Will Higher Oil Spark the Next Market Correction?

Description

After a protracted slump spanning over three years, oil has rallied strongly in recent months to see the international benchmark Brent recently break through the US$70 barrier for the first time since 2014. While some pundits claim that oil's rally may be overdone, there are signs that it could move higher in coming weeks. This could be bad news for the economy and stocks.

Now what?

Energy, more specifically, petroleum, is the lifeblood of the global economy. Oil's collapse to prices not seen since 2003, and its protracted slump caused by a marked uptick in global oil supplies and weak demand growth, was a boon for a global economy recovering from the Great Recession.

The considerable spike in oil, which sees the global benchmark Brent trading at roughly double where it was in early 2017, has sparked concerns that it could cause the world economic recovery now underway to slow.

The link between low oil prices and economic growth is clear.

High oil prices lift the supply curve for goods and services, because they increase the cost of producing them. That typically leads to lower consumption and reduced investment by businesses, leading to diminished economic growth. This was apparent during the oil shocks of the 1970s, when oil prices spiked significantly almost overnight, causing inflation to rise and GDP growth to slow.

According to information released by the Fed, nearly all post-World War II U.S. recessions were preceded by a marked spike in energy prices. There are fears that if oil continues to rally, it will cause growth to slow and spark a market correction.

You see, stocks have been on a tear since Trump's ascension to the White House and have regularly hit new highs. This has triggered fears that stocks are overvalued, having outstripped economic fundamentals, such as corporate earnings and GDP growth.

The Shiller P/E ratio, which is commonly used ratio to determine whether stocks are overvalued or undervalued, for the **S&P 500 Index** comes to 34. This is more than double the historical mean of 16.82, indicating that U.S. stocks could very well be overvalued, making them vulnerable to slower economic growth precipitated by a marked spike in energy prices.

Nonetheless, global investment bank **Goldman Sachs** believes that OPEC will move to talk down oil prices if they exceed US$70 per barrel to reduce the impact of higher energy prices on the economy. The main motive for such intervention, however, would be to prevent a significant increase in U.S. shale oil production, because +US$70 oil would be a boon for the U.S. shale oil industry.

So what?

The risk of higher oil triggering a sell-off among stocks is very real, but it is doubtful that it would become a full-scale rout. There are simply too many positive factors supporting the global economic upswing, and the fact that OPEC can simply open the spigots to boost supply, along with growing U.S. shale oil production, will blunt the impact of higher oil. If anything, we are entering a period of higher economic growth, where commodity prices notably oil and metals will firm because of stronger demand.

One stock that stands out as being positioned to benefit from the economic upswing is **Brookfield Infrastructure Partners L.P.** (TSX:BIP.UN)(NYSE:BIP). A stronger global economy means greater demand for critical infrastructure such as the ports, rail networks, communications towers, and energy utilities owned by the partnership. This will translate into improved earnings and a stronger bottom line, which will support future dividend hikes and a firmer stock price.

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Author
mattdsmith