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MACROCOSM

Is This the Oil Shock Tipping Point?

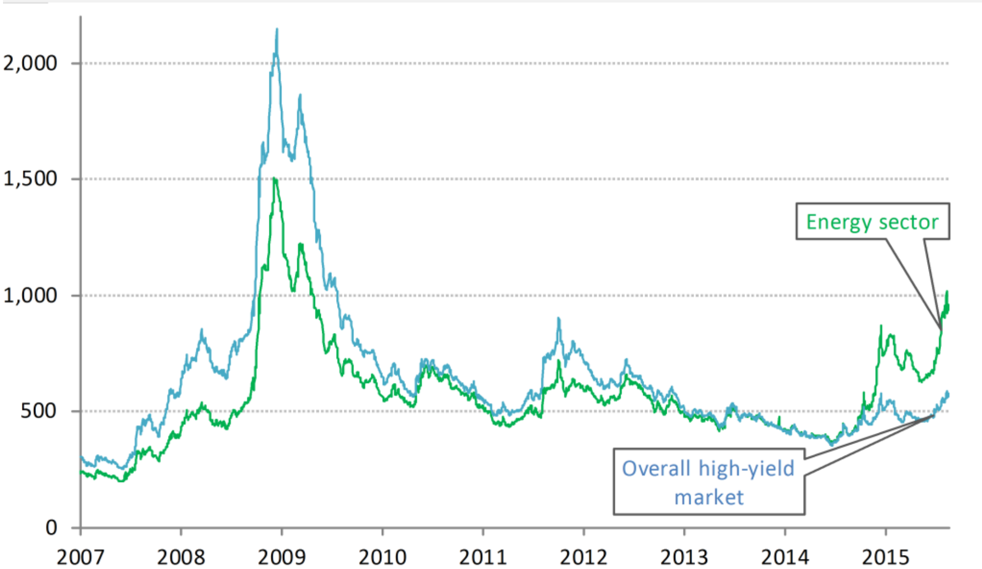
Thursday, August 20, 2015
Donald Luskin

Maybe, but stocks, the dollar, gold, TIPS, and Fed expectations don't seem to think so.

With WTI crude oil breaking to new lows, our worry is intensifying that we are on the edge of the first-ever recession caused by falling oil prices (see, among others, "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015). We don't see a convincing supply-and-demand argument for it. We're not impressed by yesterday's build in "ending stocks" -- following four months of nearly relentless draws. Overall, evolving production statistics have only confirmed our forecast for an intermediate-term shale rollover (see "Data Insights: Oil" August 11, 2015, and "US and OPEC: The New New World Oil Order, Volume II" July 27, 2015). We have to think we are seeing a credit shock, with spreads in the energy sector of the high-yield bond market blowing out to highs not seen since the worst of the Great Recession (please see the chart below), forcing smaller and leveraged frackers to dump production in spot and futures markets at any price just to maintain cash-flow.

With the energy sector representing about 16% of the face value of the junk bond market, this portends a potentially broader and more systemically damaging credit event. But we're surprised how little evidence

Spread to Treasuries, Merrill Lynch High Yield Master Index



Source: BAML, TrendMacro calculations

Update to strategic view

OIL, US STOCKS, US MACRO, US FED, US BONDS, FX, GOLD: WTI has defied our predictions and broken to new cycle lows. We don't see it as a rational response to endogenous supply-and-demand factors in the energy market. It more likely reflects a fire sale aimed at raising cash in the face of extreme financing distress, with high-yield spreads in the energy sector blowing out to highs not seen since the Great Recession. With forward earnings growth stalling, this points to the first-ever recession caused by low oil prices. With stocks only 3% off all-time highs, probabilistically it's nearly irresistible to take something off the table here. But the stock market's resilience, the US dollar, gold, TIPS yields and Fed expectations argue that we have not yet passed a tipping point.

