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MACROCOSM

The Oil Crash: One Year from the Peak

Thursday, June 25, 2015

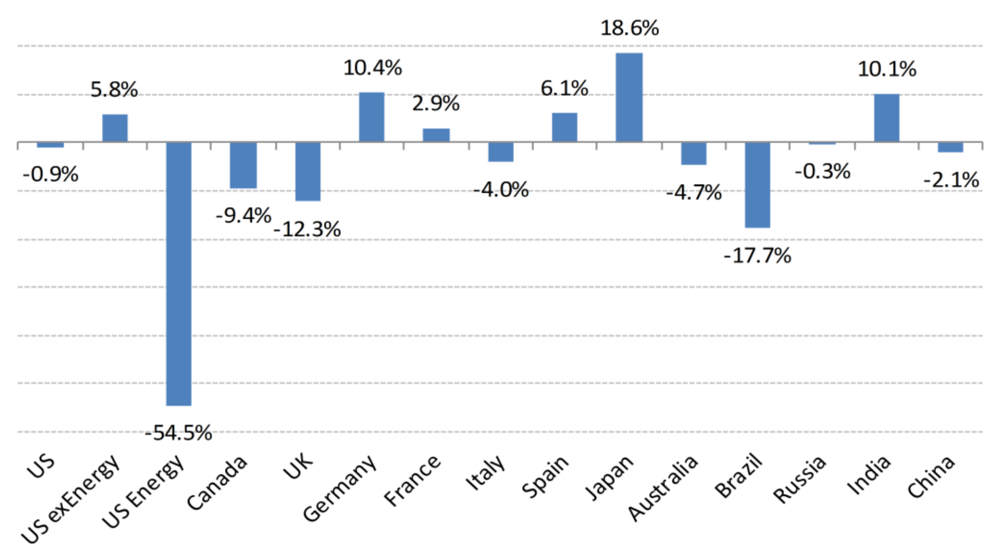
Donald Luskin

Falling crude prices almost caused a recession. Stabilizing prices are igniting expansion.

Today marks the one-year anniversary of our seminal client report in which we predicted the coming crash in global oil prices (see "The Stench of CrISIS" June 25, 2014). It has relieved the era of "secular stagnation" from the highest real oil prices in history, and points to a permanent and very positive transformation in the way the world produces energy (see, recently, "The Shale Boom Shifts Into Higher Gear" June 1, 2015). But the new abundance and reliability in crude oil supplies is a "disruptive technology" that has dealt a shock to the established order. We think that If some Wall Street mo-mo calls earlier in the year had come true (for instance, if oil had traded down to $20 this quarter as Citigroup predicted -- see "Grant Me $20 Oil, But Not Yet" February 17, 2015), we think we'd be in a recession now -- the first one ever caused by *falling* oil prices.

- We were right in mid-January, precisely at the bottom, saying oil would stabilize in a range from $50 to $65, with some overshoot on both sides (see "Oilmageddon: The Sequel" January 15, 2015).
- If we'd been wrong, the US high-yield bond market -- with 15% of face value issued by energy producers -- would be awash in defaults.

Change in forward earnings from June 25, 2014



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, OIL, FX: A year has passed since we called for a crash in oil prices, and got one big enough to almost cause a recession. Oil prices have stabilized, which has led to the stabilization of the dollar and the reduction of systemic risks arising from defaults in US high yield markets and emerging market sovereigns. For all the handwringing, energy demand has risen, retail sales have accelerated, and the housing market has moved to new recovery highs. Oil prices will remain in a tight range. So the US economy should be able get back to the accelerated growth rates we saw mid last year.

