline consumption represents about 3.1% of consumers' wallets. So, for now, these figures tell us the consumer can generally handle these higher prices. Of course, lower-income individuals and those with less efficient cars or longer commutes will be impacted.

…and a Better Prepared Consumer

Consumers are also better prepared for this event, as the relief packages from the pandemic have led to elevated savings and healthier balance sheets. This means that many have cash on hand to withstand the higher prices. We've seen estimates that an increase of $10 per barrel raises consumers' nominal spending on gasoline by around $35 billion annually, which is equivalent to about 0.2% of total consumption. Again, we think consumers can handle this increase, but they may also choose to reduce spending elsewhere, so a 0.2% reduction in consumption of other goods and services. An increase to $150 per barrel from $90 in mid-February would increase consumption by 1.2%, which would almost certainly cause consumption to fall elsewhere. But, again, we believe the consumer is better prepared today.

Conclusion

Russia's invasion of Ukraine has predictably driven oil prices higher, and sustained higher prices will put further pressure on already high inflation. We believe that the current level of higher energy prices is not enough to push the U.S. into recession. Notably, though, we expect robust consumer spending despite these higher energy prices. The Federal Reserve has also been clear about its intention to combat inflation with the market still pricing in six rate hikes in 2022. When we look at other factors in our recession risk dashboard, we still see strong business activity and a resilient consumer. We remain of the view that the current economic expansion will continue.

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