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TRENDMACRO LIVE!

On Q4 2014 GDP

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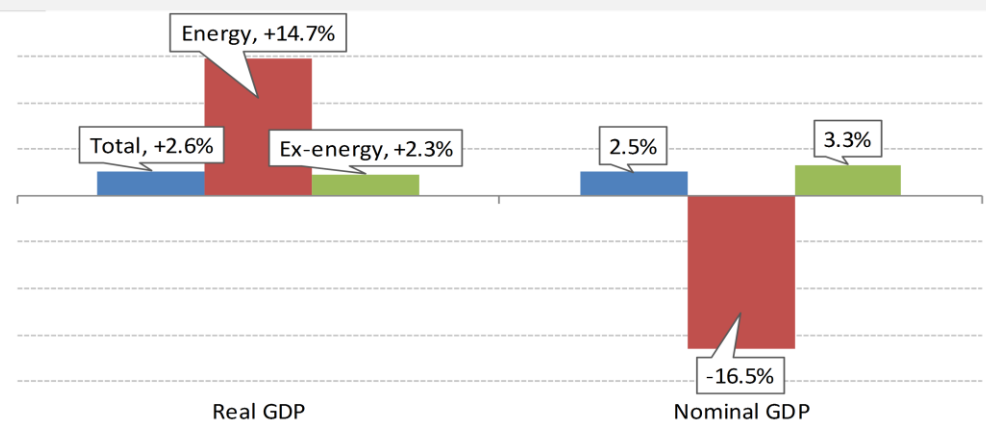
Donald Luskin

Oil is cheaper, we buy more. But pain in the energy sector leaks into the overall economy.

This morning's disappointing advance Q4 2014 Gross Domestic Product report was all about oil -- but not necessarily in the way you'd expect.

- You might think the 40% drop in oil prices in Q4 would be a deadweight loss to growth, because the value of energy goods and services produced in the economy would fall sharply. So you'd think that if you took energy out of the equation, GDP would be higher. Just the opposite is the case.
- The Bureau of Economic Analysis treats oil's price change as "deflation" and calculates it away. *Therefore without energy goods and services, instead of headline Q4 real GDP growth of 2.6%, it would be only 2.3%* (please see the chart below).
- *So taking energy out of the equation makes Q4 look even worse.*
- We think in this case that the drop in global oil prices is not "deflation" at all, but rather a change in productivity (see "The Deflation Hoax" January 8, 2015). So it makes more sense to look at Q4 in nominal terms. *That way, without energy goods and services, reported headline growth of 2.5% rises to 3.3%* (again, please see the chart below).
- *The good news: these numbers show that in Q4 people took advantage of low energy prices to buy more of it.* Indeed, in nominal terms energy goods and services declined at a 16.5%

Q4 sequential quarter change, with and without energy SAAR



Source: BEA, TrendMacro calculations

Update to strategic view

US MACRO, OIL, US STOCKS: Q4's disappointing real GDP growth is even worse if you back out energy goods and services. Cheaper energy made consumers buy more of it, adding to real growth. The drop in business fixed investment is probably oil-related, as is the decline in net exports -- because we imported more cheaper oil. The oil sector is in distress, and it is to some extent leaking into the whole economy. This can be seen in S&P 500 forward EPS where the energy sector has dragged down the whole, while non-energy sectors' growth has noticeably slowed. Q1 2015 will continue to be difficult, but we continue to expect a very strong rebound once consumers and investors gain confidence in and act upon the new regime of abundant oil.

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annual rate -- but adjusting away the price change, leaving only the quantity consumed, energy goods and services grew at a 14.7% rate.

All that said, even backing out energy goods and services, whether in real or nominal terms, the reality is that Q4 was a major slowdown from Q2 and Q3. Why?

- One reason is that simply subtracting the BEA's "energy goods and services" category doesn't really remove all energy sector effects from GDP.
- For example, the energy sector has been a major contributor to growth in business fixed investment, as the shale boom has driven purchases of equipment and structures. A sharp Q4 drop in business fixed investment -- possible mostly related to energy -- explains about 28% of the downshift in growth from Q3 to Q4.
- The other 6% is explained by the reported increase in petroluem imports. Here again, energy prices fell so we imported more of it.
- *So more than a third of the drop in real Q4 growth ex-energy is, in fact, explained by oil.*
- Another 40% is explained by a fall in federal government expenditures and fixed investment. We regard that as random noise for these purposes.
- *Those three factors -- business fixed investment, petroleum imports, and the federal government -- explain three quarters of the Q4 drop in growth.*
- Where's the remaining quarter? There's really no single explanator, though exports of goods fell noticably -- perhaps reflecting well-advertised difficulties in Europe and China.

For all that, looking at 2014 as an entire year, real growth of 2.4% makes it the best year since 2010 -- when despite just coming out of the worst of the Great Recession, and with an enormous government stimulus program kicking in, growth was 2.5%. Before that you have to go back to the the 2.6% growth of 2006 -- near the peak of the housing boom -- to find a better year.

