Oil Crushing Market; Beware the "Aggregation Bias"

Monday, 2:25 p.m. EST

The cruise along the Costa Rica and Panama coasts, ending with a trip through the Panama Canal was marvelous. The only downer was the crystal clear reception the ship received from one of the few channels available: CNBC. Let us step back to try to understand what is happening in the markets.

I estimate that anywhere from $2 to $3 trillion of capital is committed to the energy sector, broadly defined, including not only the wells and oil structures, but the pipelines, rail cars and other investment devoted to extracting and transporting this energy. This capital is designed for an oil price of $60 or higher, and now the price is less than half this level. Much of this capital, if prices do not improve, is substantially devalued, if not worthless. The US as a whole certainly gains from lower energy prices, but the adjustment costs to the recent price collapse are huge and unprecedented. Although millions of workers are involved in energy production, every American is involved in energy consumption. And the lower prices of energy will eventually boost firm profits and workers' income. We are in the process of experiencing the pain before the gain.

It is in Saudi Arabia's interest to wipe out as much of this new energy production as it can. Saudi costs of extracting crude are estimated to be $5 to $10 per barrel, so it knows that it can hold out longer than most others. By putting US frackers and other marginal producers out of business, Saudi will eventually achieve higher prices. Furthermore, the Saudis want to slow down the development of alternative energy sources and sharply lower crude prices will do just that. Many coal producers are at or close to bankruptcy and the development of solar energy and electric car production will inevitably slow.

This adjustment will cause much pain on the earnings front. We will get some significant write-downs from energy producers that will impact aggregate S&P earnings. But be aware of the "Aggregation Bias." The earnings from the energy sector will be negative this year. These negative earnings will be subtracted dollar for dollar from the earnings of the other nine positive earnings sectors when computing the overall P-E ratio. So the P-E ratio of the other nine sectors will be biased upward. One may feel that the valuation of energy stocks is too high or low, but outside the energy sector the P-E ratio of the market is about 16.3, right in line with post-war historical averages and far lower than the P-E based on aggregate earnings, which could move into the twenties.
