Weekly Market Commentary

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Arab Spring 2

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Highlights

This year, oil prices have started off on a similar path to last year, but disturbingly are already about $10 higher than they were last year.

Oil prices have climbed to just below the threshold where demand for oil has weakened in the past, suggesting a negative impact on economic growth.

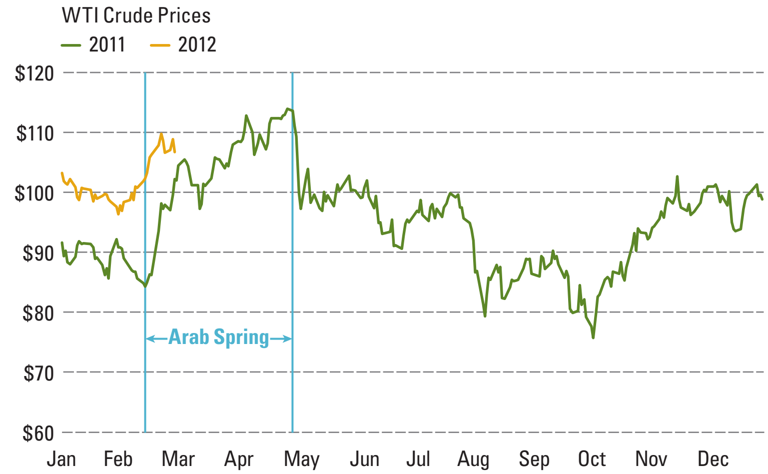
The combination of rising prices sapping consumer spending power and the deteriorating earnings outlook paint a negative picture for the markets. However, with prices already high, a resolution to geopolitical talks or added supply from other sources may provide some relief.

Hollywood has a thing for sequels. So do the markets. In recent weeks, we have pointed to the rise in the stock market and the euro early this year as mirroring those gains of early 2011. While stock market gains and currency moves can certainly grab headlines, they lack the drama of a move in oil prices. The move higher in oil prices so far this year is similar in pattern to last year's surge, but the story is a bit different this time.

Last February, a series of uprisings that began in four middle-eastern countries started to push oil prices higher. While the uprisings began in December 2010 and in January 2011 the Tunisian President fled to Saudi Arabia, the so-called "Arab Spring" protests started to gain momentum and affect world oil markets in February as Egyptian President Hosni Mubarak resigned after 30 years as Egypt's ruler. Protests quickly spread to Libya, Bahrain, Iraq, Kuwait, Jordan, Yemen, and Syria, among others. In the U.S. oil prices reached $114, but in Europe where markets are more dependent upon oil from middle-eastern countries oil (Brent crude), prices soared to about $126.

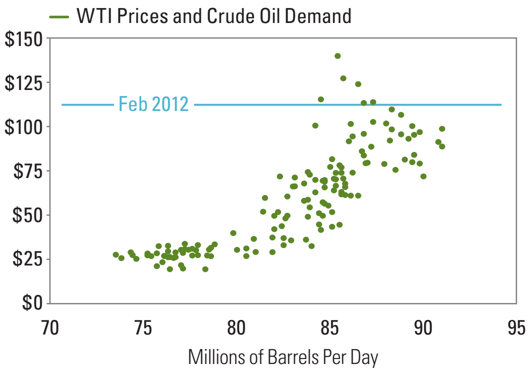
This year, oil prices have started off on a similar path to last year, but disturbingly are already about $10 higher than they were last year. The increasing tensions in the Middle East centered on Iran's nuclear program and the pressure being applied by the imposition of EU (European Union) and Japanese sanctions on Iranian oil have led to another "Arab Spring"-type pattern in oil prices.

1 Oil Prices Tracking Last Years "Arab Spring" Pattern



Source: LPL Financial, Bloomberg data 03/03/12

2 Oil Prices Nearing Threshold Where Demand Suffers



Source: LPL Financial, Bloomberg data 03/03/12

3 Weekly Retail Sales Not Showing Impact of Higher Oil Prices

Source: LPL Financial, Bloomberg data 03/03/12

Rising oil prices are adding a risk to the markets and the economy. As you can see in Chart 2, oil prices have climbed to just below the threshold where demand for oil has weakened in the past, suggesting a negative impact on economic growth.

Fortunately, weekly retail sales show that there is no discernible effect on consumer spending yet with sales rising at a 2.7% pace in the latest week compared to a year ago, as depicted in Chart 3. However, the drag of higher oil prices may be offset by unusually warm weather pulling spring sales forward.

Of course, consumers do not buy crude oil, they buy gasoline. The latest data from the U.S. Department of Energy, reported for February 27, reveal that the national average retail gasoline prices have risen 50 cents to $3.78 since mid-December 2011, when prices averaged $3.29. Gasoline prices may continue to edge higher unless crude oil prices recede.

High crude oil input costs and potentially slackening demand are not boosting earnings for the Energy sector. Consensus earnings forecasts for the Energy sector have been revised downward and are now expected to be flat versus year-ago levels, down from an 8% gain expected when the quarter began. In addition, earnings for the Consumer Discretionary sector are also falling—though in line with expectations for the overall S&P 500—with growth estimates having been cut in half from around 6–7% to about 3% for the first quarter.

The combination of rising prices sapping consumer spending power and the deteriorating earnings outlook paint a negative picture for the markets. However, with prices already high, a resolution to geopolitical talks or added supply from other sources may provide some relief.

- Geopolitical Breakthrough – A breakthrough on geopolitical talks with Iran may reverse oil prices. Iran is the second-biggest producer in OPEC and makes up about 5% of world oil production. The imposition of new sanctions by EU nations is having a broader effect on Iranian exports, since tanker owners are having trouble getting insurance from European insurers to carry Iranian crude to any destination. Inflation in Iran is running at 21%, resulting in some domestic dissatisfaction bound to worsen in the coming months. This past weekend's legislative elective elections in Iran may clear the way for compromise.
- Additional OPEC Supply – In the meantime, OPEC is expected to have 2.5 million barrels per day of excess supply to help cover lost exports from Iran. It appears that Saudi Arabia, the country with the excess capacity in OPEC, is stepping up production. Baker Hughes reported that Saudi Arabia is deploying the most oil rigs in four years. The number of rigs used more than doubled in January to 49 from 23 a year earlier, the biggest annual increase on record. But the total still stands below the 57 in August 2007.
- Emergency Release of SPR – In addition, members of the Democratic party are urging President Obama to release oil from the Strategic Petroleum Reserve (SPR) used in response to high oil prices due to

disruptions or geopolitical events that often take place during election years (1996, 2000, 2004, 2008).

Hopefully, the sequel to the Arab Spring ends with oil prices coming back down as they did last year without damaging demand or fragile consumer and investor sentiment. ■

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

OPEC -- Organization of the Petroleum Exporting Countries.