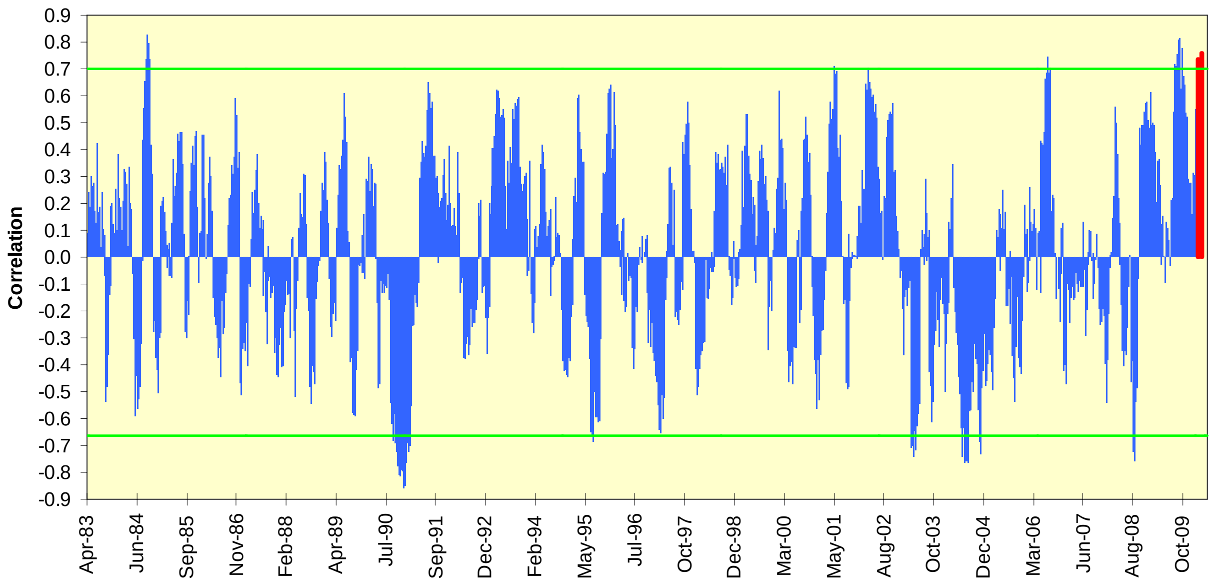
Crude Oil – S&P 500 Relationship Moving Toward Danger Zone

If you want to transmit highly classified state secrets, forget all of the James Bond stuff and just insert your message in plain English in a legal disclaimer. No one reads either them or those software licensing agreements you have to accept before installation. However, please read the following non-disclaimer disclosure: The current partial contribution of crude oil prices to the S&P 1500 Supercomposite remains positive, 0.59% on a net weighted beta at last calculation. The reason for this is simple: The positive impact across the Energy and Basic Materials sectors outweighs the negative impact across the Consumer Discretionary, Consumer Staples and Healthcare sectors.

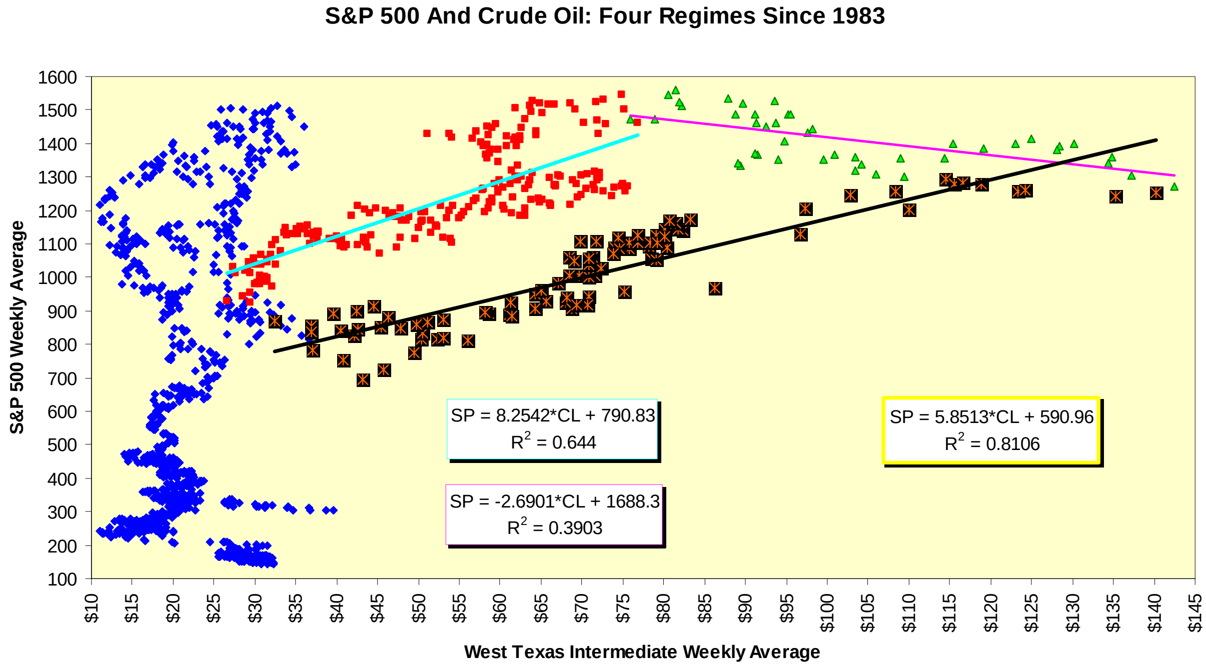
However, we are approaching a zone of concern, and that is the subject for today. While it may come as a surprise to many, the long-term correlation of weekly average returns between the cash S&P 500 and cash West Texas Intermediate crude oil at Cushing, Oklahoma, has been 0.019 since January 1983. The only times we have been outside of an in-sample 95 percent confidence interval of these rolling thirteen-week correlations to the upside over this period have been in September 1984, July 2006, August-September 2008 and March-April 2010. This last set of data points is highlighted in red.

Rolling Thirteen-Week Correlation Of Weekly Returns
S&P 500 And Crude Oil Since January 1983



The common factor here is global economic growth. Rising activity increases both energy demands and sets the stage for higher expected profits. Surprisingly, the connection between monetary largesse and rising crude oil prices is weak; this will be dealt with in a later article.

Regimes
As the pundits say, it is not a regime market but a market of regimes. We can divide the history since January 1983 into four of them. 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. It was linear; see the turquoise-framed regression synopsis.



The third regime, marked in green, extended to the July 2008 peak in crude oil prices. As noted in the magenta-framed regression synopsis, this was the only protracted period of negative correlation between the S&P 500 and crude oil. The fourth and current regime, extending from July 2008 to the present and marked in black with a yellow-framed regression synopsis, has been the most linear of all.

What, to return to the James Bond theme, is the clear and present danger? We are now entering the absolute price zone where negative correlation occurred. While that August 2007-July 2008 period also involved the credit crunch to knock stocks lower, we should remember the world did not acclimate well to $4 per gallon gasoline.

The strongest sectors of late have been the consumer-related ones. Every dollar out of the consumer's pocket for higher energy costs is a dollar unavailable to support the great national pastime of spending money like there is no tomorrow. As noted above, higher crude oil prices affect consumer-related issues negatively.

While I do not expect crude oil prices to move significantly over $100 during the present phase, that is an opinion and not a brick wall. Once we head there, the world changes and not for the better for anything dependent on consumer spending.