Week in Review

Friday, March 4th, 2022

1. Oil Prices Rise as Global Supply Tightens

Low inventories and disruption of Russian exports pushed the price for U.S. West Texas Intermediate crude (WTI) to its highest level since 2008 and the global benchmark, Brent crude, to its highest level since 2012.

Crude Oil Spot Price – YTD 2022

Source: Yahoo Finance

Low inventories in the U.S. have been the underlying driver of higher U.S. oil prices over the past six months. The low inventories have been driven by higher demand due to strong economic growth and low production growth. Low production growth is a result of a several-year period of curtailed oil investment as a result of low oil prices and pressure on the industry to decrease the investment required to hold and grow production. Currently, U.S. oil inventories are at the lowest level since 2018 and the U.S. strategic reserves have dropped to their lowest level in nearly 20 years.

In the past week, dramatic price gains followed the Ukrainian invasion by Russia. Sanctions, which so far have only targeted Russia's oil refining sector, are feared to escalate and include Russian oil and gas exports being targeted next. However, even without specific sanctions, distribution is being disrupted as some buyers and shippers are backing away from Russian products.

In terms of replacing the lost Russian oil, there has not been an immediate response. Despite the growing supply crisis, the Organization of the Petroleum Exporting Countries (OPEC) decided to maintain the current pace of output increases in March. Iran supply is another possibility, but a deal has yet to materialize as well. In any case, an already undersupplied global market has been made tighter, at least in the short term, rapidly escalating prices.

However, the current price spike may be somewhat elevated relative to the longer-term price. Currently, the forward price out six months is in what is known as backwardation, being significantly lower ($20) than the spot price.

December Contract Oil Price

Source: Yahoo Finance

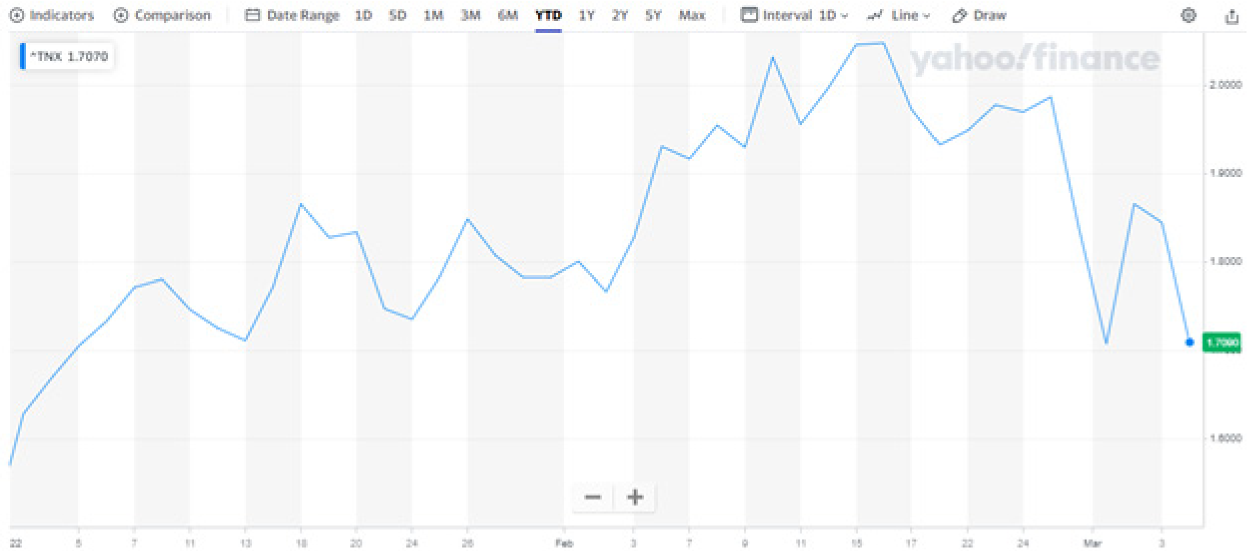
In any event, oil prices are likely to remain elevated and contribute to ongoing inflationary pressures. The willingness and ability of consumers to absorb the additional costs will have an impact on the trajectory of economic growth. Higher oil prices have been associated with higher levels of inflation and lower economic growth in the past. This effect was particularly pronounced in the oil embargoes of the early 1970s. Currently, energy expenditures comprise about 5% of U.S. consumers spending which is well below the near 10% of the early 1970s. Potentially the consumer is better positioned to weather the current increases in oil prices.

