Have you noticed that it costs less these days to fill up your gas tank? Most Americans are probably thinking, “I’ll take cheaper gas. More money in my pocket, no questions asked!” However, if you are curious, there are many moving parts driving the price of oil. You might also notice some parallels between natural gas, which was covered in our last update and crude oil, which we will touch upon below.

**The U.S. Emergence and Dollar Strength**
Since mid-June, the price of oil has dropped more than 40%, its largest drawdown since 2008. With the exception of the financial crisis, what’s the main difference this time around? We’ve talked in the past about the energy boom taking place in the United States. Shale fracking has boosted production to its highest levels in decades and the U.S. has accounted for almost all of the recent growth in global oil supply (see chart below). If the trends continue, the U.S. is on a path to becoming a net exporter of oil and hence being less energy dependent on the rest of the world.

Another factor that has negatively impacted oil prices and commodity prices more generally has been the rise in the value of the U.S. dollar vs. other currencies. The dollar’s rally is reflective of not just an improving U.S. economy but also weaker economies in the Eurozone and Japan and the monetary policies in place in these countries which are having the effect of currency depreciation. This is relevant because most commodities are priced in U.S. dollars and tend to move inversely to the dollar.

![Oil Production by Country](chart.png)

Weaker currencies should in turn help boost the exports of these countries. The Eurozone and Japan are both trying to battle deflationary risks and an easy monetary environment should be beneficial for its economies. The U.S. dollar will likely remain strong, but any stabilization of the U.S. dollar could help the performance of commodities.

**Supply, Demand, and Mind Games**
The Organization of the Petroleum Exporting Countries (OPEC) is an intergovernmental organization of 12 oil-exporting developing nations that aims to unify petroleum policies among its member countries.
This group, which is led by Saudi Arabia, accounts for roughly a third of global oil production. OPEC recently decided to maintain output at 30 million barrels per day, which caused crude oil prices and energy-related equities to slump.

OPEC’s decision is a little controversial even within the group as certain members wanted to cut overall production to support prices. For many of these members, oil revenue represents a sizable share of government budgets, so there’s a lot at stake. There is also a view that the decision is a tactic to drive down the price of oil so that it makes it uneconomic for the U.S. to continue producing and therefore, force a cut in U.S. production. However, you also have to keep in mind that it’s not just price, but also the cost to produce that’s important. Advanced technology or techniques such as fracking has brought down the cost of production for oil in the U.S., which can also vary across the country.

Slowing demand for oil is also playing a part in the decline in oil prices. For example, one of the largest importers of oil, China, is experiencing tepid growth and the same can be said for most of Europe and Japan. Depressed prices could eventually force supply to come down and demand to increase, enabling that demand/supply dynamic to improve over time.

The Potential Winners
Countries that are net oil importers (most European countries, Japan, China) should benefit from lower oil prices. It can be an indirect stimulus to these economies, although each has underlying economic issues that will need to be addressed further. For the U.S. consumer, the decline in gasoline prices is almost equivalent to a tax cut. In the near term, it’s more money in the pockets for consumers and can result in more savings and potentially more spending. Lower fuel costs are a positive because as the more people travel, the more people stay at hotels, and the more people go out to restaurants, etc. Overall, it can be beneficial to the U.S. economy.

Investment Portfolios
We’ve illustrated what has driven oil prices lower, but what could possibly reverse this trend? Global economic growth could pick up, there could be a geopolitical crisis in the Middle East, or simply, the oil demand and supply dynamic improves. Any of these factors could cause oil prices to stabilize or increase.

Generally speaking from a portfolio perspective, real assets like commodities and natural resources are intended to provide diversification and inflation protection. Despite the recent weakness in commodities and natural resources, we still view the asset class, real assets, as an important part of a multi-asset class portfolio. This allocation may vary over time depending on where we see opportunities. Under the perfect scenario, every holding in your portfolio will do well. However, that’s rarely the case as we live in and invest in, a very dynamic world. We think a common goal for individual portfolios should be to participate in the market while at the same time seeking to protect the portfolio, at least, partly through diversification. This is especially true when certain sector or regional investments go in one direction while the rest of the portfolio goes in another.

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