

# Scout Investments

## Economic and Market Outlook

### Oil – Sustainable Upward Move?

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#### 2011 Outlook

**GDP GROWTH:**

3.2%

**UNEMPLOYMENT:**

9.0%

**INFLATION:**

1.75%

**FED FUNDS RATE:**

0.35%

Since the first of this year, oil prices and energy stocks have been on a tear to the upside. As of Friday, March 25, the S&P 500 energy subsector has gained significant ground, showing a return of 14.7 percent, far outstripping the price return of the S&P 500 index, which is up 4.5 percent for the same period of time. For those who own shares in oil companies, this has been a great run. This move to the upside has been substantiated by oil prices, which have increased by \$14.02 per barrel during the same period, representing an upward move of 15.3 percent. Is this move sustainable?

#### For the Data Junkies Out There

Stock prices have been moving to the upside since the first of the year, interrupted by a short-term downward shift which we have been documenting. The upward move and the level of participation have been rather narrow in nature. As previously stated, energy stocks have generated an average return of 14.7 percent, so far this year. The only other economic sector which has outperformed the market overall this year has been industrial stocks. All other eight sectors have underperformed the major index. It is not usual for the market move, overall, to retain vigor during the long-term if only a few segments of the market are leading the charge. So, the sustainability of the upward move in stock prices is, in our opinion, suspect.

That being said, what about the energy area, which along with the industrials, are the only areas of the market which are outperforming the overall averages? Energy stock prices tend to have a rather high correlation, or relationship, to oil prices. During the last five years, oil prices have traded between a low of \$33.87 per barrel in December 2008 to a high of \$145.65 per barrel in July of 2008. It is quite a range. Currently, oil prices are at \$105.40 per barrel. Oil prices tend to be volatile. Price trends have tended not to be sustainable – in other words, when prices have risen rapidly, or fallen rapidly, eventually some of that move is retraced in the opposite direction.

One easy way of tracking these excessive moves both on the up and downside is to track the price of oil in relation to its previous 200-day moving average. If the price is currently wide (very high or very low) in relation to where it has traded on average during the last 200 days, the price tends to correct or rise toward the 200-day average. This has been the pattern for the last number of years.

### 200-Day Moving Average Examples

There have been two occasions during the last three years when oil prices and energy stock prices were both trading at more than 20 percent above their respective 200-day moving averages. This happened in July 2008 and again in October 2009. While the number of observations is low, it is instructive to understand what happened following both previous periods of price extension, particularly recently.

<u>Date</u>	<u>Oil Price</u>	<u>200 Day M.A.</u>	<u>Oil Price 90 Days Later</u>	<u>Oil Price 180 Days Later</u>
July 2008	\$145	\$110	\$63	\$45
October 2009	\$80	\$62	\$72	\$84
<b>Avg. Oil Price Change</b>			<b>-33.2%</b>	<b>-32.0%</b>

The comparisons below illustrate the relative price performance of energy stocks during these two periods when oil prices had been extended relative to their 200-day moving averages.

<u>Date</u>	<u>Energy Stocks 90 Days Later</u>	<u>Energy Stocks 180 Days Later</u>
July 2008	-15.5%	-10.0%
October 2009	-5.5%	-8.0%
<b>Avg. Relative Price Performance</b>		<b>-10.5%</b>
		<b>-9.0%</b>

**Once again, the data above is performance information based on “relative” returns to the S&P 500 Index.** In 2008, the economy was struggling with recession and Gross Domestic Product (GDP) growth contractions. This was occurring on a worldwide scale. Perhaps the more balanced period is represented by what was happening in the Fall of 2009, when the economy was regaining its footing and supply and demand trends were reasonably stable. Following that significant rise to the \$80 per barrel range, oil fell to \$72 per barrel and then rose again to \$84 per barrel. During this period, energy stock prices fell in relation to the overall stock market. Following oil hitting \$80 per barrel in October of 2009, over the next three months energy stocks underperformed the stock market by 5.5 percent. An additional period of underperformance occurred for the following three months – so energy stocks underperformed the overall stock market by 8.0 percent from October 2009 to April 2010. This time around, the same script may not apply, but from a macro-economic standpoint, this was a period when the overall economic environment was reasonably stable on a worldwide scale.

### More Historical Data

According to Ned Davis Research, it appears that energy stocks have tended to struggle in price relative to the overall stock market 18-to-30 months following the end of recessions. Following the end of the last four recessions (1980, 1982, 1991 and 2001), oil stocks performed well relative to the overall stock market, on average for 18 months after the end of recessions. However, oil stock shares have tended to underperform the overall averages from 18-to-30 months following the end of recessions. Since the recent recession ended in the summer of 2009, 18 months following the end of the recession is during the first quarter of 2011. If historical trends hold, we should not be surprised to see energy stock prices underperform the overall market for the next year or so.

### Worldwide GDP Growth – Slowing Demand Trends

Political uncertainty aside, it appears to us that overall economic growth rates are starting to slow in much of the world, which has been adding to oil consumption trends. We are looking at economic growth rates in China, India, and much of the Third World which does not export raw materials in its own right. We would add

Japan into this mix and some portions of Europe. It appears to us that growth expectations are starting to slow on a worldwide scale, driven by desired growth contraction in China, known problems in Japan and the continuing problems in Europe. In the U.S., expectations of GDP growth are being cut.

### Final Word

From a longer-term standpoint, we are expecting oil prices to remain reasonably firm. Indeed, massive stores of natural gas must play into our nation's (and other nations') energy needs. We are not of the belief that oil prices will decline substantially without an outright economic growth contraction occurring. However, we believe oil prices appear stretched. From a demand momentum standpoint, it also appears that demand growth in and of itself should start to slow. Our advice is to be careful when making newly found commitments to the energy patch at this stage.



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