2. Hawkish Monetary Policy is Mitigated

Federal Reserve Chairman Powell spoke on Wednesday of this week and laid out a map for changes in monetary policy. Among the key announcements was that the first-rate hike to take place later in March would be 25 basis points. The support for the rate hike is data that continues to show high inflation, strong economic demand, and a tight labor market offset by uncertainty catalyzed by the Ukrainian conflict.

The impact on the 10-year Treasury has been a pullback from its recent highs in mid-February to the level seen at the beginning of the year prior to the escalation of tightening expectations. The reversion is likely a result of fewer expected rate increases as well as concerns about the medium-term economic growth trajectory, given the heightened level of uncertainty from geopolitics and higher commodity prices.

U.S. 10-Year Treasury Yield – Year-To-Date 2022

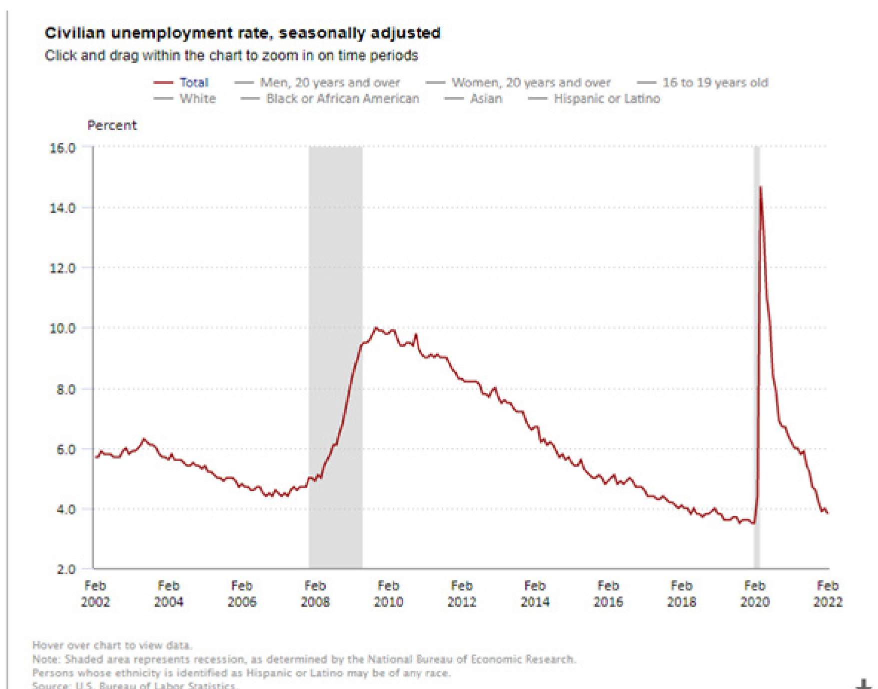


Source: Yahoo Finance

Looking further forward, Chairman Powell suggested a more moderate tightening of policy than the more hawkish view that had been building in 2022. The current expectation is that rate increases will continue at a measured pace of 25 basis points over an extended period rather than being front-end loaded.

3. Latest Job Report very Strong

The U.S. economy added 678,000 jobs in February. The monthly addition of jobs was the highest since July 2021 and well above the 423,000 level of expectations. The data supports that the underlying labor market remains very strong and has seen the unemployment rate reach 3.8%, which is the lowest level since February 2020 before the pandemic impacted the U.S. economy.



The labor market also saw an increase in the participation rate signaling more individuals were returning to the workplace. The breadth of employment gains was also broad and led by health and education service adding 223,000 jobs and leisure and hospitality adding 179,000 jobs. These industry additions support the continued strengthening of the services sector as the Omicron variant passes and service business activity furthers its extended reopening.

The continuing strength in the labor market continues to provide support for the Federal Reserve to raise interest rates to combat inflation. Positive job growth strength also provides support that the U.S. economy is on solid footing in a period where uncertainty has increased due to geopolitical events.

Thinking Ahead

A week after the Russian invasion of Ukraine, the world appears to brace itself for a more uncertain and protracted conflict. Most directly, the conflict is exacerbating an already low global inventory for energy with concerns this could put further pressure on inflation and ultimately lower economic growth. For the time being, the U.S. economy, as supported by strong employment data, appears on solid footing and the Federal Reserve appears more moderate in its task to slow inflation and growth via tighter monetary policy. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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