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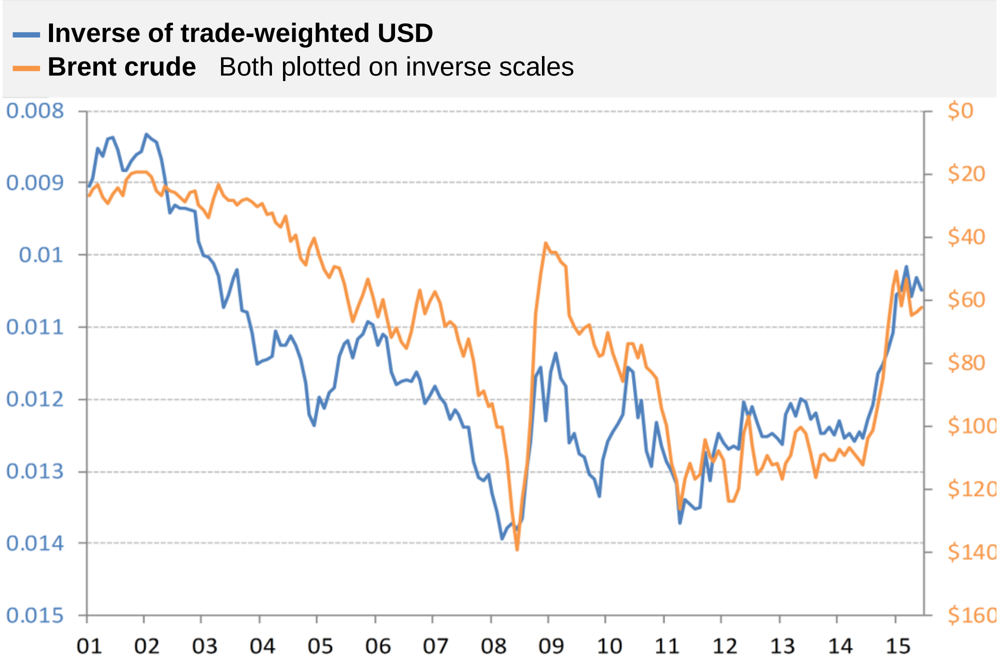
- Russian debt would be in default, too, and who knows what military adventurism in Europe would have been launched by a desperate Vladimir Putin. The "Arab Spring" would have come roaring back as an "Arab Winter."
- The US dollar, which we believe is always inversely linked to oil prices -- especially so since mid-2011 (please see the chart below, and "Dollar Strength: A Crude Connection" April 23, 2015) -- would have strengthened further, crippling US exporters and corporate debtors in emerging markets.



Source: Bloomberg, TrendMacro calculations

- But as oil has settled into the range we predicted, the dollar has become similarly range-bound, and the other risks we've just highlighted have all receded in varying degrees.
- *We think we're through the worst, and the risk of recession has transformed into signs of renewed expansion.*

The global distribution of winners and losers has been what we expected (see "2015: Oil Change for the Global Economy, US Edition" and "2015: Oil Change for the Global Economy, Non-US Edition" December 31, 2014). Generally, the corporate sectors of countries with exposure to oil production have seen contraction in forward earnings over the last year, while those with no little or no exposure have seen expansion (please see the chart on the previous page).

- So there has been some amazement among economists that, in the presence of what ought to be massive "tax cut" for global consumers, there hasn't been more evidence of emerging demand.
- But sudden shocks that produce trade-offs between winners and losers entail systemic risks of the kind we've described, even if such shocks produce positive-sum games overall. Those risks

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Recommended Reading

Climate Change Calls for Science, Not Hope
Eduardo Porter
New York Times
June 23, 2015

America's Self-Punishing Oil Export Ban
Harold Hamm
Wall Street Journal
June 22, 2015

Save Alexander Hamilton!
Ron Chernow
Politico
June 18, 2015

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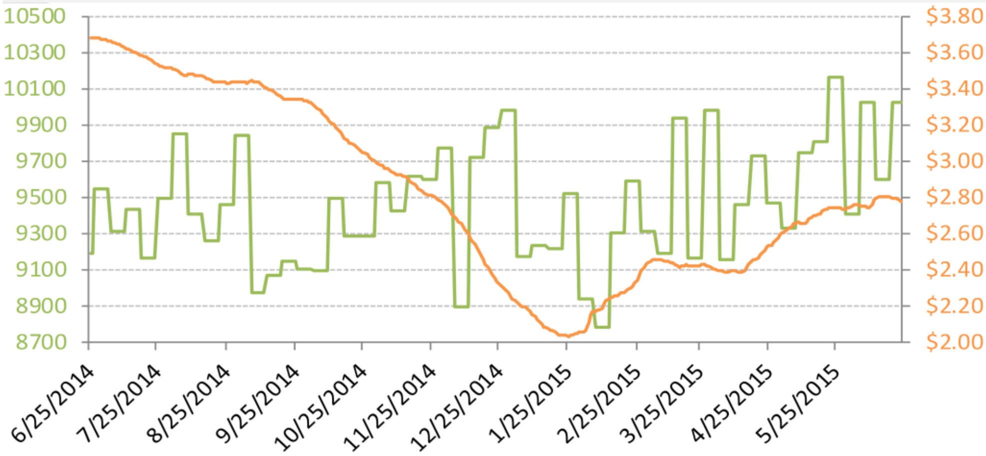
prevent the winners from fully collecting and enjoying their winnings -- earlier this year they threatened a recession (see "Houston, You're the Problem" March 9, 2015).

