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MACROCOSM

Another "Reverse Oil Shock"?

Tuesday, July 28, 2015
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Recession risk is back, but with some key differences versus the same threat in Q1.

Here we go again, facing the possibility of the first-ever recession caused by low oil prices, just as we did in Q1 (see "Houston, You're the Problem" March 9, 2015). But this time around, as oil prices test their Q1 lows, we're also seeing sharp drops in commodity prices overall. Obviously the headline culprit is China, with the consensus assuming that the so-called crash in the Shanghai Stock Exchange is a harbinger of a long-awaited "hard landing" that will crush global demand.

Commodities prices are still well within the context of the mother of all bull markets that began shortly after the terrorist attacks of September 11, 2001 (please see the chart below). That bull market peaked, as we

Update to strategic view

US STOCKS, EMERGING MARKETS STOCKS, EMERGING MARKETS MACRO, OIL, COMMODITIES, US RESOURCE STOCKS, FX: We suspect the risks of a China hard landing …

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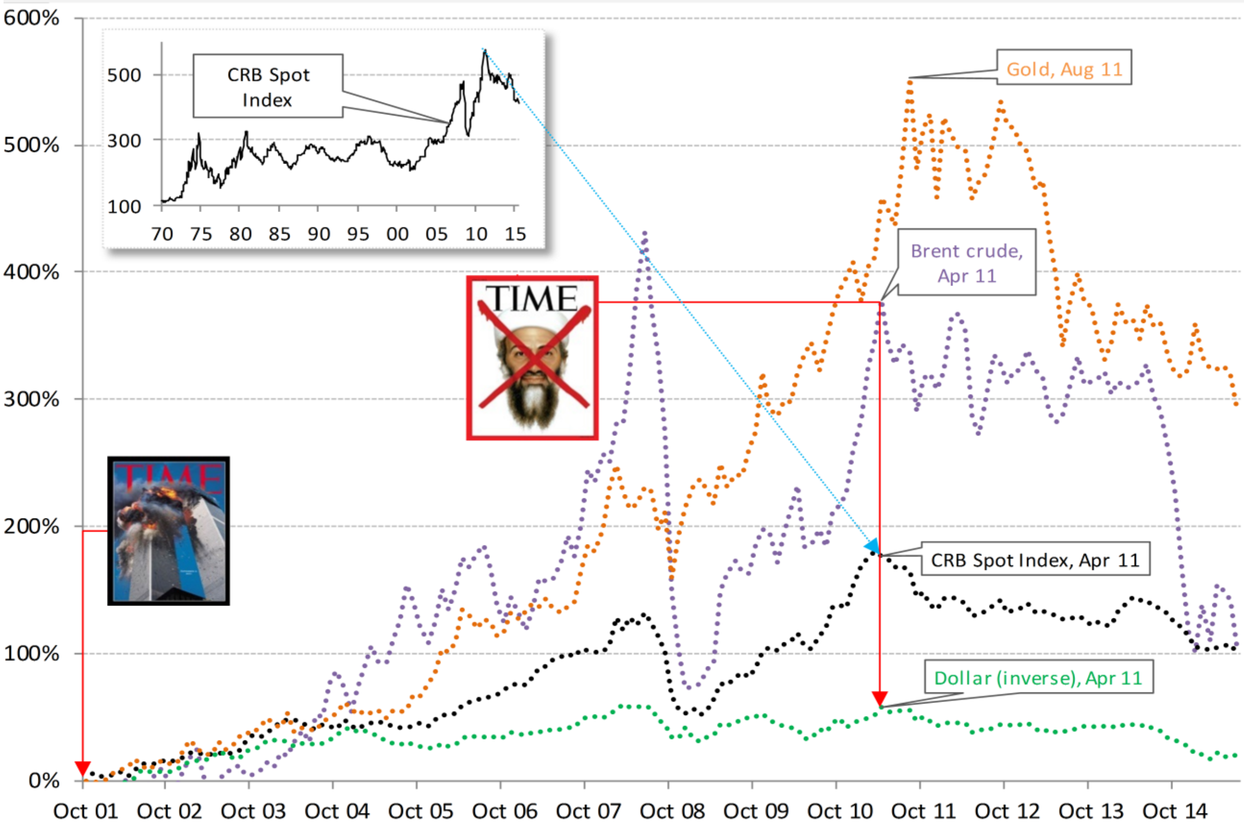
Change from October 2001, monthly data points **Inset: — CRB Commodities Index**



Source: Bloomberg, TrendMacro calculations predicted it would at the time, with the death of Osama bin Laden, which effectively ended the riskiest phase of the Global War Against Terror (see "The bin Laden Commodities Crash" May 6, 2011).

