

Commentary

Oil Tops \$100, Adding Pressure to Inflation Outlook

- Oil prices jumped after a near-halt of traffic through the Strait of Hormuz.
- Policymakers are exploring emergency measures to stabilize supply.
- Higher energy costs threaten inflation, interest rates, and growth.

When futures markets opened on Sunday night, the price of oil surged to near \$120 a barrel before settling closer to \$100 when markets opened on Monday morning. Approximately 20% of global petroleum consumption flows through the narrow Strait of Hormuz, which is now at a near standstill. The closure could last weeks rather than days, so investors are getting nervous about a prolonged closure.

The G7 Countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) are meeting today to discuss potential short-term solutions to this closure. One solution could be the coordinated release of emergency oil reserves to increase oil supplies. U.S. Treasury Secretary Scott Bessent has even suggested that the U.S. may lift sanctions on some Russian oil.

High energy prices are a concern for investors because they cause inflation and slow economic growth. While many of us think of high oil prices impacting gasoline prices, the impact is much greater. The U.S. is a consumer driven economy, and high gasoline prices take money out of consumers' pockets to spend elsewhere. But the impact is even much broader than this. Goods are transported by ships, planes, and trucks that rely on refined products (diesel, jet fuel, marine fuels), and oil is an input cost for chemicals, fertilizers and plastics, raising costs across the economy.

There are also other knock-on effects. Rising prices (inflation) cause bond investors to demand more yield for their bonds. Bond investors are interested in "real return," which is the return after accounting for inflation. Higher bond yields mean higher borrowing costs such as mortgages, auto loans, and business credit. This slows economic growth as financing costs become more expensive.

Then there is the Federal Reserve (Fed), which is in a rate cutting cycle. The Fed has a dual mandate to keep prices stable and employment at full capacity. Inflation had been moderating and the Fed had begun to prioritize the job market over inflation, cutting rates to help the labor market and stimulate economic growth. Now inflation is a big risk, and the Fed is in a pickle with potentially both rising inflation and slower economic growth. The potential for rate cuts has been pushed out further now.

Finally, higher oil prices could also cause a stronger U.S. dollar. Oil is priced in U.S. dollars, so higher oil costs require buyers to exchange more of their local currency for dollars, increasing demand. Also, the U.S. dollar is a safe-haven asset. When uncertainty strikes, investors flock to hold dollars. A higher dollar makes U.S. goods less attractive to foreign consumers and lowers profits for multinational companies operating overseas.

The oil disruption could be temporary and is evolving quickly. Diversification remains critical, and market volatility can create opportunities for long-term investors. As always, investors should avoid being distracted by short-term swings and work with their financial professional to determine strategies aligned with their goals and risk tolerance.

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