Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Europe Research Affiliate

MACROCOSM

The Stench of CrISIS

Wednesday, June 25, 2014

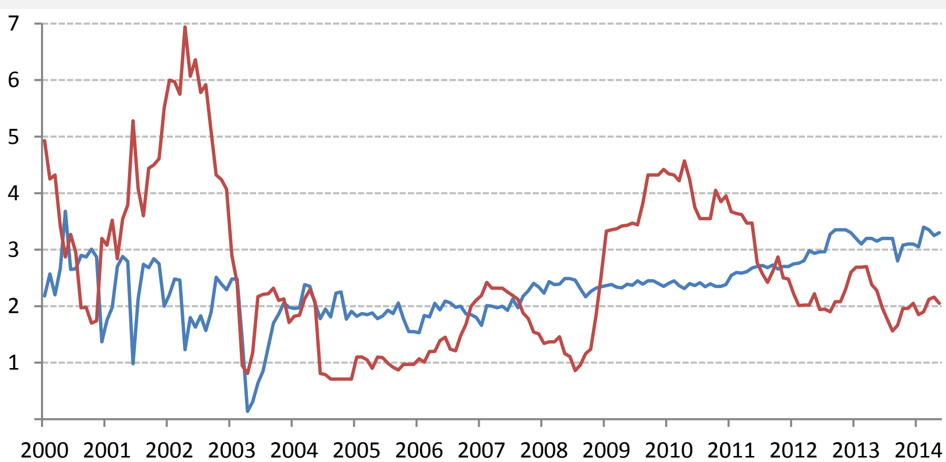
Donald Luskin

High oil prices are the hidden hand behind slow growth -- and the risk is going up.

Over the last year -- as our secular view that the crisis era is over has been rewarded with equity markets at all-time highs and volatility near all-time lows -- clients constantly ask us: *what can go wrong?* This is always a prudent question, but in some sense it reflects a lingering disbelief after the Great Recession that anything could possibly go right. Either way, our answer is always the same: *a geopolitical event that raises the price of oil.*

- *The invasion of western Iraq by ad-Dawlat al-Islāmīyah fī il-'Irāq wa-ash-Shām (ISIS) raises the specter of such an event.*
- The invasion of Iraq is the direct political consequence of America's bungling of last summer's Syria crisis (see "A Little Distant Gunfire" August 29, 2013). Ironically, the markets' non-reaction to that risk-event that really solidified our emerging view that the era of financial contagion had passed (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- The issue isn't so much the risk of a classic "oil shock." Losing a little production from Iraq is probably all we're talking about here -- assuming away the fat-tail risk of a broad regional political implosion. At least on paper, OPEC spare capacity could make up much of any likely shortfall (please see the chart below).

Iraq oil production **OPEC spare capacity**
Millions of barrels per day



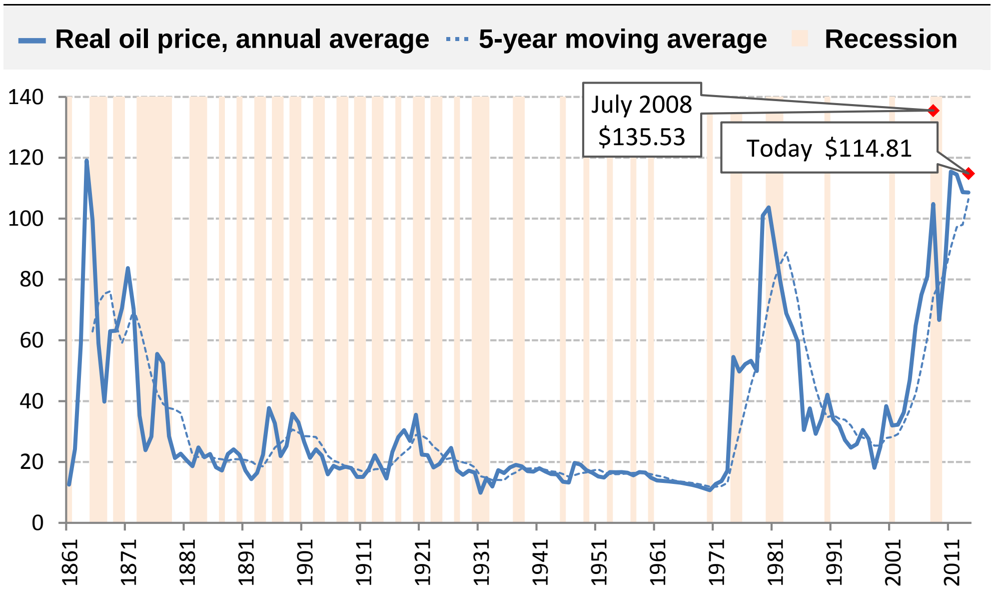
Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, OIL: The invasion of western Iraq by ISIS has driven oil prices higher, and shifted the share of US GDP spent on gasoline above the "red line" of 3%. Against what we see as a powerfully positive set of background conditions, if this persist or intensifies it will take the edge off the acceleration of growth we have been expecting. We have no reason to think this will devolve into a regional collapse that could drive a true oil shock -- but high oil prices have been a key explanator of the Not So Great Expansion following the Great Recession, and even modestly higher prices are an important drag, especially on housing. Like last year's Syria crisis, we expect this to pass. And over the intermediate term, the supply-side revolution in domestic energy production points to sharply lower prices, enabling an important growth acceleration.

