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Price of Oil Fuels Inflation, but Shows Economy is Bouncing Back

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If one has any doubt that commodity markets are cyclical, they need only look at what's been happening with oil prices. In April 2020, when the economy had just begun to feel the effects of the Covid-19 pandemic, crude oil briefly traded at negative prices as demand plummeted while supply increased. A year and a half later, on October 4, 2021, The New York Times ran a headline noting that "Oil prices hit seven-year high" at ~$78/barrel. Then, in January 2022, The Wall Street Journal included a headline with the same six words as oil prices topped over $85/barrel and thereby hit their highest level since the 2014 shale-induced oil crash.

Several factors have fueled the recent rise in oil prices, including geopolitical tensions in the Middle East and Russia, as well as tight supply. The oil market is probably the biggest indicator of how rapidly inflation is coming to the fore, but there are signs in other sectors too. Even though they may not be back to driving at pre-pandemic levels, most consumers are feeling the pinch at the gas pump. And the fact is, despite all the talk about clean energy and the increase in wind and solar power, without petroleum, the global economy would likely grind to a halt for now.

Current oil consumption is ~100 MM barrels/day. Despite the rise of electric vehicles and greater fuel efficiency, today there are over 1 billion gasoline-powered vehicles road globally. That compares with only 5.6 million electric vehicles. It'll likely take 10-20 years before the increase in electric vehicles puts significant downward pressure on oil consumption. And then there's the amount of petroleum that goes into aircraft jet fuel and diesel that powers ocean-going ships. It's hard to see how electrification will materially disrupt commercial aviation or ocean freighting in the relatively near future.

Moreover, oil is used for many other things in the global economy besides powering transportation, such as manufacturing and industrial uses. Consider that between 8-10 million barrels/day are used to manufacture plastics which are used in just about everything, including electric vehicle manufacturing. It's estimated that the U.S. consumes ~12 million barrels of oil per year to make the plastic bags fouling our oceans and other waterways.

The new oil boom has been highly beneficial for oil patch companies that use fracking technology to find new supplies but were left for dead when oil prices fell so dramatically. The companies in that sector that have fared the best were those that filed for Chapter 11 during the crisis and were thereby able to eliminate as much debt as possible, two of which we've covered previously in this space.

Chesapeake Energy Corporation (NASDAQ: CHK) is one of those companies. It emerged from bankruptcy after eliminating ~$8.0 billion in debt, with senior secured lenders getting the lion's share of the newly restructured company's equity. That's the best way to fix a distressed company, particularly a commodity company that's subject to volatile swings in the price of the products it sells. A firm that is able to do that, all other things equal, will have a lot more flexibility to effectively compete in the future after restructuring. That's what's happening now with Chesapeake since it now generates significant cash flows that have kept its balance sheet clean, allowed it to acquire Vine Energy, and even gave the company flexibility to distribute wealth to shareholders via dividends and a $1.0 billion stock buyback.

Whiting Petroleum Corporation (NYSE: WLL) is another similarly situated company. It eliminated $3.0 billion in debt through its bankruptcy, and, like Chesapeake, its senior lenders got most of its newly issued stock. When it emerged from Chapter 11, WLL stock traded in the mid-teens, but it now trades above $71/share! And, like Chesapeake, this company will also reward shareholders with capital distributions since it is also generating so much free cash flow after having reduced interest expense by nearly $200.0 million/year.

When distressed companies clean up their act and balance sheets like this, that process can create a powerful new cash flow engine for shareholders who come in at the right time via the restructuring. It's certainly been beneficial for several companies in the energy sector.

And, in all likelihood, the dramatic rise in oil prices may not be over yet. Today, spot crude oil prices are higher than futures prices, an unusual condition that economists call "backwardation." In practical terms, that means supplies are so tight, and there's so much demand for oil right now that people are willing to pay $7-8/barrel more for oil today than if they take its delivery in 6-12 months. That bodes well for speculators because they can make money by rolling their futures contracts—buying distant oil contracts and then selling them on the spot market as they mature. That type of speculation can create a self-fulfilling prophecy of even higher spot prices going forward if it continues. If the world's economy keeps reopening, although that's happening in fits and starts due to Omicron, we're likely going to see even more economic growth. This means more demand for plastics, more demand for oil generally, and more cars on the road, even as more manufacturers get into making electric vehicles.

And while oil and energy are major components of the global economy, it makes sense to look beyond that sector and focus on overall current macroeconomic trends. In the U.S., we're currently experiencing record low unemployment at 3.9%. After reaching historical lows following covid, interest rates are now really starting to climb as the onset of inflation forces the Fed's hand. Inflation is running at 7%, which is way above the Fed's 2% target, and Chairman Powell is really struggling with it.

Most economists, therefore, expect the Fed to raise interest rates in 2022 – Goldman Sachs is calling for four rate increases this year. That's causing turbulence in equity markets and a bloodbath for fixed income investors who aren't conditioned for downside volatility. As rates rise, fixed-income securities' market prices fall since prices and interest rates are inversely correlated. On the other hand, rising rates are also a sign that the economy is doing well (Y/Y GDP growth of +4.9%).

As a result, commodities like oil should continue to outperform, given underlying economic strength. Overall, 2022 promises to be an interesting year, but investors may need to be cautious navigating through minefields as they evaluate investment opportunities, given the changing landscape.