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MACROCOSM

Don't Let a Good Oil Crisis Go to Waste

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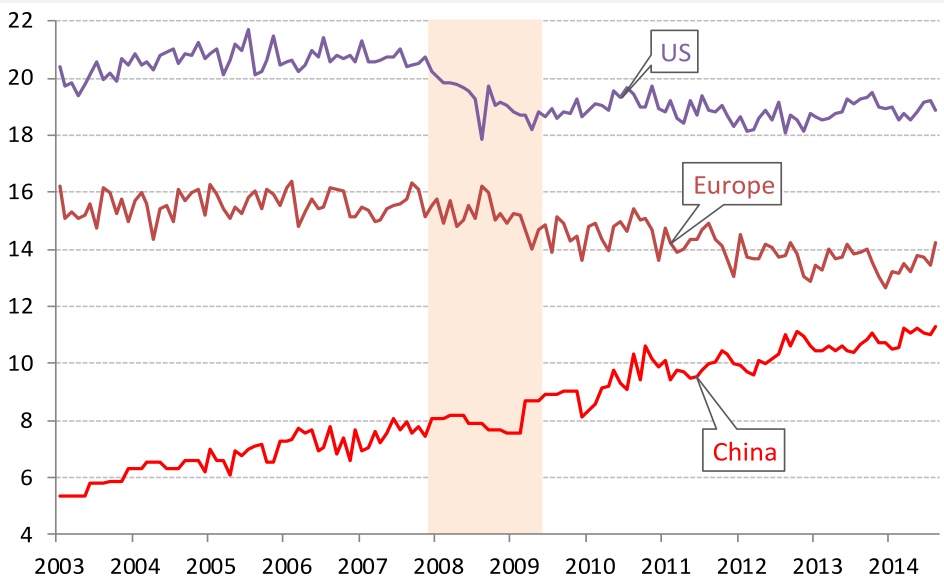
Low oil prices are a gift for the global economy, but there will be winners and losers.

We're in the midst of a "good oil crisis." The recent sharp drop in global oil prices has coincided with the sharpest correction in global equities in more than two years -- so the standard narrative is that oil is signaling a global slowdown. We don't think it's that simple, nor that pessimistic. *Indeed, we see sharply lower oil prices as a supply-side gift to the global economy, one that we've expected and awaited for several years* (see "Back in the Hot Zone" October 10, 2014). *But it's a crisis, too -- after so many years of high prices, this gift is a regime change that will produce a few losers along with the many winners, and therefore some degree of instability.* And as lower oil prices feed into the structure of consumer prices, there will be challenges for central banks obsessed with arresting deflation.

SUPPLY-SIDE OR DEMAND-SIDE? *The recent 25%-plus drop in crude oil prices over the last four months doesn't correspond to contemporaneous demand-side shocks.* China's consumption is at all-time highs, and US and European consumption are in the high ends of their ranges following the Great Recession (please see the chart below). For all

Oil consumption Millions of barrels per day **Recession**



Source: EIA, NBER, TrendMacro calculations

Update to strategic view

OIL, US MACRO, EUROPE MACRO, EMERGING MARKET MACRO, US STOCKS, US RESOURCE STOCKS, US FED: We're in a "good oil crisis" -- a sudden drop in crude prices driven by a US supply surge finally having overmatched sluggish global demand growth. This is important relief for the global economy, with the real oil price at all-time highs for four years. It's a demand-side tax cut, and a supply-side stimulant enabling the consumption of more energy. It's a special windfall for the US, the center of the supply surge, transforming import dynamics. Oil companies and producing nations are the losers -- forward EPS for the S&P 500 energy sector are already off almost 5% in just three weeks, alarmingly dragging down overall S&P 500 EPS. Financial pressures on over-leveraged oil companies and producing countries could create counterparty risk -- but those pressures will keep Russia from…

