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An Oil Shock Tipping Point?

Thursday, March 3, 2011

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You'd think we'd already be there, but stocks and gold are clearly saying we're not.

High oil prices and inflation -- two distinct but interrelated issues -- have emerged as risks to the improved outlook for stocks and the economy that we expressed last year (see "Stock Outlook: Differences Make a Difference" November 10, 2010). In the face of these obvious risks why have stocks fallen only about 1.5% from their February 18 high? They ought to be especially vulnerable, having now gone 107 days without a 3% correction and 190 days without a 5% correction (please see the note about this on the next page). We have admitted that a correction is certainly possible here -- who wouldn't (see "The Libyan Connection" February 22, 2011)? But we aren't actively calling for anything very serious to happen, unless something far worse occurs in North Africa and the Middle East than we see on the radar now.

Let's start with the oil situation.

- We have been nothing but bullish on oil for a long time (see, among many, "What Should the Fed Do?" August 5, 2010).
- As our growth outlook improved, we've continued to be bullish on oil (see "Gold Acts Leaden" January 25, 2011). We've seen a rising oil price to be a healthy symptom of better growth.
- So the mere fact of a higher oil price doesn't surprise us and it doesn't scare us.
- The typical intuition is that a higher oil price, *ipso facto*, will cause growth to slow. We understand the appeal of that, but it is not borne out by the data. Simple time series analysis shows changes in GDP and the oil price to be almost completely uncorrelated. More complex analysis shows some correlation. But given the strength of the intuition about this, we shouldn't have to try so hard to find it.
- The reason the intuition persists is that, while typical changes in the oil price make no difference, *large shocks* can make large differences. In other words, the relationship between the oil price and growth is *non-linear*.

Update to strategic view

US MACRO, OIL: At this moment the US economy has not yet passed through an oil shock tipping point. We think the oil price would have to be another 25% higher to do that. Geopolitical threats are impossible to predict, but we don't expect oil to go there.

US STOCKS, GOLD, FED FUNDS: Stocks, which ought to be vulnerable to correction, are strong because the oil threat is, for now, less than meets the eye. That is in part because the gold price is signaling that the Fed will not make a deflationary error in response to expected oil-driven inflation.

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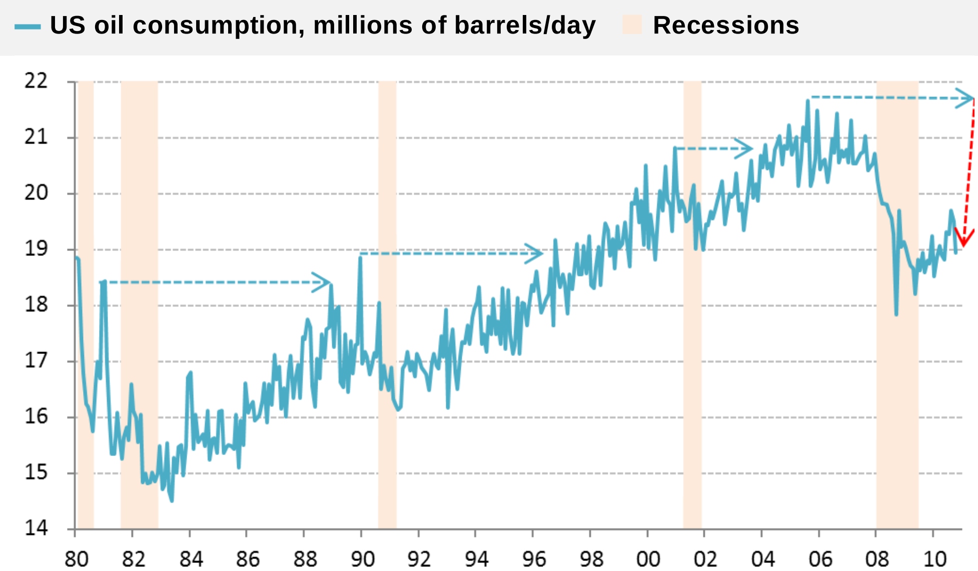
- So we shouldn't sweat the small stuff. When Pimco's Bill Gross said yesterday on CNBC that higher oil prices would take 0.5% off Q1-2011 GDP, we just dismiss it. The only real question is: what kind of magnitude and duration would an oil price shock have to have in order to push us through a tipping point into recession?

Context argues that we are probably not yet at a tipping point. First, the US economy is less vulnerable to a given oil price shock today, running well below capacity, than it would be if it were running closer to capacity (again, see ["The Libyan Connection"]). There are complex arguments for this having to do with marginal efficiency of inputs.



Source: US Energy Information Administration, NBER

Separately, but related, US petroleum consumption is now 12.5% below its 2005 peak (note the red line in the chart above). By contrast, the last three recessions all occurred only after oil consumption had reached a new high.

