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Investment Institute

Weekly perspective on current market sentiment — April 20, 2022

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Last week's S&P 500 Index: -2.1%

Will high prices cure high prices?

Key takeaways

- Historically, high prices have tended to push producers to increase production, which, eventually, can lead to oversupply.
- We believe this is unlikely to be the case in the oil market, at least in the intermediate term, as companies focus on capital discipline.

There is an old saying amongst commodity traders that "high prices cure high prices." That bromide could be applied to many other industries as well. It goes back to the relationship between supply and demand. When demand exceeds supply, prices typically rise. Then, in response to higher prices, producers of the goods seeing strong demand start to produce more of those goods. Eventually, the amount of supply is more than what the level of demand can support and prices fall. This back-and-forth relationship between prices, demand, and supply can be traced back many centuries, especially in the commodities markets. For example, there are many tales of the boom-and-bust cycles of the price of rice in Japan and wheat and other grains in ancient Egypt. It really isn't that complicated. It is a matter of basic economics.

We all know that the price of many, if not most, commodities has surged over the past 18 months as the world catapulted out of the economic depths of the pandemic. Demand surged for manufactured goods and the raw materials needed to produce them. Prices for everything from industrial metals to paper goods to copper to oil, natural gas, and grains rose dramatically. The well-known supply-chain disruptions that absolutely couldn't handle the jump in volumes are a big part of the story. Factories, mines, and other production facilities also suffered from virus-related closures that resulted in dwindling supplies relative to demand.

In recent days, as this strategist filled up his tank with $4 gasoline (we realize that is a bargain when compared to either coast), one has to wonder why, given the current price of crude oil, every producer in the country isn't boosting oil output to take advantage of the elevated price. There are a number of reasons, but the most crucial factor in the decision, based on a recent survey by the Dallas Federal Reserve, is that investors (shareholders) want companies to focus on capital discipline. In other words, rather than reacting to higher prices by putting meaningful capital to work ramping up operations, investors want oil producers to put cash generation and returns to shareholders at the top of their focus list. Also consider that the cost to boost production has increased dramatically. As an example, due to supply-chain issues, the cost of steel and cement has risen more than 40% and the cost of fracking has tripled. A severe labor shortage has also created headwinds for the industry.

The bottom line for investors is that we are not looking for oil prices to pull back any time soon. We continue to project West Texas Intermediate (WTI) oil prices to be in the $120-$140 per barrel range at the end of this year. We recommend that portfolios carry a market-weight allocation to the Energy equity sector as well as a full long-term or strategic allocation to the broader commodities asset group. Unfortunately for consumers, at least in the intermediate term, we do not expect higher prices to cure higher prices.

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