[Strategy Dashboard home]

- But the risk here is that even a small rise in oil prices, if persistent, could derail the nascent acceleration in growth in developed economies.
- We think the Great Recession was triggered, in part, by the shock of all-time high oil prices in 2008. After that transient shock, the Not So Great Expansion has been held back by lingering high prices -- indeed, on a 5-year moving average basis, the real oil price *right here and right now* is the highest in history, and has been for the last four years (please see the chart below).



Source: BP, NBER, BLS, Bloomberg, TrendMacro calculations

- As high as oil prices have been over the last five years, they have been contained within a gently declining trading range ever since the assassination of Osama bin Laden in May 2011. We see that trading range as a "peace dividend" earned by being able to end the combat phase of the Global War Against Terror (see "The bin Laden Commodities Crash" May 6, 2011).
- While still high, at least oil prices haven't kept going up, so the economy has been able to absorb them without outright shock. To put it another way, energy prices have been stable enough for cumulative growth to render them a smaller and smaller part of the economy.
- As a rule of thumb, we think of US spending on gasoline at 3% of GDP as the "red line" -- to borrow a term from US Middle East diplomacy. Periods below 3% have been characterized by fast economic growth -- periods above have been slower (please see the chart on the following page).
- We've been flirting with the 3% "red line" throughout the Not So Great Expansion following the Great Recession. The rise in global oil prices as Middle East tensions have intensified this year has pushed us above it (again, please see the chart on the following page).
- The persistence over many decades of 3% as a pivot-point for US

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Agenda Research
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

Recommended Reading

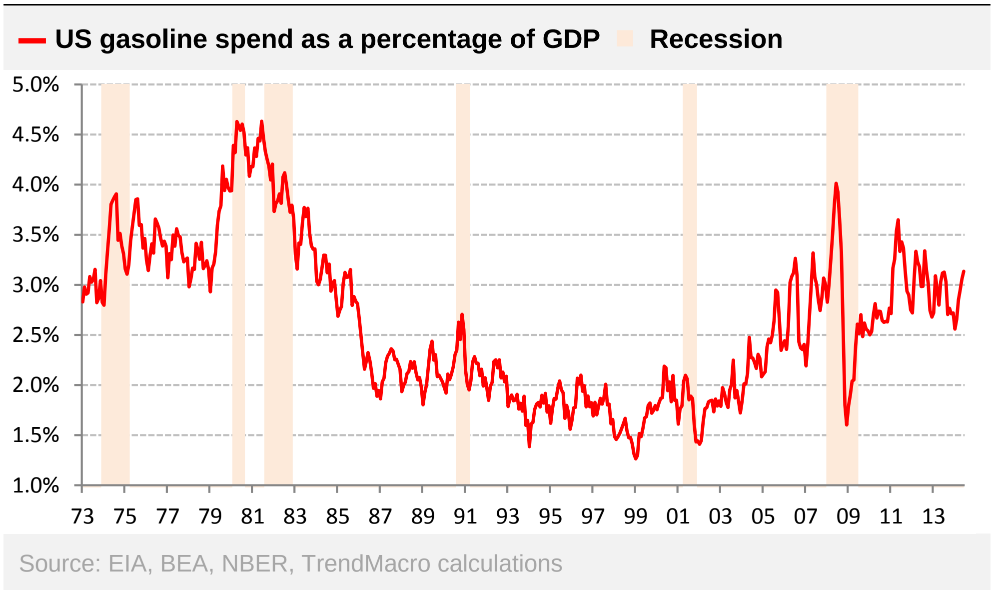
Energy and Economic Growth: The Stylized Facts
Zsuzsanna Csereklyei, Vienna University of Economics and Business
M. d. Mar Rubio Varas, Universidad Publica de Navarra
David I. Stern, Australian National University
April 12, 2014

Turmoil in Iraq Spells Trouble for Oil Markets
Gal Luft and Robert McFarlane
Wall Street Journal
June 24, 2014

