April 2022

CAPSTONE PACIFIC
INVESTMENT STRATEGIES INC

THE CAPSTONE QUARTERLY

Spring is in the air, the days are getting longer, and the markets are continuing their wild ride. In this newsletter, Bryce discusses the reason behind the high oil prices, and Casey provides some clarity on the hot topics in our news headlines these days.

BRYCE'S POINT OF VIEW

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Chief Investment Officer

War and Petrol

If you've driven anywhere in southern California in the last month, you've probably seen it. The sign on the side of the road. The one that makes your jaw drop. The one that makes you slam on the brakes and exclaim, "What on earth is going on?"

You know the sign I'm talking about. It reads:

Regular Unleaded…$6.25

Over the last few weeks, oil prices have risen at a historic rate. That has translated to a brutal price at your local pump, leaving motorists pulling their hair…and investors wondering how it will affect the economy. As you can imagine, I've gotten a lot of questions from clients about this over the past few weeks, and in this message, I'm going to answer them. So, grab your coffee, settle down in your favorite chair, and get comfy as we do a little Q&A on oil.

After all, with gas prices this high…you probably aren't going anywhere.

Q: Okay, Explain. Why are oil prices so high?

A: The quick and simple answer is due to the war in Ukraine. But let's dive a little deeper by first explaining how oil prices work.

The price of oil is largely determined by a triad of factors: Supply, demand, and speculation. As you probably know, the Law of Supply and Demand states that when the *supply* of oil decreases, but the *demand* for it does not, prices will go up.

Now, before Russia ever invaded Ukraine, the world's oil supply was already on the low side due to the pandemic. When the world went into lockdown back in 2020, both oil mining and oil refining ground to a relative halt. But along with this drop in supply was an even greater drop in demand. Before the pandemic, the global demand for crude oil was "normally around 100 million barrels a day."[1] Soon, it had dropped to somewhere between 65 and 80 million barrels.[1] This plunge in demand prompted an even greater plunge in price. (You may remember that at one point, oil prices were briefly *less* than zero!)

Lately though, oil prices have rebounded along with the overall economy. That's because *demand* has risen as more people are traveling and working. Supply, however? Not so much. The same countries and corporations that cut back on production are yet to ramp it up again. (More on this in a moment.)

So, oil prices were already poised to catch fire. Then Russia lit a match.

As of 2021, Russia was the world's third largest oil producing nation, accounting for 11% of the world's total supply.[2] But soon after Russian forces invaded Ukraine, multiple nations slapped a historic load of sanctions on the country. These sanctions caused the ruble, Russia's currency, to collapse. They also led to a shutdown of Russia's financial markets. So, whether you're a bank, a factory, a shipper, or any other type of company, doing *any* sort of business with Russia has become a dicey proposition, both politically and financially. To add more fuel to the fire, the United States has placed a ban on Russian oil, with other countries saying they may follow suit.

Which brings us to the third leg of our triad: Speculation.

Tracking the *how* and *why* of oil pricing is a notoriously tricky task. That's because supply and demand are only part of the equation. The *expectation* of *future* supply and demand has a major say, too. In this case, the expectation is that Russian oil – which comprises a huge part of the world's supply, remember – will be off the market. That means supply would drop significantly.

Because speculators expect oil to be less available – and thus more expensive – in the future, they are willing to pay *more* now for the right to buy it later. A *lot* more. This is why a single barrel of Brent crude – a type of petroleum that serves as the global benchmark for oil prices – topped over $130 a barrel in early March.[3] It's also why gasoline prices have risen to a national average of $4.24 a gallon.[4]

Q: Why do higher oil prices lead to higher gas prices?

A: This is more of a straightforward answer, so we'll cover it very quickly.

The price of gas is also determined by many factors. Supply and demand, obviously, but also taxes and transportation costs, to name a few. But the cost of crude oil makes up the largest portion of the price you pay at the pump. (AAA puts it around 55%.[5]) When oil prices rise, companies that *refine* it into gasoline must spend more. Seeking to recoup those costs, they then pass them along to customers at your local gas station.

Now, some bad news: Oil prices and gasoline prices don't move simultaneously. In fact, gas prices often lag oil prices by around three weeks. That means the price you see *now* is in response to oil prices from *February*. So, gas prices may well grow higher soon even if oil prices stabilize.

Q: What can the U.S. do about this?

A: In truth, not much. At least, not directly.

In reality, it doesn't matter who is in the White House or which party controls Congress. There's just not a lot the government can do to directly control prices…because the government does not control the means of production.