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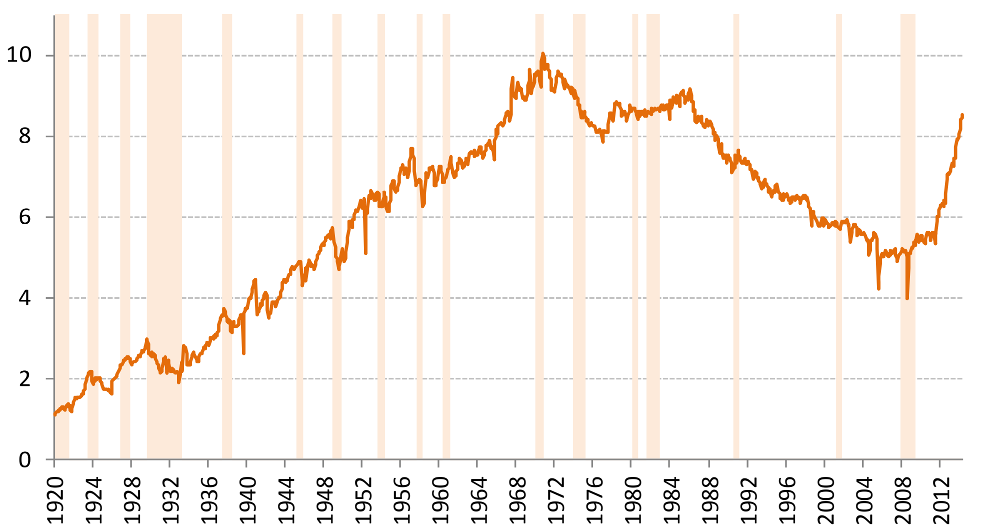
the talk about Europe and China slowing, it's not showing up in the oil consumption data.

What jumps off the page is that the global oil market is in the throes of a significant supply-side shock -- a very positive one. Over the last three years, US crude oil production has experienced its greatest surge in history thanks to widespread application of advanced technologies for horizontal drilling and staged hydraulic fracturing (please see the chart below).

US crude oil production Millions of barrels per day **Recession**



Source: EIA, NBER, TrendMacro calculations

- Tight markets like the oil market are subject to sudden discontinuities that occur at tipping points that are difficult to quantitatively anticipate as specific intersections of supply and demand functions.
- We think we have come through one of those tipping points.
- After five-plus years of mediocre global growth -- coinciding with three years of surging new supply -- the oil price has moved to a new and lower equilibrium.
- Soon enough lower prices will inspire more consumption, which will inspire faster growth, which will inspire more consumption, and so on -- until another equilibrium is reached at a higher oil price and with higher global output.

THE CONTEXT *The positive supply-side shock we are now experiencing really matters because it comes as a rescue after a decade of rising real crude oil prices, driven simultaneously by combat phase of the Global War Against Terror and the rise of China as an economic superpower.*

- We believe that record high oil prices in 2008 were as much a trigger for the Great Recession as the post-Lehman banking panic.
- In the aftermath, after a brief sharp drop, oil prices recovered and remained high -- on a 10-year moving average basis, adjusted for

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…cutting gas to Ukraine or Europe this winter. Falling crude prices since July 2008 explain all the deflation and most of the low inflation since the Great Recession. It hasn't been a monetary policy error, and central banks will err if they try to inflate away low oil prices. Next week's FOMC will not extend quantitative easing, but will assuage markets by acknowledging risks to growth and inflation, and preserving the "considerable time" language.

