Investors wonder what's next for oil
Sharp correction or higher prices?

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NEW YORK — Ask anyone on Wall Street what's been ailing the stock market lately, and they're likely to tell you, “It's oil, stupid!”

Ask those same investors when record-high oil prices, which have been flirting with $50 a barrel, will start to recede, and the answer is far less clear. And therein lies the biggest risk — and opportunity — facing investors.

The prices for oil and stocks have been moving in opposite directions for months. As oil prices have moved higher this summer, up roughly 30% since the end of June, blue chips in the Dow Jones industrial average have fallen more than 3% and the tech-rich Nasdaq composite has lost more than 10%.

Wall Street is now debating whether the trend of rising oil prices and falling, or stagnant, stock prices is nearing its end. Rising crude prices have been driven by speculation, geopolitical risks ranging from terrorism to Iraq, tight supply and strong global demand, especially from China.

Bulls argue that elevated oil prices are unsustainable and that a sharp downturn in the price of a barrel of crude, which closed at $47.86 Friday, down 84 cents, is inevitable. They agree with the Federal Reserve's assertion that higher energy prices are “transitory.”

“The price of oil is so stretched that at any moment we can get a sharp correction and stocks will skyrocket,” says Bruce Bittles, strategist at Robert W. Baird. Analysts say a terrorism premium ranging from $5 to $15 a barrel is baked into crude prices.

Friday's trading could be a harbinger. The three major U.S. stock indexes rallied amid a 1.7% drop in crude prices.

Still, there are signs that investors' obsession with oil has not run its course. While oil has emerged as the dominant “story,” just as Iraq did last year in the weeks leading up to war, it has yet to approach an extreme signaling a shift in market psychology, says behavioral finance expert Woody Dorsey.

Dorsey adds that periods of speculation, such as the tech stock mania in the 1990s, often last longer than people expect. That suggests oil prices could still spike higher. He stresses, however, when bubbles burst, prices drop sharply.

Another potential negative for stocks: The past three times oil prices doubled in a short period, the Standard & Poor's 500 went on to fall 30%, 15% and 46%, respectively, notes Sasha Kostadinov, research analyst at hedge fund Clarion Group. This time around, the S&P is down just 4% since oil prices jumped 100%. “If you do the math, you would expect further downside for stocks,” he says.