Removing the ban on importing Russian oil won't really have an impact, because the U.S. doesn't import much anyway. (Only around 8% of U.S. oil imports came from Russia in 2021.[6])

Second, simply "drilling more," which some people have called for, is something of a non-starter, too, at least in the short term. The United States is already the world's top oil producer and even if the U.S. started producing more oil, local supply has a minimal impact on local price. Also, oil producers, whether they be companies or countries, simply don't have much incentive to increase their output right now. Currently, higher oil prices *benefit* producers.

One interesting proposal that gained some traction on both sides of the political aisle is to declare a "gas tax holiday." Currently, the Federal gas tax is 18.4 cents per gallon, while the average *state* tax is near 31 cents.[7] It's an open question whether the benefits to suspending these taxes would get passed on to consumers. But this is certainly something to keep an eye on!

In the meantime, it's worth noting that oil prices, like oil itself, are *fluid*. The situation could change in the blink of an eye. For example, the last time prices were this high was in July 2008. Back then, gas peaked at an average of $4.16. [8] By November, however, prices had fallen almost 50%![8]

Q: So, what should we, as investors, do?

Did you know?

If you traded and sold any virtual currency last year (i.e., Bitcoin, Ethereum, etc.) you may have to recognize this on your taxes. The virtual currency is treated as property and therefore the general tax principles that are applicable to property transactions are applicable to your virtual currencies.

Your tax person will be able to guide you through all the rules, but you may have to pay taxes on any gains (profits) that you made from that sale.

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A: As you can see, oil prices are a complex subject. There are so many factors at play.

So, what are we going to do? We are going to keep following our investment strategy and you should concentrate on your long-term financial goals.

I hope you found this analysis interesting. I know high gas prices can be frustrating and bewildering. Hopefully, by understanding a bit more about what's going on, the situation will be easier to bear both mentally and emotionally. As always, please let me know if you have any questions or concerns. My team and I are always here to help!

CASEY'S CORNER

Casey Morris, CFP®

Tune Out the Noise

Imagine you're an elite athlete. Maybe it's March Madness, and you're about to shoot the game-winning free throw. The crowd is screaming in your ears. Opposing fans are taunting you with homemade signs and foam fingers. The opposing team is trash-talking. And, when you look at the faces of your teammates, you can see they are silently imploring you to succeed.

In short, there is a lot of noise and distraction, at the precise moment when what you really need is a little quiet. Nevertheless, that's the nature of the game. The question is, what are you going to do about it? Let it affect you…or tune it out?

Every few years, investors are confronted with our own "March Madness." A time when there's a lot of noise to contend with. We are going through just such a period right now. The markets have been volatile, the headlines have been scary, and it's extremely easy for investors to panic and abandon their game plan. That's especially true for folks who are nearing retirement. Because the noise may well increase over the next few weeks, I decided to preview some of the noise you're likely to hear this spring. That way, you can be mentally prepared for it – and like an elite athlete, tune it out entirely.

Let's look at some of the noise in our headlines these days. Since Bryce has already covered the topic of oil, let's start with:

Russia

Russia is the major storyline right now. Militarily, economically…and financially. The financial side doesn't get as much press, but it's certainly something Wall Street is keeping an eye on. You see, western sanctions have hit Russia hard. They've caused the value of the ruble – Russia's currency – to plummet. The Russian stock market has been closed for almost a month. And they've also contributed to the possibility of Russia defaulting on its debt.

Here's the situation in a nutshell. As of 2021, Russia owes around $490 billion in debt to foreign countries/companies/funds, etc.[9] Of that number, $20 billion is hard currency sovereign debt. (Debt that Russia must pay back in the creditor's own currency, like the dollar or Euro.) Of that number, $4.7 billion was due to be paid in both interest and principal this year.[9] The problem is that sanctions have frozen much of Russia's foreign currency reserves. That means Russia can't access the dollars and Euros it has in reserve to pay back these loans. Furthermore, trying to pay them back in rubles would trigger an automatic default.

For Russia, and Russia's creditors, this is definitely an issue. But for the average investor, it isn't something to lose sleep over. Most bond funds – other than some specialty emerging market funds – have little exposure to Russian debt. And even if Russia does default, which it has currently not yet done, there are other issues that affect us in the States to a far greater degree. Issues like…

Inflation (and Interest Rates)

Slowly but surely our economy has reopened from COVID-19. Unfortunately, while unemployment has dropped and consumer spending has risen, supply chains are still in recovery mode. That means the world's demand for goods and services has largely outpaced the world's supply. This has led to a general rise in price on everything from eggs to electricity. Economists have a name for this, of course. They call it inflation.

As you know, inflation has skyrocketed over the last year. Initially, the Federal Reserve, which is tasked with keeping prices stable, believed inflation to be temporary. So, they focused instead on stimulating the economy to end the recession and decrease unemployment.