- The nine and a half years of this great bull market in commodities were years of multiple uncertainties -- not just the Global War Against Terror, but also the historic financial panic of 2008-9 and its aftermath. In such an environment it's not surprising to see commodities impound a huge risk premium. The clearest example is gold, the ultimate store of value in times of danger. But it extends to commodities of all types, hoarded for fear of disruptions to global supply chains, but also seen as safe havens against risks both physical and monetary (virtually all have been used as money at some point in history).
- *In this sense, it is good news to see that risk premium come out of commodities. It means there is less risk in the world -- less risk of physical harms to capital, and of inflationary monetary policy errors. The contraction of the risk premium can be thought of as a peace dividend.*
- Surely the rise of China over the same period, from abject poverty to one of the world's largest economies, played a key role in rising commodities prices. For what it's worth, China's growth is itself a creature of the Global War Against Terror, with China's long-blockaded admission to the World Trade Organization coming only as a geopolitical necessity decided by the US the day after the 2001 terrorist attacks.
- As we always disclaim when clients ask us about China, we won't pretend to be experts (in fact, we think there are no experts).
- But we know that all superior growth is temporary, and that China, like all great growth stories, has always been destined to settle into lower and more sustainable growth rates. As it makes the transition from hypergrowth to growth, accidents might happen -- indeed, booms are often followed by busts.
- All this is axiomatic, and says nothing about timing. Forecasts of China's demise have been a staple of financial media chatter for years. Such chatter had kept the Chinese stock market the most undervalued in the world through much the aftermath of the Great Recession, until the run-up that began about a year ago merely brought it to parity with valuations already achieved by most other markets (see "China: Toil and Trouble, but No Bubble" July 10, 2015).
- Now its so-called "crash" -- which only brought prices back to where they were a few months ago -- has diminished confidence in the Chinese authorities' ability to manage the economy's transition to sustainable growth. Fair enough -- far be it from us to suggest that central planning can tame the business cycle, in China or anywhere else.
- *All that said, we caution against overblown reports of Chinese growth falling off a cliff.*
- To be sure, official estimates of growth are likely manipulated to meet Communist Party targets. Many observers look instead at three likely more truthful growth indicators, reported to be the

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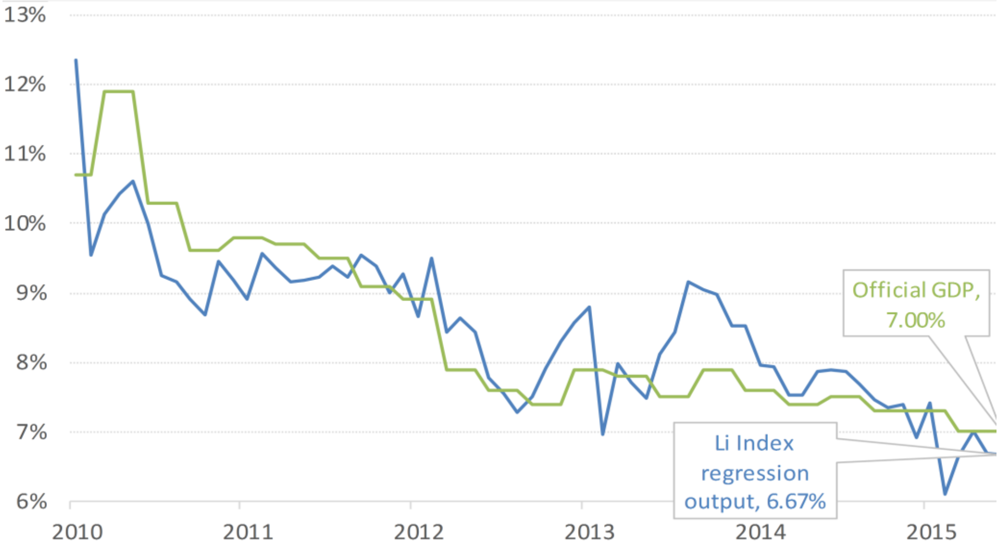
…are overstated, and that the present drop in commodities prices is only the continuation of a long-term correction in the mother of all bull markets, presenting on the whole a "peace dividend" to the global economy. We think oil and commodity prices have probably seen their lows for this move, and that we can avoid a "reverse oil shock" recession. Yet credit risk in the US energy sector is very elevated, and currencies in oil-sensitive countries are extremely weak. But the trade-weighted dollar isn't surging as it did in Q1, and forward earnings are holding up. Stocks will likely remain in correction for a while as these uncertainties resolve, but they have been surprising resilient. It makes sense to take some risk off the table, but our point-estimate is that the present uncertainties will resolve well.