- But we think the best is yet to come.
- That said, the first quarter of 2015 could be very difficult.
- The recent historic drop in oil prices will usher in an epochal leap forward for the global economy -- but first we'll have to get through significant short-term instabilities because of the depth and suddenness of this economic regime change (see, among many, "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014 and "2015: Oil Change for the Global Economy, US Edition" December 31, 2014).
- *In the short-run, the energy sector finds itself in the terrible situation of selling more of its product yet making less money.*
- Capital investment and employment in the oil sector will continue to contract to adapt to this reality. There could be near-term defaults in securities and institutions levered to high oil prices.

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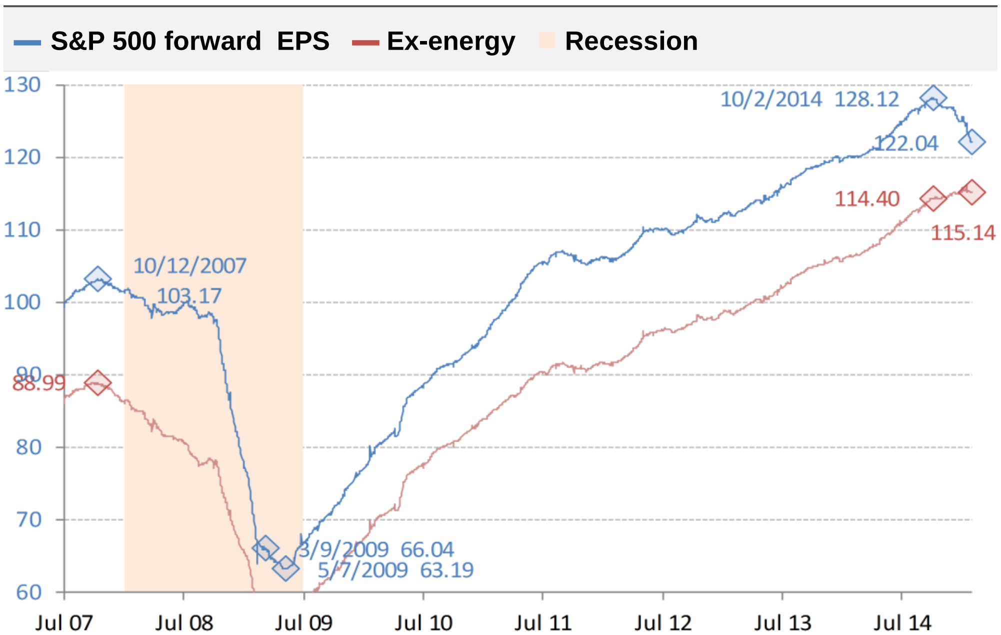
- *But it will take time for consumers and investors across the whole economy to first acquire confidence that the new oil abundance will be long-lived, and second to figure out what to do once they have that confidence, free from a decade of oil scarcity*.
- We're seeing all this play out while we endure a particularly choppy earnings season.
- Though earnings surprises have generally been positive across the board, there have been high-profile exceptions, and guidance has been disappointing in some cases -- especially in firms associated with energy and commodity development such as Caterpillar, and firms exposed to oil-related dollar strength such as Microsoft.
- *The chilling effect of all this is seen in S&P 500 forward earnings per share. They peaked on October 2 2014 at $128.12, and they've now fallen to $122.04 (please see the chart below). That sharp drop would normally signal to us that there's a recession in our very near future -- it's always happened that way in the past.*



Source: Bloomberg, NBER, TrendMacro calculations

- But on the face of it that drop is more than entirely explained away by a 63% drop in EPS in the energy sector. Indeed, ex-energy S&P 500 EPS are up $0.64 since October 2.
- *But it's not that simple. October 2 also marked a very obvious downshift in the growth rate of ex-energy EPS (again, please see the chart above). This shows that the economy ex-energy is, to some extent, inextricably joined to the energy sector -- think of Mercedes dealers in Houston.*
- *To be sure, soon enough there will be large net gains outside the energy sector -- and in the very long term, gains in the energy sector too, as is lowers its cost structure. But the pain comes first.*

Bottom line

Q4's disappointing real GDP growth is even worse if you back out energy goods and services. Cheaper energy made consumers buy more of it, adding to real growth. The drop in business fixed investment is probably oil-related, as is the decline in net exports -- because we imported more cheaper oil. The oil sector is in distress, and it is to some extent leaking into the whole economy. This can be seen in S&P 500 forward EPS where the energy sector has dragged down the whole, while non-energy sectors' growth has noticeably slowed. Q1 2015 will continue to be difficult, but we continue to expect a very strong rebound once consumers and investors gain confidence in and act upon the new regime of abundant oil.