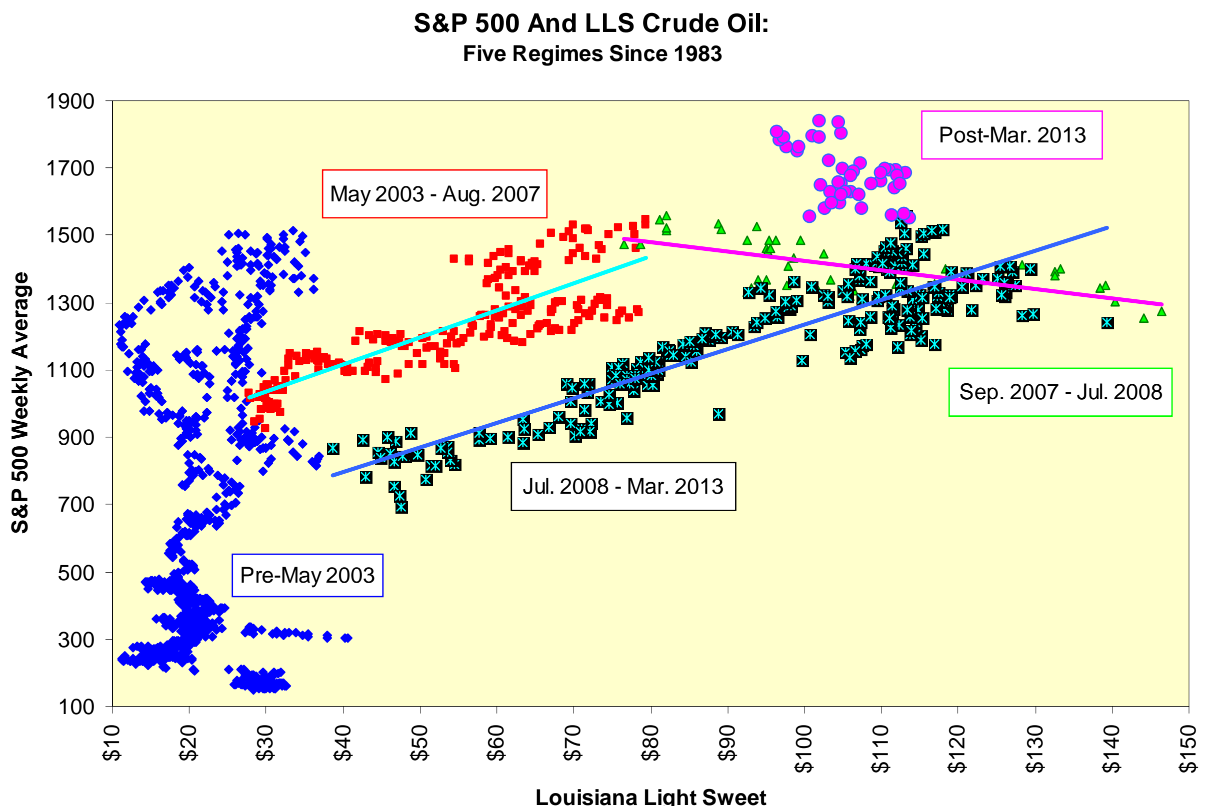
A Rare Switch In Crude Oil – U.S. Equities Relationship

There is really no such thing as "till death do you part" in intermarket relationships. Let's take our subject here today, the relationship between crude oil and U.S. equities. This once was considered a no-brainer: Higher crude oil prices were associated with slower growth and (erroneously) with higher inflation and interest rates and therefore were considered poisonous for equities. Occasionally, an equally erroneous reference to higher crude oil prices leading to a stronger dollar and depressed earnings for multinationals was added for good measure, but the conclusion remained the same: Crude oil up, S&P 500 down.

Four Regimes Turn To Five

Let's return to a modified analysis from April 2010 on the relationship between crude oil prices and the S&P 500. The modification consists of replacing West Texas Intermediate, the basis for the NYMEX futures contract, with Louisiana Light Sweet. This sidesteps some of the massive discounts seen in recent years at Cushing, Oklahoma, by using a similar grade of crude oil produced and priced at the Gulf Coast.

I had divided the relationship's history since May 1983 into four regimes. The first, marked in blue, extended to the Federal Reserve's first declaration of war on deflation in May 2003. It was random. The second, marked in red went from May 2003 until the Bernanke Federal Reserve abandoned all semblance of monetary discipline in August 2007. The third, marked in green, was crude oil's rampage higher during the early phases of the financial crisis; up until the present period, it was the only time of demonstrable negative correlation between crude oil and equities. The fourth, marked in black, encompassed both crude oil's crisis-induced crash and subsequent rebound through March 2013.



We now have to add a fifth regime, marked with magenta, beginning in March 2013. This is the second regime involving negative correlation. Unlike its September 2007 – July 2008 predecessor, this one involves a combination of declining crude oil prices and rising equity prices. In this sense, it is different this time, if those famous last words can be uttered on these pages.

Rise In Supplies

Previous periods of positive correlation were characterized by a combination rising global demand for crude oil combined with massive monetary stimulus. As night follows day in all commodity markets, the resulting higher prices for crude oil led to a combination of slowing demand growth and rising supply. If we add the technological revolution of fracking to the mix, we find ourselves in the same combination of demand growth and monetary stimulus but supply growth is pushing prices lower.

The irony for those of you who enjoy such things is the present regime is a reversed full-circle from the one presumed in the 1970s and 1980s: It is crude oil down, S&P 500 up.