In recent months, though, the Fed has been forced to concede that inflation isn't going away on its own. You see, the current low interest rates prompt more spending and borrowing while discouraging saving. Perfect for juicing the economy during a pandemic! Higher interest rates, on the other hand, encourage saving. This helps the economy cool off, thereby restraining inflation.

On March 17, the Fed raised interest rates for the first time since 2018. But the increase was small – just one-quarter of a percentage point.[10] That's because the Fed doesn't want to raise rates too high, too quickly and derail the economy. But this is merely the first in a series of planned increases, all culminating in a level near 2% by the end of the year.[10]

The Fed has also signaled that if the current plan isn't enough to bring inflation to heel, more aggressive steps may be necessary. Either way, be prepared for volatile days in the markets leading up to any rise in interest rates. Should this happen, though, remember that rising interest rates have been our expectation all along. Maybe look at refinancing your home sooner rather than later, if that was ever in your plans.

COVID-19

I know, I know. We're all ready to never hear the word "Covid" again. And with cases dropping dramatically over the past few weeks, there's hope that the worst is behind us. Nevertheless, as long as the virus continues to fester on some part of the planet, it must continue to factor into our thinking. As of this newsletter date, cases are skyrocketing again in China. Scientists have also reported the discovery of a new variant: BA.2, an offspring of the Omicron bug that hit us so hard in December and January. It's unknown what these twin developments mean for the rest of the world, but what we are watching for is how COVID continues to affect supply chains. As we've already covered, problems with supply are largely responsible for inflation, so a COVID resurgence is the last thing the global economy needs. The good news is the world is better prepared to deal with flareups due to the treatments we've developed and the lessons we've learned from previous variants. Hopefully, these lessons will help the economy continue to recover in the face of COVID rather than wilt under its onslaught. It's true: COVID remains an issue. Continued vigilance is required. But negative headlines don't necessarily mean the return of conditions like we saw in 2020 and 2021. The virus may be evolving, but we're evolving with it!

Over the next few weeks, you're going to hear a lot of noise from talking heads in the media. You'll see a lot of distractions when the daily headlines pop up on your phone. But, now you know what to prepare for. Now you know what to expect. Which means you can tune out all that noise. All these issues are important, but as an investor, it's not necessary to stress or overreact to them. We have a game plan in place for all of this. One set in place long before any of it ever happened. Please let us know if you have any questions or concerns. My team and I sift through the noise so you can tune it out, and we are always here for you. Now, go enjoy your Spring!

FINALLY…

For many taxpayers, it is now tax refund season! Because tax refunds come outside of a person's regular income, some people treat them like "free money" – extra spending money – when in fact it is your regular income that has been set aside. Some will think "Now I can buy that new iPad, or go away for the weekend!", and others will be more prudent and use the cash to pay down their debts or line their savings accounts.

As financial advisors, we don't have a problem with either of these answers because it is always good to save but it is equally as important to enjoy the money you've worked so hard to attain. Our philosophy is that money you've earned that isn't earmarked for expenses should always be put towards reaching your goals, so if one of your goals is to camp along the California coast then there's no harm in using your tax refund to go there. We also think it is a shame to waste your tax refund on a whim or to spend it for the sake of spending it. Consider this: pay down your debts, put it aside as an emergency fund, or invest it! It's not as exciting as a weekend in Vegas, but achieving a goal is always a bigger thrill than satisfying a whim.

Sincerely,

The Team at Capstone Pacific

P.S. If you ever run across anyone who could use our services or is unhappy with their current adviser's performance, we always appreciate it when you pass on our name.

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4 "National Average Gas Prices," (as of March 30, 2022). *AAA. https://gasprices.aaa.com/*

5 "How rising oil prices make gasoline more expensive," *Market Place,* March 7, 2022. https://www.marketplace.org/2022/03/07/how-rising-oil-prices-make-gasoline-more-expensive/

6 "Why Are Gasoline Prices So High?" *The Wall Street Journal,* March 9, 2022. https://www.wsj.com/articles/why-gas-prices-expensive- 11646767172

7 "How much tax do we pay on a gallon of gasoline?" *U.S. Energy Information Administration,* August 23, 2021. https://www.eia.gov/tools/faqs/faq.php?id=10&t=5

8 "U.S. All Grades All Formulations Retail Gasoline Prices," *U.S. Energy Information Administration,* March 7, 2022. https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=emm_epm0_pte_nus_dpg&f=m

9 "Russian debt default fears stalk bond markets," Financial Times, https://www.ft.com/content/3f53ad5e-17a3-432b-bf20-99e5256345dd

10 "Powell Says Fed Will Consider More Aggressive Interest Rate Increases," The Wall Street Journal, https://www.wsj.com/articles/powell-saysfed-will-consider-more-aggressive-interest-rate-increases-to-reduce-inflation-11647880218