[Strategy Dashboard home]

economic dashboard of Premier Li Keqiang -- rail freight loadings, electricity consumption, and new loans.

- A multiple regression of Li's three indicators against officially reported GDP growth reveals an extremely tight correlation (r-squared is 71%). The latest readings of the three indicators are consistent, in the regression equation, with growth of 6.67% -- not significantly lower than the officially reported rate of 7.00% (please see the chart below).

Chinese GDP growth SAAR



Source: Bloomberg, TrendMacro calculations

- *The purpose of this exercise is not to suggest that China isn't slowing. It is. It has been slowing for five years. Even the official statistics confirm that. The point is that this isn't new -- and for all the fireworks on the Shanghai Stock Exchange, at the moment the slowing is not catastrophically gaining momentum, and is not atypically at variance with the official statistics.*

Now let us turn specifically to oil.

- Oil is a unique commodity -- unique in the universality of its use, and unique in the extent to which so many institutions -- huge global firms, indeed whole countries and cartels of countries -- are dependent on its production and distribution. In the long-term it's a very positive-sum game for oil prices to have finally fallen after a decade at the highest inflation-adjusted levels in history. But in the short-term, those institutions are put at risk by the transition to abundance and low prices ushered in by the breakthrough technologies of horizontal drilling and hydraulic fracturing (see "I Have Seen the Future, and It Fracks" February 24, 2015).
- Fracking threatens these institutions just as a "disruptive technology" like Uber threatens incumbent taxi medallion owners in New York City.

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New York Times
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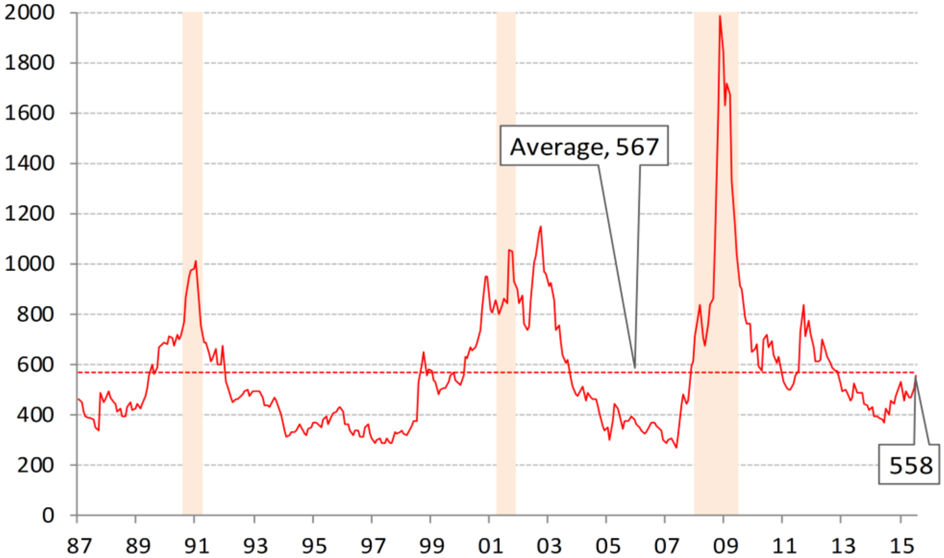
- At the same time, the business of creating "disruptive technologies" is itself fraught with risk. So low oil prices are not only a threat to incumbent institutions, but also to some of the entrepreneurs doing the "disrupting" -- whose business plans, CAPEX schedules and debt obligations were formed when oil prices were considerably higher.
- *So in the short-term, while lower oil prices are a global tax-cut for consumers and non-energy producers, they present a considerable risk to global financial stability.*
- *<u>The loudest warning: in the US high yield bond market, spreads-to-Treasuries in the energy sector -- which comprises about 16% of the overall market by face value outstanding -- have now blown out well above their late-2014 highs</u>* (please see the chart below).

US high-yield bonds, spread to Treasuries BofA Merrill High Yield Master Index
— Energy sector — Overall — Ex-energy

Source: Merrill Lynch, TrendMacro calculations

- Spreads in the energy sector haven't taken overall spreads -- nor ex-energy spreads -- to new highs, but it's close. At today's levels, overall spreads are still slightly below the long-term average (please see the chart on the following page).
- But they've been moving in the wrong direction ever since the sharp drop in oil prices began last year -- meaning that financial stress in the energy sector has to some extent infected the overall economy with higher costs of capital.
- At the same time, Russia and Brazil, industrialized countries dependent on high energy and commodity prices are now coming back under intense pressure. The Russian ruble is revisiting is Q1 lows, and the Brazilian real is the weakest in 13 years.
- Last time around, we warned that these emerging credit risks -- along with the closely related surge in the USD, the collapse in CAPEX driven by falling rig counts, and the rollover in S&P 500 forward earnings led by energy and USD-sensitive consumer

US high-yield bonds, spread to Treasuries BofA Merrill High Yield Master Index



Source: Merrill Lynch, TrendMacro calculations

staples -- could trigger a recession (see "Houston, You're the Problem" March 9, 2015). Indeed, GDP contracted in Q1 -- and it would *not* have without these factors acting to push it down (see "On the April FOMC and Q1-15 GDP" April 29, 2015).