The drop in consumption over the last three years is demand destruction on a scale not seen since the early 1980s. At the same time, it has been a revolution in efficiency. Real and nominal GDP are both at new all-time highs, while oil consumption remains well below all-time highs. You have to go back to April 2000 to find consumption as low as today's -- yet real GDP is 21% higher than it was then.

With that anomalous context in mind, we should take caution with indicators that would otherwise make a drop-dead case for an oil-driven tipping point. For example, consider the run-rate percentage of GDP spent on crude oil (please see the chart at the top of the following page). Using the Brent crude price, which is at the moment considerably higher than the WTI price typically reported in the US, the run-rate is now 4.5% of GDP. The last time we saw that run-rate was in April 2008, four months after what we know now was a business cycle peak. The run-rate got as high as

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[About us]

Key documents

Nonlinearities and the Macroeconomic Effects of Oil Prices
James D. Hamilton
Department of Economics
University of California, San Diego
December 9, 2009

Oil Price Shocks and Real GDP Growth: Empirical Evidence for Some OECD Countries
Rebeca Jiménez-Rodríguez
University of Alicante
Marcelo Sánchez
European Central Bank
April 2003

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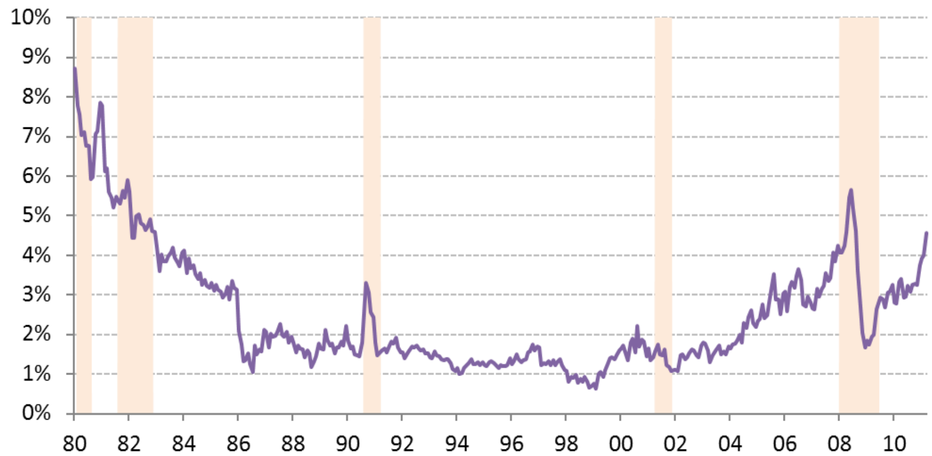
Note

In our February 22 report "The Libyan Connection" we misstated as 107 the number of days the S&P 500 had gone without a 3% correction. It was in fact 97 days, and is 107 days *today*. We regret the error. A corrected version of the report can be downloaded by clicking here.

5.6% in June, and may well have triggered a recession even without the banking collapse that was unfolding at the same time.

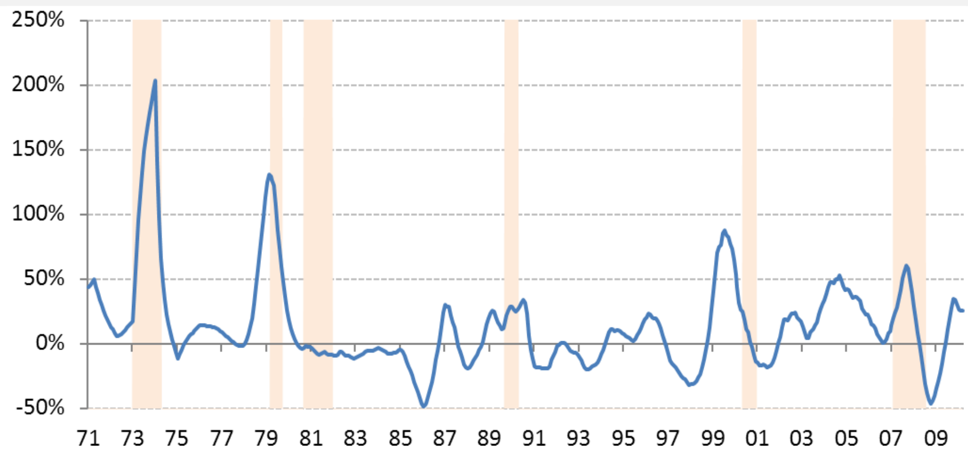
Run-rate spending on oil as percentage of GDP **Recessions**
Brent crude, nominal



Source: USEIA, BEA, Reuters, NBER, TrendMacro calculations

The run-rate spending indicator is contextualized in the sense that it embodies both the volume of consumption and the scale of output. But it doesn't speak to context in an important sense -- the *path* by which the oil price got to its present level. A high oil price achieved suddenly is more of a shock than one achieved gradually. And an unexpected shock is worse than one similar to an event that has already been experienced. This concept of the path-dependency of shocks is embodied in the "shock ratio" -- the difference between the 12-month average oil price today versus one year ago (please see the chart below). To obtain a high "shock ratio," a move upward in the oil price must be both large and lasting. Today's price