Inside the vast liberal conspiracy
Kenneth P. Vogel
Politico
June 23, 2014

[Reading home]

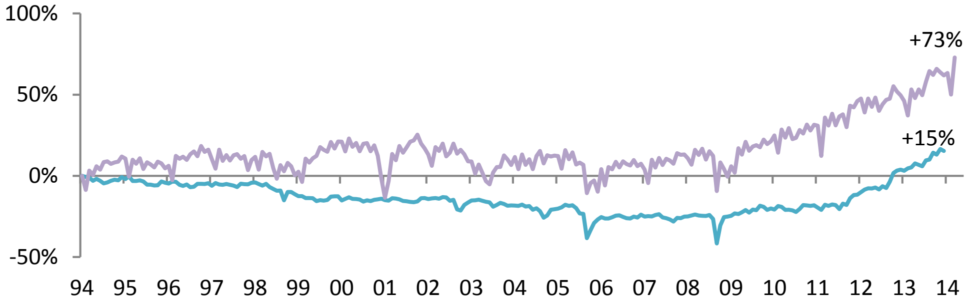
gasoline spending shows how, where the rubber really meets the road, the US economy has not in fact become more oil-efficient. Yes, in quantity terms, the US consumes only about 15% more crude oil than it did forty years ago. But in terms of *quantity times price as a share of output*, there really has been no net efficiency gain.



Source: EIA, BEA, NBER, TrendMacro calculations

- *So in an important sense growth today is as much a hostage to oil prices as it was at the worst moments of the Arab oil embargo and the Teheran hostage crisis, when there were lines a gas stations.*
- *Today we are at risk because of our failure to leave behind in Iraq a stable government capable of securing order in our absence. <u>If the worst case for the ISIS crisis comes to pass, the bungled Iraq exit may stand as the worst among the many anti-growth policy blunders of Barack Obama's presidency.</u>*
- Again, we see the worst case as only a fat-tail risk. Indeed, the present crisis may end up creating a more stable partitioning of Iraq, with the sensible Kurds in the north controlling significant oil resources. But in the meantime, higher oil prices are a barrier to the reacceleration of growth we've been expecting.
- *Oil prices are especially crucial to the US housing recovery.*
- *<u>Housing affordability is intimately tied up with the cost of commuting, especially over the long distances required between places of employment and new low-cost single-family homes that are, of necessity, located in remote suburbs and exurbs.</u>*
- Looking through the Iraq crisis, we can't fail to mention here that there has been a fundamental supply-side technology breakthrough in energy. Hydraulic fracturing and horizontal drilling, spurred on by entrepreneurial incentives put in place by high oil prices, have accelerated to the point where we have come to expect a breakout to the downside from oil's trading range, and a secular shift lower in prices (please see the chart on the following page).
- As producers acquire more experience with fracking -- it is still a very new technology -- its cost-effectiveness is improving rapidly. According to sources, the cost of drilling the marginal fracking well

US production, change from 1994 — Crude oil — Natural gas



Source: EIA, TrendMacro calculations

in North Dakota costs today only half what it did three years ago. That means the cost-effectiveness of fracking is improving at about half the rate of Moore's Law -- which is very fast indeed. Continued exponential improvement means that fracking will remain profitable even when the abundances it unleashes will lower oil prices considerably.

- This will be helped along when, as we continue to expect, the Republican party takes control of the US Senate is this November's mid-terms. We think it's highly likely that even without a filibuster-proof majority, and without control of the president's veto pen, meaningful moves toward deregulation in domestic energy production can be accomplished.
- So over the horizon, oil prices -- that is, *lower* oil prices, maybe *much lower* oil prices -- are a key part of our secular belief that growth can accelerate out of the stagnation of the last five difficult years following the Great Recession.
- In the meantime, the crisis in Iraq is an annoying counterpoint to an economic environment that we see as powerfully positive, hopefully of fairly small magnitude, and hopefully something that markets will be able to see across.

Bottom line

The invasion of western Iraq by ISIS has driven oil prices higher, and shifted the share of US GDP spent on gasoline above the "red line" of 3%. Against what we see as a powerfully positive set of background conditions, if this persist or intensifies it will take the edge off the acceleration of growth we have been expecting. We have no reason to think this will devolve into a regional collapse that could drive a true oil shock -- but high oil prices have been a key explanator of the Not So Great Expansion following the Great Recession, and even modestly higher prices are an important drag, especially on housing. Like last year's Syria crisis, we expect this to pass. And over the intermediate term, the supply-side revolution in domestic energy production points to sharply lower prices, enabling an important growth acceleration.