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War and Petrol

If you've driven anywhere in the last week, you've probably seen it. The sign on the side of the road. The one that makes your jaw drop. The one that makes you slam on the brakes and exclaim, "What on earth is going on?"

You know the sign I'm talking about. It reads:

Regular Unleaded…$3.937

Over the last few weeks, oil prices have risen at a historic rate. That has translated to a brutal price at your local pump, leaving motorists pulling their hair…and investors wondering how it will affect the economy. As you can imagine, I've gotten a lot of questions from clients about this over the past few days, and in this message, I'm going to answer them. So, put the kettle on, settle down in your favorite chair, and get comfy as we do a little Q&A on oil.

After all, with gas prices this high…you probably aren't going anywhere.

Q: Okay, Bob. Explain. Why are oil prices so high?

A: The quick and simple answer is due to the war in Ukraine. But let's dive a little deeper by first explaining how oil prices work.

The price of oil is largely determined by a triad of factors: Supply, demand, and speculation. As you probably know, the Law of Supply and Demand states that when the *supply* of oil decreases, but the *demand* for it does not, prices will go up.

Now, before Russia ever invaded Ukraine, the world's oil supply was already on the low side due to the pandemic. When the world went into lockdown back in 2020, both oil mining and oil refining ground to a relative halt. But along with this drop in supply was an even greater drop in demand. Before the pandemic, the global demand for crude oil was "normally around 100 million barrels a day."[1] Soon, it had dropped to somewhere between 65 and 80 million barrels.[1] This plunge in demand prompted an even greater plunge in price. (You may remember that at one point, oil prices were briefly *less* than zero!)

Lately though, oil prices have rebounded along with the overall economy. That's because *demand* has risen as more people are traveling and working. Supply, however? Not so much. The same countries and corporations that cut back on production are yet to ramp it up again. (More on this in a moment.)

So, oil prices were already poised to catch fire. Then Russia lit a match.

As of 2021, Russia was the world's third largest oil producing nation, accounting for 11% of the world's total supply.[2] But soon after Russian forces invaded Ukraine, multiple nations slapped a historic load of sanctions on the country. These sanctions caused the ruble, Russia's currency, to collapse. They also led to a shutdown of Russia's financial markets. So, whether you're a bank, a factory, a shipper, or any other type of company, doing *any* sort of business with Russia has become a dicey proposition, both politically and financially. To add more fuel to the fire, the United States has placed a ban on Russian oil, with other countries saying they may follow suit.

Which brings us to the third leg of our triad: Speculation.

Tracking the *how* and *why* of oil pricing is a notoriously tricky task. That's because supply and demand are only part of the equation. The *expectation* of *future* supply and demand has a major say, too. In this case, the expectation is that Russian oil – which comprises a huge part of the world's supply, remember – will soon be off the market. That means supply would drop significantly.

Who sets these expectations? Speculators. A speculator is a person who trades derivatives, commodities, bonds, equities or currencies with a higher-than-average risk in hopes of a higher-than-average profit potential. Basically, speculators are a special breed of investors who try to project whether the value of a commodity will rise or fall in the future, then either buy or sell that commodity accordingly. This is done mainly through "futures contracts." A futures contract is a legal agreement giving someone the right to purchase oil at a preset price on a preset date in the future. These agreements play a large part in determining what the future price of oil will be.

Because speculators expect oil to be less available – and thus more expensive – in the future, they are willing to pay *more* now for the right to buy it later. A *lot* more. This is why a single barrel of Brent crude – a type of petroleum that serves as the global benchmark for oil prices – topped over $130 a barrel in early March.[3] It's also why gasoline prices have risen to a national average of $4.31 a gallon.[4]

Q: Why do higher oil prices lead to higher gas prices?

A: This is more of a straightforward answer, so we'll cover it very quickly.

The price of gas is also determined by many factors. Supply and demand, obviously, but also taxes and transportation costs, to name a few. But the cost of crude oil makes up the largest portion of the price you pay at the pump. (AAA puts it around 55%.[5]) When oil prices rise, companies that *refine* it into gasoline must spend more. Seeking to recoup those costs, they then pass them along to customers at your local gas station.

Now, some bad news: Oil prices and gasoline prices don't move simultaneously. In fact, gas prices often lag oil prices by around three weeks. That means the price you see *now* is in response to oil prices from *February.* So, gas prices may well grow higher soon even if oil prices stabilize.

Before we move on, a few tips on how to potentially save money on gas:

- Fill up early in the morning. Gas prices sometimes rise as the day goes on.
- Fill up on Mondays. One survey found that gas tends to be cheapest on Mondays in many states.[6] Wednesday, Thursday, and Saturday tend to be the most expensive.
- Use a gas app on your phone to find the cheapest prices around town. (Bear in mind, however, that apps like these sometimes will sell your data to other companies.)

