Awash in Oil: the impact of falling oil prices

Article Highlights

• Oil prices have fallen by more than 45% since June to a five-year low, reflecting greater supply, particularly from the U.S.

• Airlines, trucking companies, chemical makers and agricultural producers stand to benefit most from lower energy costs, and almost every company will benefit somewhat. Falling oil prices could add more than $1 trillion to the U.S. economy alone.

• Rising global demand should help oil prices rebound in 2015 and trade between $80 and $90 per barrel over the next two years.

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Crude oil is one of the most important natural resources for the global economy, and its price has an influence on everything from airline tickets to plastic cups. Since June, the price of oil has plunged by more than 40%, from $108 per barrel to less than $60 recently, the lowest since mid-2009.

2014 Average monthly oil prices

Source: Energy Information Administration. *Through December 15
Falling oil prices mean lower costs for heating, transportation, and materials like plastics that are petroleum-based, benefitting the broad economy. We think the decline will add more than $1 trillion to the U.S. economy alone.

Will oil prices keep falling?
Oil prices are difficult to predict over the short term, but the combination of rising U.S. crude oil production and weak growth overseas will probably keep prices low for the time being. Global demand is still rising, however, and barring a new recession in Europe, we expect oil prices to vary between $80 and $90 per barrel over the next two years.

How will the drop affect the U.S. economy?
Lower oil prices have both a short-term and long-term impact on the economy. Gasoline prices have already fallen significantly, dipping in some areas to less than $2 per gallon. That will have an immediate positive impact on consumer spending in the same way a tax cut would. In addition, reduced energy costs filter through the economy slowly as well, lowering prices all along the production chain because less money is spent on producing, storing, and transporting each item to the end consumer. Competition puts downward pressure along this supply chain which means goods cost less for the consumer. That will likely raise consumer demand and help accelerate U.S. economic growth and job creation. The longer the lower price lasts, the greater the effect.

What industries will benefit from lower oil prices?
In general, companies that use large amounts of oil — transportation-related companies such as airlines, trucking companies and parcel delivery companies, as well as chemical makers, building material manufacturers and even agricultural producers — will benefit most. Other companies will also benefit as lower energy costs flow down the production chain, reducing costs at every stage.

How will it impact the energy sector?
Oil prices affect energy companies in many different ways. Falling oil prices undercut revenues for oil exploration and production (E&P) companies, which pump oil out of the ground and sell it to refineries. E&P companies may postpone or cancel projects that are not as profitable with lower prices. With fewer projects starting up, the oil equipment and services industry — companies that make drilling equipment or provide seismic surveys — will likely see their business slow.

On the other hand, oil refining companies — which buy oil and process it into refined products such as gasoline and heating oil — may actually benefit, since their costs will be going down. If the price of crude oil falls more than the price of gasoline, refiners may even see increased profitability.

Overall, a positive impact
The decline in oil prices has already led to a steep drop in the cost of gasoline, an important expense for most people. Winter heating bills will probably decline as well, not only for those who use heating oil, but also natural gas, whose prices tend to
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decline when oil prices suffer a significant drop. Falling energy costs means consumers will have more money to spend, boosting economic growth.

From an investment perspective, energy companies make up less than 10% of the value of the companies in the Standard & Poor’s 500, and so far the decline in some energy stocks has not led to a significant decline in the broad market. Lower energy costs help non-energy companies become more profitable, leaving an overall positive impact.

While falling oil prices benefit the economy, it is tough to predict how they will affect different types of investments over long periods of time. Since oil prices can be volatile, it may be wise to stick with a broadly diversified approach that reflects your individual risk tolerance and financial needs. If you have questions about oil prices or other economic trends that may affect your portfolio, contact a TIAA-CREF financial advisor. By taking the long-term view, you may avoid overreacting to short-lived events and changing your strategy at an inopportune time.