- Now that those risks are receding and confidence can be restored, we think we're starting to see some very positive signs.
- A key example is US gasoline demand, which only started to respond to prices below the year-ago peak once those prices bottomed and began to recover (please see the chart below). *Indeed, gasoline consumption is now the highest in the history of the data.*

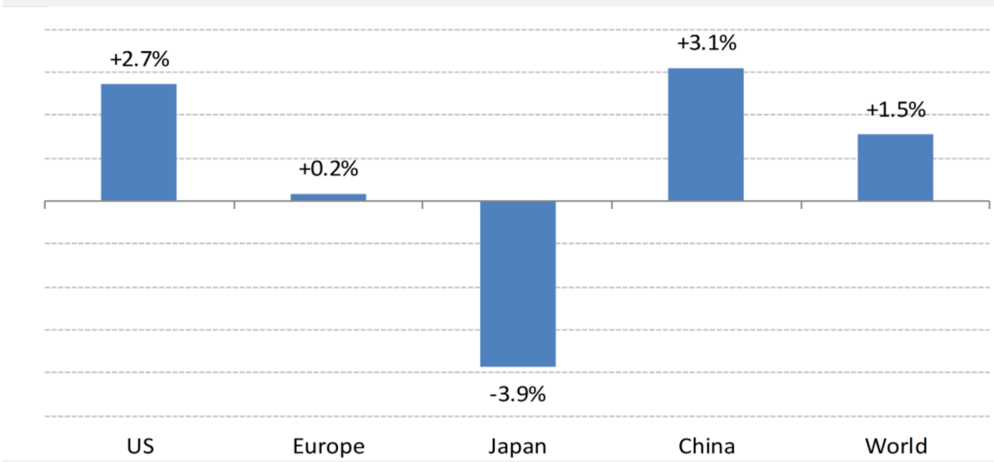
US gasoline consumption Thousands bbl/day **Regular unleaded price**



Source: DOE, TrendMacro calculations

- Global crude oil demand was similarly slow to respond, but is now higher than a year ago (please see the chart below).

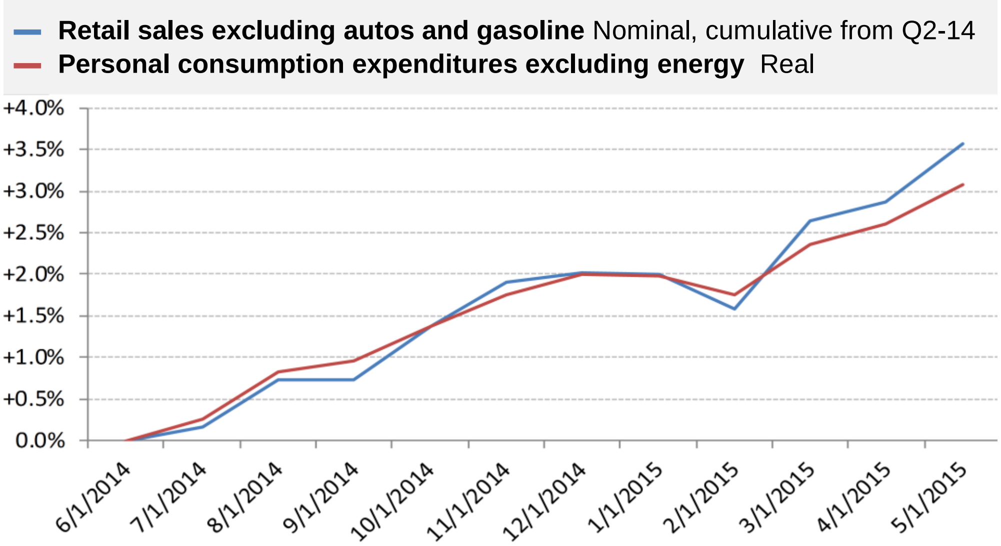
Change in crude oil consumption, 3-month average versus year-ago



