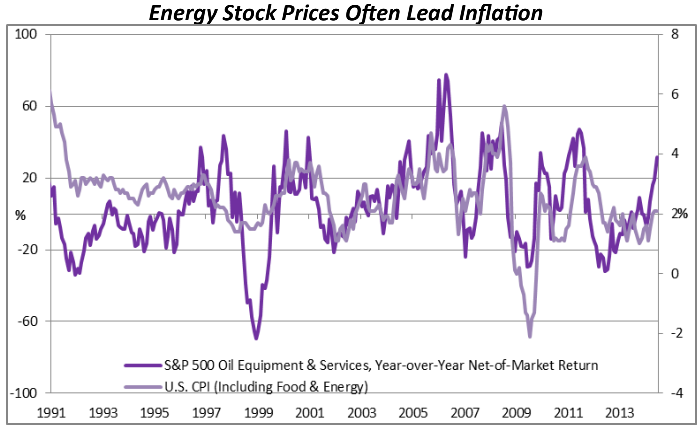
Matarin Capital Management aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients

Greasing the Wheels of Inflation

With geopolitical risk on the rise in some oil-producing regions of late, from Russia to Iraq, we have witnessed increases in oil prices and related securities. Questions should begin to arise regarding the potential economic impact of these moves. After all, rising oil prices are an indirect tax on the consumer, and more subtly they dampen the economy by placing potential upward pressure on inflation. In the United States, rising inflation is already a growing concern with the most recent monthly CPI report coming in at 2.1%, slightly above the Federal Reserve's long-term target (PCE, which is the Fed's preferred measure is still below 2% but rising). How much of an additional concern should developments in the energy market pose to this already escalating inflation outlook, and how can investors protect themselves?

At Matarin, we have a long history of developing inflation forecasts, in which changing energy prices have played a part. Interestingly, we have found that changes in the stock prices of energy companies are a better measure than changes in crude oil (or other) spot prices in assessing expectations about the future economic impact of energy prices. Stock prices tend to reflect forward looking expectations, while spot prices only reflect the current reality. Thus, for example, leading into Operation Desert Storm in Iraq in 1990-91, crude oil spot prices, which had been trading in the low teens, spiked by over $20 from trough to peak. But stock prices of energy companies, on the other hand, were much calmer by comparison due to the expectation that dislocations in oil markets from the operation in Iraq would be relatively short-lived with a quick victory in Desert Storm. This did indeed turn out to be the case. The conflict ended quickly and the short-term spike in energy prices did not lead to excessive inflation. Thus far in 2014 by contrast, we have seen crude oil spot prices moving upward somewhat – by around 4% for both US WTI and LME Brent during Q2 2014 – but energy company stock prices have moved up by quite a bit more. Energy stocks made up the top performing sector in the second quarter, returning over 11%, suggesting that expectations for future oil price moves may be quite a bit higher than the current reality that's reflected in spot prices.

Energy Stock Prices Often Lead Inflation



Data as of June 30, 2014 Source: Bloomberg

From a macro perspective, increasing oil price expectations, which are reflected most clearly in oil stock prices, will tend to increase Matarin's inflation outlook and dampen our outlook for broad stock markets (rising inflation would likely force central banks to tighten monetary policy sooner than they otherwise would have to, which would create a headwind for stock markets). Investors may consider managing this potential inflation risk by directly managing their exposures to changes in oil prices. For example, at Matarin we utilize the Northfield U.S. Single Country Risk Model to help us manage this risk and others in our equity portfolios. One of the risk factors in this model quantifies each stock's past relationship (beta) to changes in oil prices. By monitoring and controlling the risk in our portfolios relative to this factor, we can ensure that we are not overly exposed to changing oil prices. It is consistent with intuition that going back to 1994, the sub-industries with the highest "oil price betas" are Oil & Gas Drilling and Oil & Gas Equipment and Services, and that the sub-industry with the most negative oil price beta is Airlines. Thus the former may provide a good hedge to rising energy prices, and the latter could leave investors in the lurch if geopolitical risk remains elevated and oil prices continue to rise. However, it is important to note that not all energy stocks will respond to rising oil prices in the same way. Some are more exposed to natural gas than crude oil, some are more focused outside the U.S. and as such may be exposed to geopolitical tensions, and some industries within the energy sector are more exposed to changing oil prices than others.

For companies in the Energy sector, operations are often broken down into two categories—upstream and downstream. Upstream activities are focused around exploration and production, while downstream activities include refining and distribution of refined products. Upstream companies tend to be heavily sensitive to the risk of changes in oil prices. Higher oil prices typically lead to more exploration, drilling, production, and higher profits for these companies. On the other hand, profits for downstream operators are less affected, or even negatively impacted by rising oil prices. For example oil refiners may be hurt by higher crude oil prices, as they may not be able pass to their increased costs onto consumers (and thus protect favorable profit margins) if people respond to higher gas prices by driving less. Lastly, because the larger, more integrated companies (like Exxon Mobil (XOM) and Chevron (CVX)) have operations spanning from upstream to downstream, often their business bottom lines can be mixed. For example, in periods of rising crude oil prices, an integrated company may actually have lower profit margins than a non-integrated rival as a result of having greater downstream than upstream capability, or vice-versa.

Should geopolitical tensions in oil-producing regions continue to escalate, this could lead to continued increases in the price of oil and to the continued outperformance of higher oil-beta stocks. We would expect this to be most beneficial for U.S.-focused companies with minimal overseas exposure. Therefore, U.S.-centric upstream companies can in some ways be thought of both as a hedge against rising geopolitical risk and as a hedge against inflation. An example of such a name which we like at Matarin is Basic Energy Services (BAS). Basic Energy is a beneficiary of increased drilling and exploration activity; they drill, service oil wells, provide fluid services, and provide completion and remedial services. They derive all of their revenue from the U.S. and roughly 70% of revenue comes from oil (as opposed to natural gas). The stock's price has appreciated over 85% during 2014, which suggests to us that the market may already be anticipating a protracted period of higher oil prices and the associated benefits that will flow to this