Just a month ago, before the Iran nuclear deal put a dark cloud of uncertainty over global oil prices (see "Iran: The New New World Oil Order, Volume I" July 20, 2015), we were confident that the risk of a recession caused by a "reverse oil shock" had passed (see "The Oil Crash: One Year from the Peak" June 25, 2015). But now, even if oil prices have pretty much seen their lows here, as we expect (see "US and OPEC: The New New World Oil Order, Volume II"" July 27, 2015), we worry that enough damage has already been done to impart another negative jolt to growth such as we saw in Q1.

But there are some differences this time around.

- *Despite WTI's near round-trip to revisit the lows in March, the US dollar on a trade-weighted basis is nowhere near as strong as it was then -- which takes pressures of earnings of US multinationals.* This is quite a surprise given the very tight negative correlation between USD and oil (see "Dollar Strength: A Crude Connection" April 23, 2015) -- and all the more so with gold probing below $1100. It's very unusual to see such weakness in gold without symmetric strength in the dollar.
- We've seen some deceleration in the strong recovery in S&P 500 forward earning ex-energy from their late-February lows (and that can be explained largely by downgrades to a single highly influential company: Apple). *But so far we're seeing nothing like the outright earnings rollover that began last October as oil prices began the sharpest phase of their decline.*

- Here we may differ from the consensus -- but this time around we think it *less* likely that the Fed will take the risk of "liftoff" from zero interest rates than it was the last time low oil prices presented a threat. In the first half of 2015, the Fed had to learn what risks could arise from a "reverse oil shock," ultimately causing us to back off from our long-held conviction, and specific promises by chair Janet Yellen, that the first hike would come in June (see "On the April Jobs Report" May 8, 2015). Now that the Fed understands the risks we face as oil tests the Q1 lows, we think "liftoff" is on hold indefinitely until circumstance necessitate that it suddenly not be (see "On the June FOMC" June 17, 2015).

We note also the peculiar resiliency -- at a time of seemingly peculiar fragility -- of stock prices. We are now going on three years and two months without a 10%-plus correction in US stocks. The forward price-earnings ratio of the S&P 500 is well above this historical norm (see "Ms. Yellen, We Don't Quite Agree" May 21, 2015).

- Yet for all the very visible trouble in the world, the S&P 500 has so far only managed a 4.3% correction from top-tick in May to low-tick in June.
- We think the greatest strategic threat facing equity valuations is a sharp rise in long-term yields. As long as yields are low -- which is to say, as long as the inflation rates that largely explain long-term yields are low -- then stocks are not overvalued at all. *At today's 30-year Treasury yield, the equilibrium price-earnings ratio for the S&P 500 is about 22.*
- And the one thing we know about the consequences of the drop in oil and commodities prices is that inflation will be kept in check.
- And the one thing we know about the Yellen Fed is that only a visible inflation threat could, when push comes to shove, drive "liftoff." Without that threat, the risk of venturing into a dark forest of implementational unknowns, and the opportunity cost of impeding an already sclerotic economic recovery and a labor market with considerable remaining slack, make "liftoff" a non-runner.

While the possibility of a "reverse oil shock" recession plays out, and while we wait to see if the China panic passes, we have to expect equity markets to continue in the correction that began in late May. We are extremely respectful of the uncertainties here, and would argue from a purely probabilistic point of view that one should consider taking some risk off the table. But in terms of our point-estimate of how all this will resolve, we remain ruthlessly optimistic.

Bottom line

We suspect the risks of a hard landing in China are overstated, and that the present drop in commodities prices is only the continuation of a long-term correction in the mother of all bull markets, presenting on the whole a "peace dividend" to the global economy. We think oil and commodity prices have probably seen their lows for this move, and that we can avoid a "reverse oil shock" recession. Yet credit risk in the US energy sector is very elevated, and currencies in oil-sensitive countries are extremely weak. But the trade-weighted dollar isn't surging as it did in Q1, and forward earnings are holding up. Stocks will likely remain in correction for a while as these uncertainties resolve, but they have been surprising resilient. It makes sense to take some risk off the table, but our point-estimate is that the present uncertainties will resolve well.