Source: DOE, TrendMacro calculations

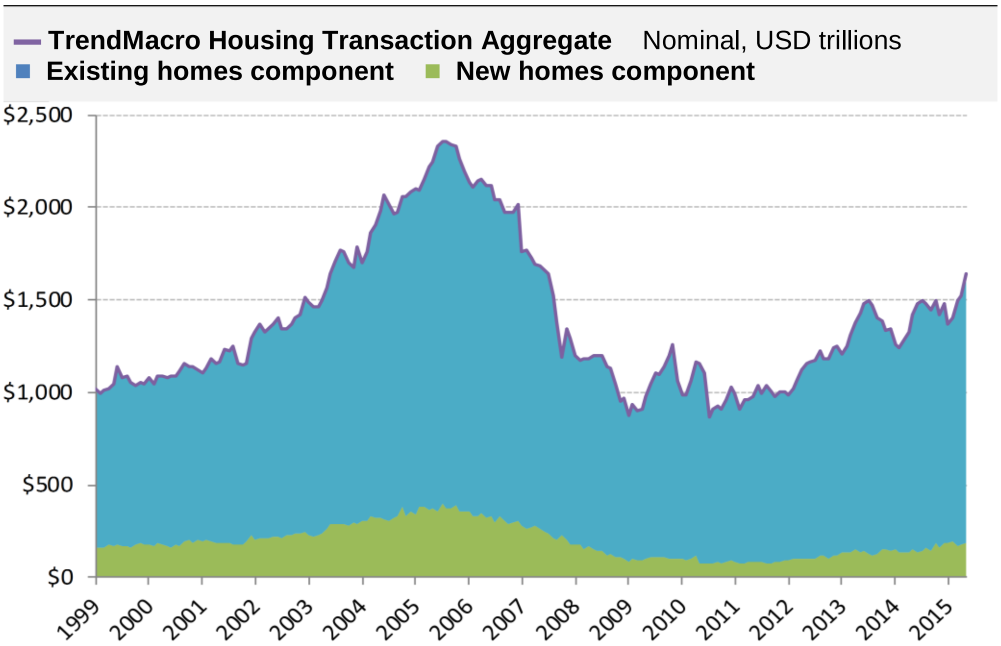
- Looking beyond just energy demand, there has been much handwringing about poor US retail sales and personal consumption expenditures. But once you look beyond the difficult first quarter -- when crude oil prices were facing the worst downside risks --

growth has actually been quite robust. And it has been recently accelerating (please see the chart below).



Source: Census Bureau, BEA, TrendMacro calculations

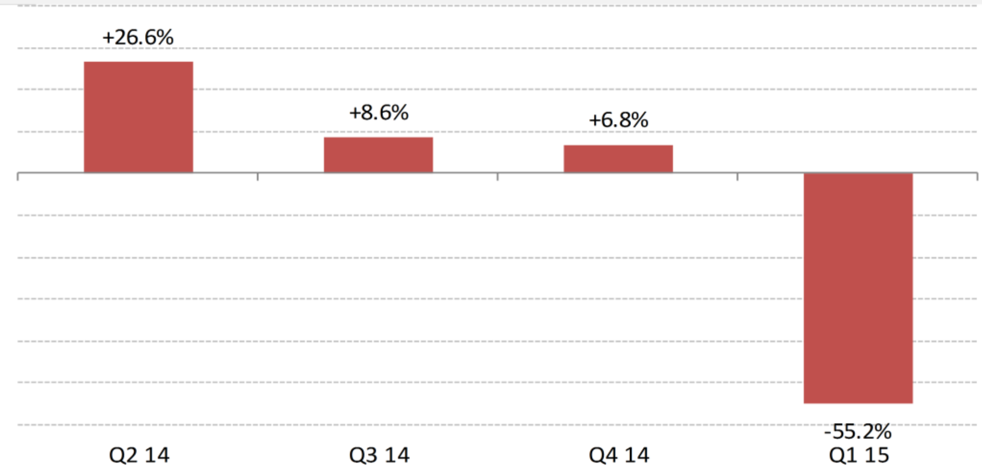
- Of particular interest to us is the resurgence -- totally unexpected by most economists other than us -- in the US housing market. We have long said that housing could not recover until falling gasoline prices made it feasible for home-buyers to afford long commutes. Now, as gasoline prices have fallen, our favorite housing index, the TrendMacro Housing Transaction Aggregate (the total value of transactions in new and existing homes -- see "It's Okay You Didn't Build That" July 20, 2012) has broken out to new recovery highs (please see the chart below).