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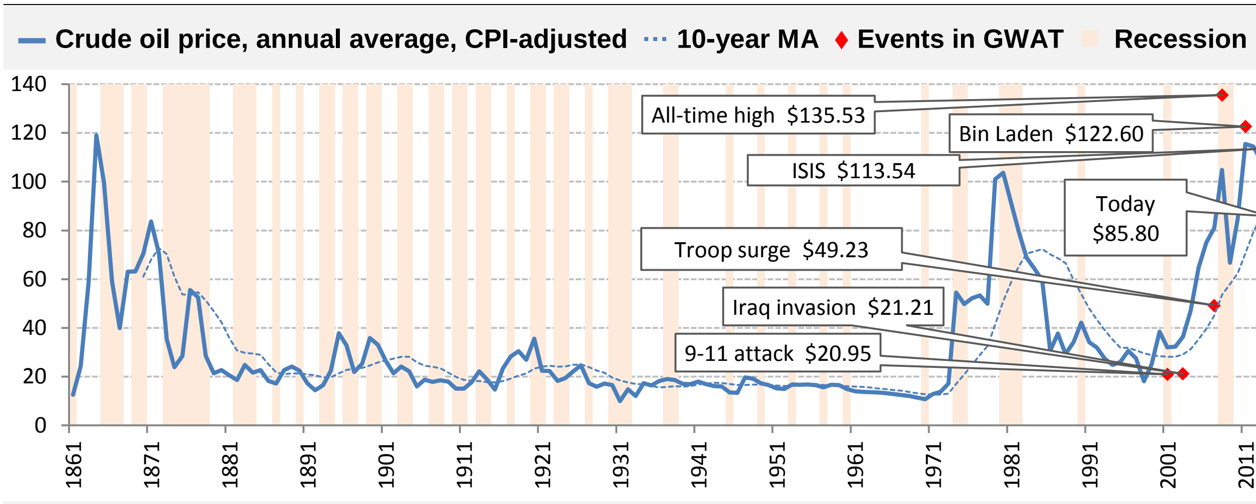
inflation, they have been the highest in history for the last four years (please see the chart below, and ["The Stench of CrISIS"](#) June 25, 2014).

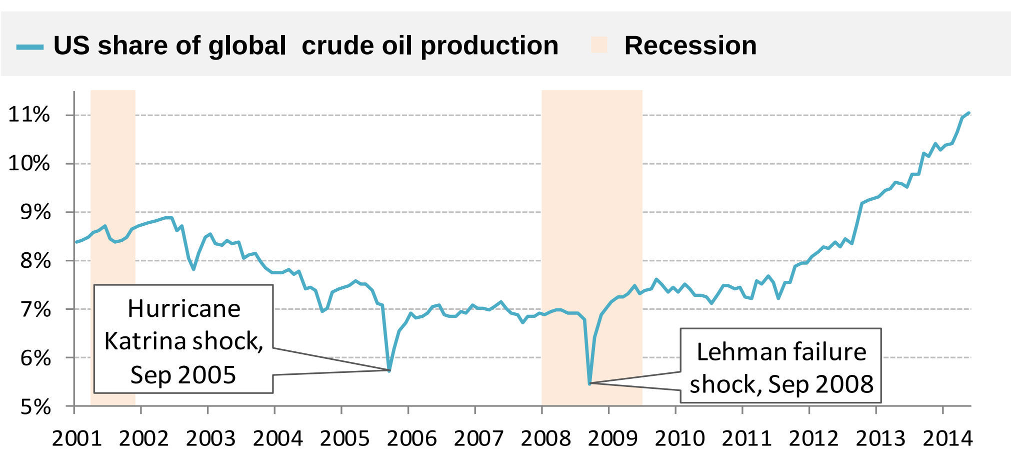
- Now, for the first time in a decade, the spot oil price is below the 10-year moving average (again, please see the chart below).