Oil price "shock ratio" **Recessions**
Brent crude, 12-month average over year-ago 12-month average

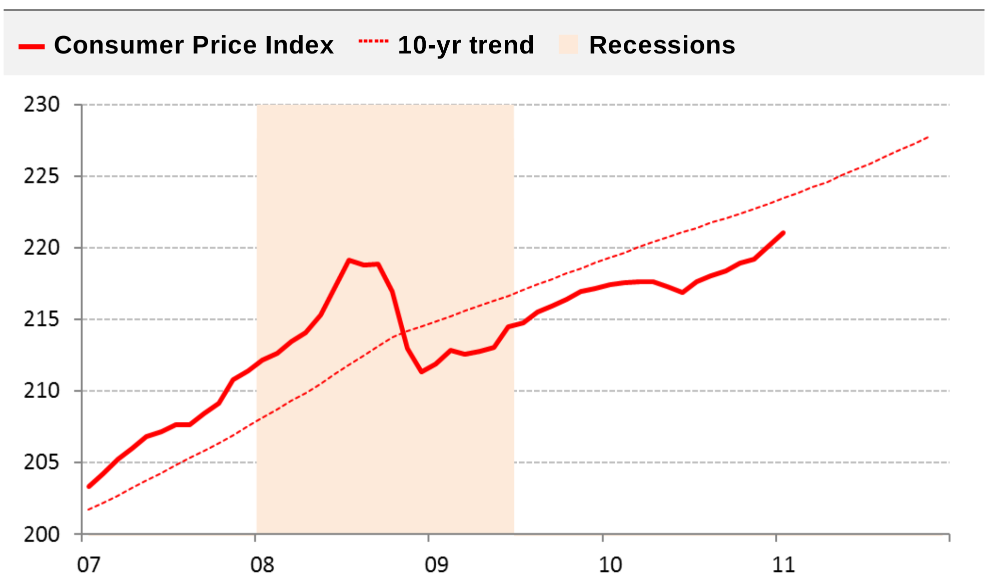


Source: Reuters, NBER TrendMacro calculations

doesn't qualify -- even using the higher Brent crude price of $115, and no matter how long it persists. It would take something more like $150 to pull this trigger.
Setting aside for a moment whether today's high oil price is enough to set up a recession tipping point, what about its inflationary implications? Won't the inflation resulting from the oil price erode growth, even if the oil price itself doesn't?

Yes, but here again context is everything.

- An increase in the oil price is not inflationary, *per se*.
- It is not inflationary *in origin* unless it occurs as the result of monetary conditions. A price shock due to political events driving supply or transportation blockages is something else entirely. We don't agree that those political events are themselves the result of inflation-driven food price shocks (see "Are We Running Out of Armageddons?" February 3, 2011).
- It is not inflationary *in consequence* unless the central bank accommodates the oil price shock by excess money creation (as we saw in the US in the 1970s).
- We think there is a good chance that the Fed will, in fact, do just that if push comes to shove. The fact that gold has risen to new all-time highs as the present oil shock has unfolded is evidence of this. It only strengthens what we've come to think of as the second-best bull case for gold, driving our persistence in our $1500 price target (see, among others, "On the January FOMC" January 26, 2011).
- While gold is signaling an accommodative response from the Fed, that doesn't necessarily point to *runaway* levels of inflation within any relevant tactical horizon. The whole reason the Fed will feel comfortable accommodating an oil shock -- assuming one even really materializes and persists -- is that the Fed still regards the US economy to be predominantly deflation-oriented. Remember, it was only last November that the US price level finally re-attained



Source: Bureau of Labor Statistics, NBER, TrendMacro calculations the high-water mark logged in July 2008, and we remain far below trend inflation (please see the chart at the bottom of the previous page).

- All this means that *for now*, inflation is our friend because deflation is our enemy. In a world still struggling to recover from a world-historic credit crash, with much unwanted debt still lingering, the greatest threat is even the smallest whiff of deflation.
- As the Libya crisis has unfolded over the last couple weeks, we have been comforted by the fact that gold was rising. This was the signal that central banks would not make the mistake of lapsing into deflation in the name of fighting a perceived oil-driven inflation. If they had appeared to be about to err that way, stocks wouldn't be down 2% -- they'd be down 20%.

Bottom line

At this moment the US economy has not yet passed through an oil shock tipping point. We think the oil price would have to be another 25% higher to do that. Geopolitical threats are impossible to predict, but we don't expect oil to go there. Stocks, which ought to be vulnerable to correction, are strong because the oil threat is, for now, less than meets the eye. That is in part because the gold price is signaling that the Fed will not make a deflationary error in response to expected oil-driven inflation.