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Stock Rally Slips, Falls as Oil Surges

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Just when it looked like nothing could stop the stock market's surprising rally, oil is fueling worries that last week's 2.1% decline by the Dow Jones Industrial Average might be a sign of more trouble to come.

Unrest in the Middle East and North Africa pushed up crude-oil prices by as much as 15% last week, while the Dow piled up losses of more than 400 points by Thursday. On Friday, crude-oil futures steadied and stocks staged a modest rebound, but still the Dow suffered its worst week since early August.

For stock investors, the big concern now isn't that oil costs around $100 a barrel. Many forecasters had seen triple digits coming for months. The surprise is that the jolt came so swiftly, echoing major flare-ups in the Middle East such as the Arab oil embargo of 1973 and the outbreak of two Iraq wars.

Last week was just the seventh time since 1982 that oil prices have jumped 10% within two days. And history shows that what happens next isn't pretty: The typical result for the six months after an oil-price shock like last week's is an average decline of 9.3% by the Standard & Poor's 500-stock index, according to an analysis by Cleve Rueckert, senior equity strategist at Birinyi Associates in Stamford, Conn.

Paul Zemsky, head of asset allocation for ING Investment Management, says, "This is just not the right time for this to be happening, given the fragility of the recovery." Even though some of the worst fears eased Friday after major oil-producing nations said plentiful supplies can replace lost output from Libya, widening strife "is the catalyst and reason to get that pullback [in stocks] that everyone's been waiting for," he says.

Mr. Zemsky predicts surging oil prices could drag the S&P 500 as low as 1200, or an 11% comedown from the index's two-year high of 1343.01 on Feb. 18. On Friday, the index closed at 1319.88.

Bernard Baumohl, chief global economist at Economic Outlook Group in Princeton, N.J., last week cut his year-end forecast for the Dow by 3% to 12677, citing higher crude-oil prices. On Friday it closed at 12130.45. He now expects the S&P 500 to finish 2011 at 1409. That projection is 5% lower than his previous target.

Mr. Baumohl, who warned clients "to move into cash for the time being and lock in these gains until the dust settles," says the crisis in the Middle East and North Africa is a jarring "reality check" to stock-market bulls like him.

"Every one of these countries faces a different situation, but they're all critical. It's a migraine trying to figure this part of the world," he says. "I don't recall another time when there's been this much uncertainty about where the economy and financial markets are headed over the next year or two."

Some investors and market watchers aren't so rattled, noting that stocks have kept rocketing higher over the past two years despite all sorts of forces that could have dragged the market back to earth: a persistent reluctance by U.S. companies to rev up hiring, deepening public-sector debt and geopolitical hot spots from North Korea to Iran.

Kate Warne, market strategist for brokerage firm Edward Jones in St. Louis, concedes that $100-a-barrel oil "clearly is an important psychological level," but says investors are overreacting. "We see this as a buying opportunity, and the reason is the longer-term fundamentals, which are that global economic growth remains in place."

James Bristow, London-based portfolio manager for asset manager

BlackRock's global equities team, expects the stock market to eventually shrug off the oil scare just as it did last spring's sovereign-debt crisis in Europe.

"We got past that worry," Mr. Bristow says. He has been adding to positions in sectors and markets that were battered by inflation fears, such as Brazilian stocks. "My broad macro view is unchanged. It's absolutely stay the course.

The "What, me worry?" case is bolstered by another look at the past. According to Birinyi, oil prices have jumped at least 20% a total of 31 times since 1982, sometimes in a blur and other times over slightly more than two years. The S&P 500 rose in 17 of those 31 instances, with an average gain of 5.2% over the same time span as oil was rising. The best performers: energy and technology stocks, up by a respective 15% and 10% on average.

That pattern held for most of 2009 and 2010, with oil and stocks ticking higher and higher because many investors saw them as proxies for an economic recovery. Like a feedback loop, rising stocks were a sign of growing demand for energy, pushing up oil, which pushed up stocks.

Last week, though, the 30-day correlation between crude oil and the S&P 500 fell to negative 17%, its most deeply negative level since the doom and gloom of September 2008. The sudden reversal shows how much some investors are spooked by the recent political chaos and oil-production threats. Investors also are having an increasingly hard time ignoring a lesson from Economics 101: Higher oil prices spell inflation and lower consumer spending.

Gina Martin Adams, senior analyst at Wells Fargo Securities, argues that current oil prices are pushing U.S. consumption to a "tipping point," with food and energy spending now accounting for 12.5% of U.S. disposable income. Spending dropped off sharply during the last economic cycle once food and energy spending rose to 13% of disposable income, she says.

She discourages putting money into consumer discretionary stocks, which are especially vulnerable to a falloff in consumption.