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

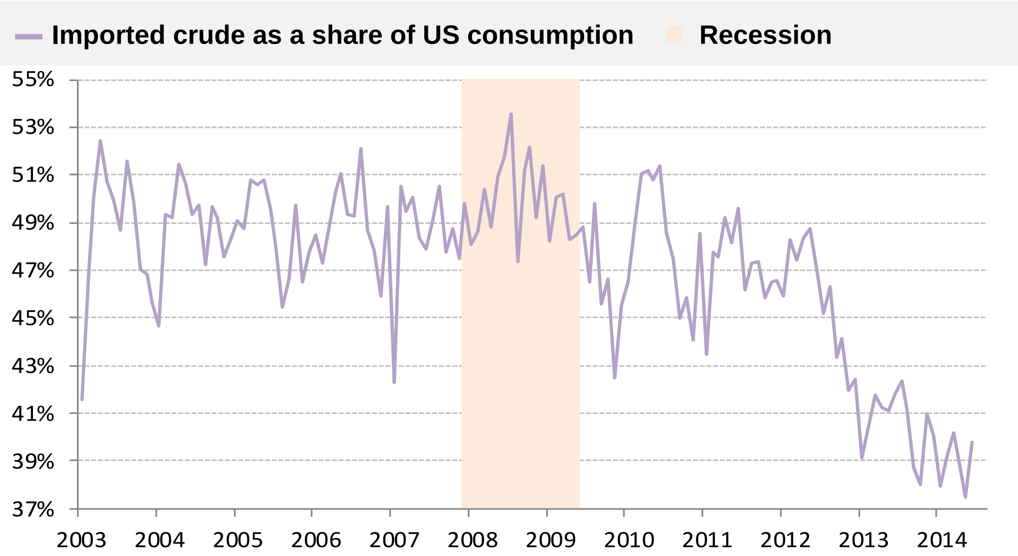
- There have been many theories explaining the slow global growth seen in the aftermath of the Great Recession. But surely record-high real oil prices are a key factor -- in fact, we think they're the elephant in the room, yet we rarely hear them cited.
- With that key factor significantly mitigated, there's an opportunity to enter a new and better economic environment beyond "global stagnation" -- beyond the Not So Great Expansion following the Great Recession.

THE EXCEPTIONAL POSITION OF THE US *The US economy stands to benefit disproportionately, because the US happens to be the point of origin of the supply-side shock that makes the gift possible*. That shock has increased the US share of global crude production by more than half, from 7% to 11%, in just three years (please see the chart below).



Source: EIA, NBER, TrendMacro calculations

- The US will get all the same advantages as any other economy from lower prices -- a demand-side tax cut that frees up marginal dollars for consumption of goods and services other than oil, and a supply-side tax cut that allows more growth-creating oil to be purchased for the same number of dollars.
- But the US will also get the advantage of the jobs, infrastructure, tax revenues, and -- most important, perhaps -- technological and managerial know-how that will flow from the domestic oil industry.
- Another view on the same dynamic is to see that a decreasing share of the US oil spend will leak outside the US economy. Thanks to the supply-side surge, the percentage of US crude consumption from imports has fallen from the high 40's to the low 30's, an improvement of 25% (please see the chart below).



Source: EIA, NBER, TrendMacro calculations

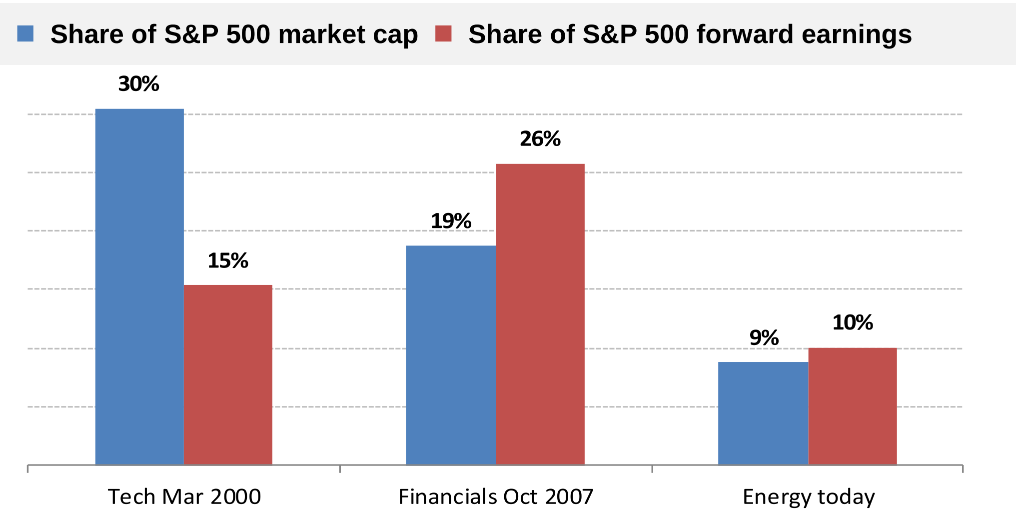
- While oil predominately trades in US dollars in global supply chains, we can't rule out that the recent sharp drop in crude prices has sensitized markets to this new import dynamic, and explains what is to us an otherwise somewhat inexplicable strengthening of the US currency (see "On the September Jobs Report" October 3, 2014").