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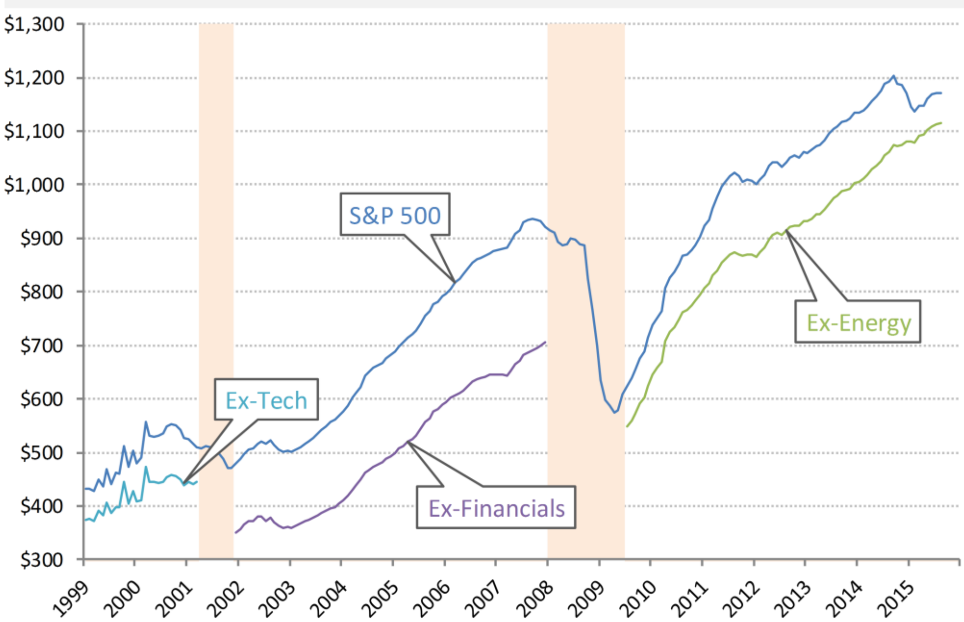
of stress we see anywhere else in markets, especially with the "China hard landing" bear-case reverberating through the market echo-chamber (see "On the RMB Devaluation" August 11, 2015).

- The major corroborating negative is forward earnings, which historically have tended to roll over several months before the onset of recessions (see "Houston, You're the Problem" March 9, 2015). They peaked last October, and the recovery attempt that began after oil provisionally bottomed in March has now apparently lost steam (please see the chart below).
- This is largely, though not entirely, due to the more than halving for forward earnings in the energy sector. Indeed, ex-energy forward earnings are at all-time highs, although their rate of growth has notably slowed over the last month (again, please see the chart below).
- It is not entirely comforting that the earnings rollover can be made to go away be eliminating the earnings of a single sector -- energy. The same could have been said for the financial sector when earnings rolled over in 2007 ahead of the Great Recession, or the technology sector when earnings rolled over in 2000 ahead of the 2001 recession (again, please see the chart below). We worry that it has become a modern pattern that single sectors become disproportionately dominant over an earnings cycle, are then the first to roll over, and eventually prove to have been indispensable underpinnings to the rest of the economy when *all* sectors later roll over too.
- This time is slightly different in several respects. In 2000 and 2007, the peak in the overall stock market coincided nearly to the day of the peak in overall forward earnings, even with the onset of recession many months in the future. This time, earnings peaked

S&P 500 consensus forward earnings USD billions **Recession**



Source: IBES, Zacks, Bloomberg, NBER, TrendMacro calculations

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Higher reserves are a less painful way to fix the banks
Alan Greenspan
Financial Times
August 18, 2015

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last October 2, after which stocks went on to make several new all-time highs.

- The peak for stocks (so far, at least) was about three months ago. They've been in a narrow consolidation ever since, presently just 3% from their all-time highs.
- *Stocks, it seems, are not as worried as we are about the possibility of the first-ever recession caused by lower oil prices. Perhaps that's a paradox, or perhaps we're simply wrong to worry. <u>Or maybe it's a gift.</u> Remember, stocks haven't had so much as a 10% correction for three years, two months and two weeks. <u>Thinking purely probabilistically, if we are anywhere close to right to be worried about a credit event emanating from the large energy sector of the high-yield market, or about the rollover in forward earnings, then we've got to want to take something off the table.</u>*

Stocks are not alone in contradicting our sense of alarm. Perhaps the safety valve here is that large private equity energy play Samson Resources gives up the ghost in a high profile bankruptcy, many billions of *new* private equity money waits on the sidelines ready to pick up shale assets as financial distress deepens among overleveraged producers.