Source: TrendMacro calculations

The worst of the oil crash occurred in Q4-2014. And though prices bottomed early in Q1-2015, at the same time there were fears of a fire-sale that would take prices to new lows, and by then cutbacks in CAPEX by US shale producers were starting to be substantively felt. Indeed, in Q1, though oil prices ended the quarter higher on net, CAPEX contracted at an astonishing 55.2% annual rate, taking something like 50 basis points off Q1 GDP (please see the chart below, and ["On the April FOMC and Q1-15 GDP"]() April 29, 2015).

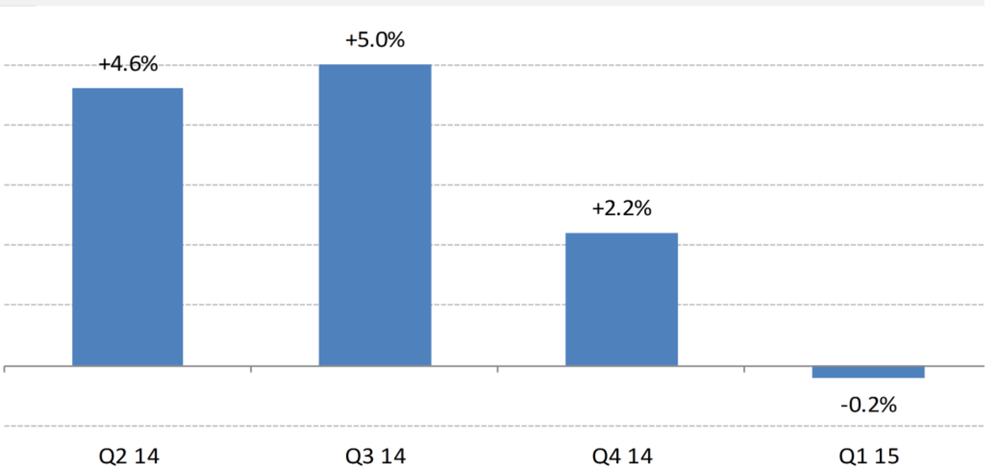
Growth of fixed assets: mining, exploration shafts and wells QOQ, SAAR



Source: BEA, TrendMacro calculations

This put a chill into real growth in Q4-2014 and Q1-2015. But we forget that in the two quarters just prior, real growth had begun to run at rates significantly higher than what we've become used to in the Not So Great Expansion following the Great Recession (please see the chart below).

Real GDP growth QOQ, SAAR



Source: BEA, TrendMacro calculations

Now, we believe, the shock of suddenly lower oil prices has dissipated -- and oil prices, we expect, will be stable going forward, ruling out further *shocks. With systemic risks that arose from the initial shock mostly off the table, why shouldn't growth get back to where it was beforehand?*

- *Indeed, why shouldn't growth come back even stronger, considering the triple-barreled advantages of lower energy prices, the containment of inflation that will come along with them, and the containment of interest rates and long-term yields that will come along with contained inflation* (see "Unyielding" May 13, 2015)*?*

Bottom line

A year has passed since we called for a crash in oil prices, and got one big enough to almost cause a recession. Oil prices have stabilized, which has led to the stabilization of the dollar and the reduction of systemic risks arising from defaults in US high yield markets and emerging market sovereigns. For all the handwringing, energy demand has risen, retail sales have accelerated, and the housing market has moved to new recovery highs. Oil prices will remain in a tight range. So the US economy should be able get back to the accelerated growth rates we saw mid last year.