What Crude Oil at US$110 a Barrel Means for the Global Economy

Description

It's been more than three months now that crude oil has been trading comfortably above US$100 a barrel. Already tight energy markets were further squeezed after the Russia-Ukraine war and sent the oil prices to such high levels. While energy producer stocks have been topping the charts since last year, oil in triple digits will not bode well for the global economy.

How do high oil prices impact the economy?

Crude oil is the most consumed commodity across the globe, as it can be refined into petrol, chemicals, diesel, lubricants, etc. As crude oil prices increase, household spending on gasoline increases, leading to lower spending on other discretionary items.

On the macroeconomic front, crude oil forms one of the major raw materials for businesses. So, they try to shift the burden of higher oil prices onto their consumers, leading to higher prices and, ultimately, inflation.

A $10 increase in crude oil prices pushes inflation higher by roughly 0.2% in the United States. In emerging countries like India — the world's third-largest oil importer — the relationship is much more gruesome.

Notably, the longer crude oil trades at elevated levels, the more serious its impact will be on global growth. That's why the IMF has reduced its global growth outlook to 3.6% this year, a sharp downward revision of 0.8% from its earlier estimate. In comparison, the global economic growth last year was 6.2%.

Is a recession on the cards?

While there is not a perfect correlation, higher oil prices have been, in fact, followed by a recession on several occasions in the past. According to historical data, economic collapse was led by higher oil prices combined with several other economic shocks like unemployment, higher commodity prices, rising Treasury yields, etc. This time as well, some of these factors seem to confluence together, primarily led by war in Europe.

Very high energy prices could start demand destruction soon, especially in the emerging economies. At the same time, a potential ban on Russian oil could wipe away more supply from global energy markets. So, if there happens to be a confluence of these two factors, oil prices could rather climb higher.

Energy markets have almost always been risky and unpredictable, and it does not take long to reverse things. While there seems to be more room for strength in oil prices, a resurgence of the pandemic might change its course.

Energy producers have been in a sweet spot

The world is struggling with decade-high oil prices, and energy-producing companies are having merry times this year. Rallying oil prices have contributed to windfall cash flows and substantial margin expansion.

Since mid-2020, North American energy-producing companies have focused on deleveraging efforts that saw enormous improvement in their balance sheets. As a result, Canadian and U.S. energy stocks have more than tripled since the pandemic.

TSX energy stocks will likely climb higher, driven by higher oil and gas prices. None of the previous oil rallies helped producers achieve the balance sheet strength that they are currently enjoying. So, energy investors might get to see more dividend payments and aggressive share buybacks. Interestingly, the outperformance of the once value-ruining sector should continue for some more time.

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