- We note -- gladly -- that while oil prices have *fallen* over the last three months, the US dollar has not commensurably *risen*. With WTI and new lows, the USD is not at new highs. This breaks what has been a pattern for decades -- and nearly an iron law for the last four years -- that the dollar and oil move inversely with each other.
- The extreme dollar strength we saw in Q4-2014 and Q1-2015 -- as oil played out the worst of its cascade from the June 2014 highs -- was a strong contributing factor to poor growth in Q1-2015 and Q2-2015. It would seem we are avoiding a replay of that in the current quarter.
- The USD's surprising weakness is all the more notable given the devaluation of the Chinese RMB. While weakening the RMB versus USD at the same time as USD has weakened versus the euro and the yen, this is a double-victory for China, and is at least on element cutting against the alarmist hard-landing consensus (again, see "On the RMB Devaluation").
- We note that gold has bounced sharply over the last month, swimming against the downward current of oil and commodities overall. We don't want to assign too much importance to this, having to some extent lost interest over the last couple years in gold as a macroeconomic indicator. Be we must say that many times in the past we've seen it be the first to turn, signaling that deflationary pressures seemingly being signaled by other commodities are about to abate.
- We note that real long-term Treasury yields have been quite strong, with the 10-year TIPS yield 20 basis points higher since the peak in oil prices in early May. If falling oil prices were signaling recession, surely real yields would not be rising.
- The strength is real yields is all the more encouraging given that the market is coming around to our view that the Fed will not "lift off" from zero interest rates at the September FOMC (see, among

many, "On the July FOMC" July 29, 2015). We suppose the Fed's deferral of liftoff has to be added to the list of forces cushioning the economy from any ill effects of oil breaking to new lows. But we don't put it high on the list, as this does not represent a change at the margin, at least insofar as *our* expectations are concerned.

- Finally, we note an element that many clients have pointed out as we've been discussing our worries about too-low oil prices. For all the sectoral financial stress those prices may impart, for the rest of the economy they are in many ways a shock-absorber, if not an outright positive. The financial shock from the Lehman failure in 2008 was surely worse for the fact that, then, the global economy was laboring under the highest real oil prices in history (oil traded at $147 five weeks before Lehman Day, and was still as high as $107 a week after). This time around, with real oil prices now merely at the top end of the core range in which they've traded for most of the last century and a half, we would enter into recession now with a great deal of consumer resiliency.

So where does all this leave us?

- We were wrong in thinking WTI would not trade as low as it has. But we don't see anything new in the supply/demand picture. If this is a vicious cycle arising from credit stresses, then it's highly unpredictable -- but from first principles, there's no particular reason to think such a thing will continue any more than there is to think it has burnt itself out. Meanwhile, the fundamentals are the fundamentals. So until we have any new information to change our minds, we're treating this as a rather extreme technical overshoot.
- Is it enough to trigger the first-ever recession caused by falling oil prices? Should we treat the stress in the junk bond market and the rollover in forward earnings as pointing to recession? Literally, yes: they are indeed *pointing* to recession, although there may be reasons why that recession will not come. But *probabilistically*, with stocks only 2% off all-time highs (and other risk-assets analogously positioned), it's nearly irresistible to take something off the table, just in case.
- The problem with our theory about a "reverse oil shock" recession is that there's nothing that tells us in advance what WTO price or what Brent price would be the exact tipping point. The best we can do is say "we'll know it when we see it." And given the panoply of confirming indicators that are presently pointing in the exact opposite direction, at this moment we don't think we've seen it yet.

Bottom line

WTI has defied our predictions and broken to new cycle lows. We don't see it as a rational response to endogenous supply-and-demand factors in the energy market. It more likely reflects a fire sale aimed at raising cash in the face of extreme financing distress, with high-yield spreads in the energy sector blowing out to highs not seen since the Great Recession. With forward earnings growth stalling, this points to the first-ever recession caused by low oil prices. With stocks only 3% off all-time highs, probabilistically it's nearly irresistible to take something off the table here. But the stock market's resilience, the US dollar, gold, TIPS yields and Fed expectations argue that we have not yet passed a tipping point.