WINNERS AND LOSERS *Obviously, while we've been describing a windfall for the global economy, oil companies and countries dependent on oil revenues are the losers here.*

- One of the equilibrating dynamics that limits how low oil prices can go is the cost of producing it with the new technologies of fracking. Exploration technology has gotten so good, dry holes are much rarer than they used to be -- and the cost of extraction has been collapsing at about half the speed of Moore's Law.
- Under present technology, fracking in Texas breaks even as low as $43 per barrel, and in North Dakota at $65.
- Ultimately, an increasingly technology-driven oil sector can be

profitable even when prices relentlessly fall, much as the semiconductor industry has learned to do.

- But within any short-term framework, and all else equal, it's axiomatic that profitability for conventional and unconventional drillers is squeezed when prices fall. So already the frackers are talking about reining in their capital plans, which have been going hell bent for leather for most of the past decade.
- *Within the US equity universe, lower profits for oil companies matters -- especially to us, because of the emphasis that we put on aggregate forward earnings both as a macro indicator and as a key input in our equity risk premium model.*
- S&P 500 forward earnings per share have been in decline for three weeks now. It's only 64 basis points -- made up of miniscule declines in most sectors explaining in aggregate about a quarter of it, and a huge 4.7% drop (in just three weeks!) in the energy sector, which explains three quarters of the overall decline.
- But as long-time clients know, we take this very seriously. The last two great bear markets -- the ones that began in March 2000 and October 2007 -- both began with stock market tops that coincided within days of what turned out to be the cyclical peak in forward earnings. In both cases it was a single sector -- tech in 2000, and financials in 2007 -- that triggered what eventually metastasized into a market-wide rout.
- We hate to use these words, but we think that this time it will be different. In 2000 and 2007, the respective trigger sectors had been in valuation bubbles, and represented large and disproportionate fractions of forward earnings and market cap -- none of that applies presently to the energy sector (please see the chart below).