Q: What can the U.S. do about this?

A: In truth, not much. At least, not directly.

Both political parties like to criticize each other when gas prices go up. In reality, it doesn't matter who is in the White House or which party controls Congress. There's just not a lot the government can do to directly control prices…because the government does not control the means of production.

First, removing the ban on importing Russian oil won't really have an impact, because the U.S. doesn't import much anyway. (Only around 8% of U.S. oil imports came from Russia in 2021.[7])

Second, simply "drilling more," which some people have called for, is something of a non-starter, too, at least in the short term. There are a few reasons for this.

1. The United States is already the world's top oil producer. Remember how I said Russia was #3? The U.S. is #1, producing 20% of the world's total in 2020.[2] Back in December, the U.S. was already producing 11.6 million barrels *per day.* The world's (future) supply issues are simply not coming from this side of the Atlantic.
2. Even if the U.S. started producing more oil, local supply has a minimal impact on local price. That's because the oil market is a *global* one. Every country and company that produces oil sells their products across the world, largely regardless of borders and boundaries. Russia sells to Mexico, Mexico sells to the US, the US sells to Canada, and on and on it goes. You simply cannot separate a global commodity, traded across global markets, from global prices.
3. Oil producers, whether they be companies or countries, simply don't have much incentive to increase their output right now. Currently, higher oil prices *benefit* producers. OPEC – the Organization of Petroleum Exporting Countries – certainly has the capability, for example, but has stated it has no plans to do so in the near future. (It's worth noting, though, that one key member of OPEC, the United Arab Emirates, has hinted at favoring production increases.)

President Biden has recently announced the release of thirty million barrels from the nation's Strategic Petroleum Reserve, but this is mainly to ensure consistent supply and is unlikely to affect prices much, or for very long. One interesting proposal that gained some traction on both sides of the political aisle is to declare a "gas tax holiday." Currently, the Federal gas tax is 18.4 cents per gallon, while the average *state* tax is near 31 cents.[8] It's an open question whether the benefits to suspending these taxes would get passed on to consumers. But this is certainly something to keep an eye on!

In the meantime, it's worth noting that oil prices, like oil itself, are *fluid*. The situation could change in the blink of an eye. For example, the last time prices were this high was in July 2008. Back then, gas peaked at an average of $4.16.[9] By November, however, prices had fallen almost 50%![9]

Q: How do higher prices affect the economy?

A: This is a great question. Surprisingly, the answer isn't that clear cut. In fact, it's a question that economists have debated for years.

On the one hand, gasoline makes up only a small portion of consumer spending – roughly 2.6%.[10] So expensive gas doesn't necessarily translate to less spending. That's important because consumer spending is largely what our economy is based on.

If it *did* lead to a cut back in spending, that's also not necessarily a bad thing. As you know, inflation is sky-high right now. As of March 10, inflation rose 7.9% from the previous year.[11] That's the highest level in forty years! Lower spending could help cool this inflation down. Or, at least, **core inflation,** which measures the price of consumer goods and services *minus* food and energy prices. (Because food and energy prices tend to be highly volatile, the Federal Reserve doesn't use them as much when making projections about the economy.)

On the other hand, higher fuel prices mean fewer people travel. This affects airlines, hotels, and industries dependent on tourism. It also makes production *and* shipping costs higher. Given that inflation is high in part due to supply chain issues, higher fuel prices likely won't make the problem better.

As always, this is a matter of degrees. How high will oil prices rise? How long will they rise for? Will it affect how Americans spend? If so, how much? Will it affect how businesses produce? If so, how much? The needle could swing in different directions for *each* of these questions. How large a swing will determine whether the economic impact will be good or bad.

Q: So, what should we, as investors, do?

A: As you can see, oil prices are a complex subject. There are so many factors at play. (Friendly tip: if you are ever looking for an effective sedative, just start reading crude oil forecast reports. Works like a charm.) Trying to make bets on how each factor will play out is a fool's errand.

So, you can probably guess my answer. It's boring. It's predictable. But it's also served us well, time and time again: **Keep following our investment strategy and your long-term financial plan.**

In his great work *War and Peace,* Leo Tolstoy wrote, "The strongest of all warriors are these two — Time and Patience." We have time. We will wield patience. In the long run, both will help you work toward your dreams and goals.

I hope you found this analysis interesting. I know high gas prices can be frustrating and bewildering. Hopefully, by understanding a bit more about what's going on, the situation will be easier to bear both mentally and emotionally. As always, please let me know if you have any questions or concerns. My team and I are always here to help!

Sincerely,

Robert G. Elliott, CFP
Vice President

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