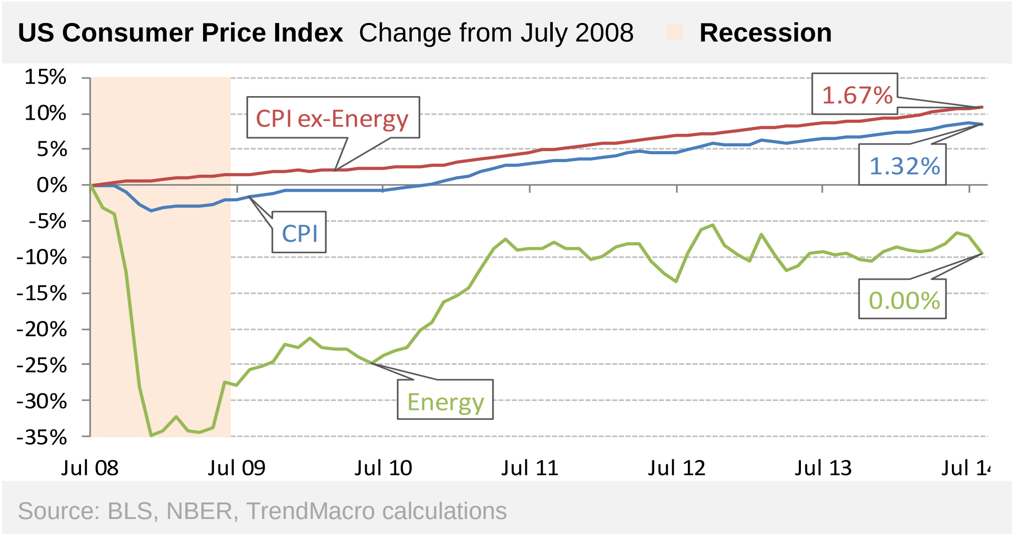
Source: Zacks, Bloomberg, TrendMacro calculations

- But more fundamentally, there's just no comparison between the negative externalities generated by the collapse of the dotcom and mortgage lending bubbles on the one hand, and the positive ones generated by a supply-driven drop in crude oil prices on the other. The former case produces nothing but cascading losses -- the latter, a windfall for all energy users, which is to say: everyone.

- Which users benefit the most from the windfall? We would argue that it is those companies and those countries who can make the best use of the marginal barrel of oil, of which they can now buy more. Energy-importing emerging economies such as China and India come to mind -- already, new Indian Prime Minister Narendra Modi has used the oil windfall to push through what would have otherwise been painful reforms in his nation's growth-suppressing system of energy controls and subsidies.
- To be sure, one negative externality is that over-leveraged oil companies (and oil producing countries) may come under financial stress, and transmit that stress to their stakeholders. In a post-crisis world grown soft from coddling by central banks and other rescuers of distressed entities, and ever on the lookout for financial contagion real or imagined, this could produce a couple of noisy scares in the coming months.
- Financial pressure on oil-producing countries will have at least one positive externality: it ought to sharply reduce the risk that Russian natural gas will fail to flow to Ukraine or to Europe this winter. Oil producers like Russia have little to do to mitigate their losses in the face of lower prices than to "make it up in volume" wherever they can. For all the talk about a triple-dip in Europe having been set in motion by the Ukraine crisis, lower oil prices will probably be the catalyst for resolving the crisis by applying pressure to Russia more intensely than sanctions ever could have.
- This will be especially good news for Germany, which has been the spear-point of Europe's negotiations with Russia -- and which through its export relationships and gas dependency, has had the most at risk.

THE CHALLENGE FOR CENTRAL BANKS *Falling oil prices are contributing to low inflation, indeed even outright deflation, in the face of the sharp drop of the last three months -- this is an entirely good thing, yet central banks risk interpreting it as a sign of too-tight policy, and over-reacting to it.*

- In this context, it's useful to step back and realize that while the drop in crude prices this last three months has been head-spinning, in fact prices have been falling since the all-time highs of July 2008.
- Shortly after that, when Lehman failed and the world banking crisis got underway, central banks mobilized to fight deflation with unconventional and vast new policy initiatives.
- *But the months of outright deflation in consumer price indices that registered in 2008 and 2009 is entirely explainable -- and the low inflation that has obtained ever since is significantly explainable -- by the drop in crude oil prices*.
- After the post-Lehman deflation, the Consumer Price Index price level didn't return to its July 2008 level for 27 months (please see the chart on the following page). And from July 2008 to now, the CPI has fallen month-over-month 18 times, including the most recent month (please see "Data Insights: Consumer Price Index" August 18, 2014). Its compound annual growth rate has been 1.32%, considered scary-low by central bankers everywhere,



supposedly threatening to un-anchor long-term inflation expectations (see ["'Whatever It Takes' Comes to Jackson Hole"]() August 25, 2014).

- Take out the energy component -- which has never returned to its July 2008 starting point, and has had a CAGR of negative 1.59% -- and CPI ex-Energy shows only two negative months, and a far less scary-low CAGR of 1.67%. That's not so far off the Fed's and the European Central bank's targets of below but near 2%.
- We are well aware that almost all major CPI categories have experienced lower-than-historical inflation since the Great Recession -- health care has been the only major exception. But energy has to bear at least some of the blame, because energy prices permeate almost everything -- air fares, and apartment rent for example -- and the official "ex-Energy" calculations are not very good at removing it.
- *Granting that the decline in oil prices since 2008 is the major factor explaining persistent low inflation, then why should central banks object? Why should they try to use inflationary monetary policy to effectively undo the benefits created by lower oil prices?*
- *And if they elect not to do so -- or try and fail -- should markets even care?*
- We would argue that the only reason why central banks should try to reflate in the face of falling oil prices is if the fall in prices was, itself, a malign consequence of too-tight monetary policy that needs to be reversed -- rather than an exogenous relative price change.
- Is there good evidence for that? We think not. The initial drop in oil prices after the peak in 2008 was the joint and simultaneous consequence of the demand-killing effects of a record price shock and the onset of a world banking crisis. After that, the oil price substantially recovered as the global economy did. Then it’s been generally declining for the last three years, since Osama bin Laden was assassinated -- ending the geopolitical threat of the combat phase of the Global War Against Terror (see ["The bin Laden Commodities Crash"]() May 6, 2011) -- and as the fracking revolution got traction.
- The only evidence that the fall in oil prices is a monetary

phenomenon would be to claim that, if monetary policy were sufficiently inflationary, then demand would be sufficiently greater to have more than absorbed the supply surge of the last three years. That seems to us like a vastly exaggerated conception of what central banks could possibly achieve.

- *We think the drag on the global economy has been that oil prices have been too high -- not there has been insufficient inflation to make them higher*.
- So now that oil prices are lower -- though still quite high by historical standards -- the last thing we need is for the Fed to bow to panicky impulses to continue quantitative easing, as was proposed last week by Saint Louis Fed President James Bullard -- he who had complained just two weeks earlier that rate hikes were "far behind the schedule." We see no serious chance of that happening.
- But after global markets' very negative reaction to the European Central Bank's October policy meeting, at which the new stimulus on offer was seen as too little and too slow (see "No Way ECB QE" October 1, 2014), next week's FOMC will probably have to at least make a least a gesture toward dampening the volatility. It will no doubt acknowledge recent threats to growth and a heightened risk of deflation. And it will probably once again fail to change the ambiguous "considerable time" language with respect to liftoff above the zero-bound for the funds rate, thus making plain the idea -- which should be obvious in any event -- that liftoff will require a sufficiently strong economic backdrop, one not yet quite achieved.

Bottom line

We're in a "good oil crisis" -- a sudden drop in crude prices driven by a US supply surge finally having overmatched sluggish global demand growth. This is important relief for the global economy, with the real oil price at all-time highs for four years. It's a demand-side tax cut, and a supply-side stimulant enabling the consumption of more energy. It's a special windfall for the US, the center of the supply surge, transforming import dynamics. Oil companies and producing nations are the losers -- forward EPS for the S&P 500 energy sector are already off almost 5% in just three weeks, alarmingly dragging down overall S&P 500 EPS. Financial pressures on over-leveraged oil companies and producing countries could create counterparty risk -- but those pressures will keep Russia from cutting gas to Ukraine or Europe this winter. Falling crude prices since July 2008 explain all the deflation and most of the low inflation since the Great Recession. It hasn't been a monetary policy error, and central banks will err if they try to inflate away low oil prices. Next week's FOMC will not extend quantitative easing, but will assuage markets by acknowledging risks to growth and inflation, and preserving the "considerable time" language.