BUTLER, LANZ & WAGLER

For the discerning, risk-conscious investor.

December Newsletter 2014

The Oil Price Collapse

Oil struggled in November to put it mildly. Oil is not only an important part of daily economic life, but its price also gives clues as to the state of the global economy. This month's newsletter will look at the decline of oil as well as what it means for the economy going forward.

Commodities in general performed quite poorly in November and that can be seen in the Goldman Sachs Commodity Index chart below.

The index lost over 10% of its value in November. Energy, particularly oil, is a large component of just about every commodity index because it gets consumed more than any other commodity.

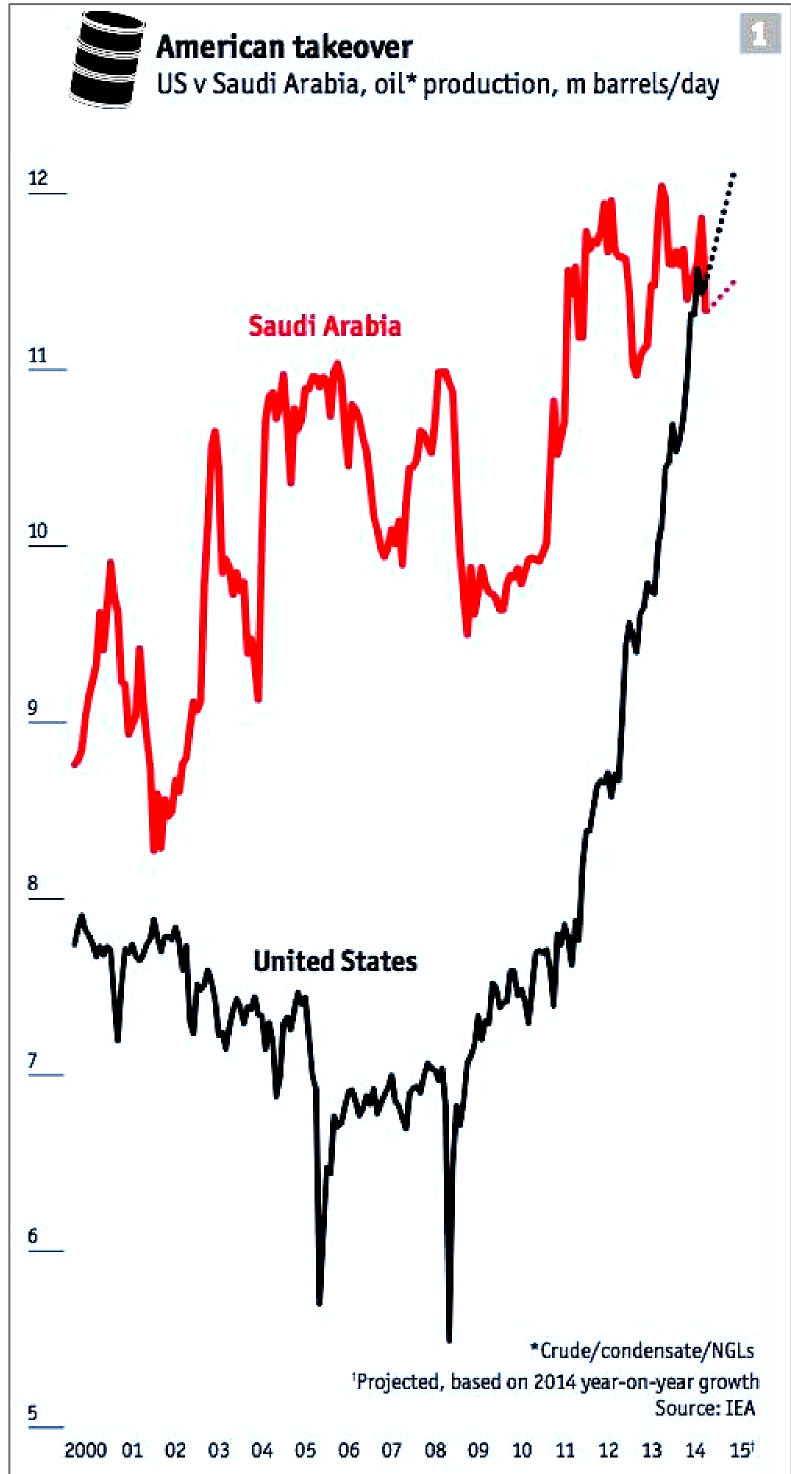
Oil (West Texas Intermediate, to be exact) lost over 18% of its value in November, ending the month at about $66 per barrel - a price not seen since 2009.

The result has been a dramatic drop-off in gas prices. In Kansas City, gas prices dropped to an average of $2.45 per gallon - a price not seen since 2010.

So what's going on? Why the drop in oil and gas prices? The drop has been largely portrayed as a supply story by the financial press. And certainly the decision by OPEC on Thanksgiving Day to refrain from production cuts is impactful. But there are actually three conditions currently all conspiring to bring down the price of crude and bringing down gasoline prices along with it. Or, maybe, the more accurate way to describe this is to say that two factors are currently bearish for oil and perhaps a third, depending on your willingness to accept rumor as fact. Let's address the rumor first.

Western allies have imposed sanctions on Russia and Valdimir Putin. Oil exports are an important part of the Russian economy. They are a major oil producer and supplier to the global economy. But if the price of oil drops, so does the profit of producing oil, whether that's Russia, the US or Saudi Arabia. The important factor is how much it costs to produce a barrel of oil. The lower the cost-of-production, the more a country can withstand falling oil prices. Estimates of Russia's cost to produce a barrel of oil range from $45 to $60 per barrel. Once oil prices drop below the cost of production, the producer starts taking losses and will generally shut down production.

Rumor has it that western allies have approached Saudi Arabia and asked them to keep producing regardless the market price, and convince OPEC to do the same. That seems a little farfetched, however, as US producers, who have a higher cost of production, would be hurt by that policy. And, what would the Saudis gain from hurting their own profit margins? Of course, something could have been promised to them to make it worth the losses, but we do not know. It seems more reasonable to assume that the Saudis, and the rest of OPEC, would endeavor to flood the market with supply in an effort to drive US producers out of production. Why? Because the recent growth in oil production in the US has put them in a position of "feared competition" to OPEC.



That truly is illuminating. We've all heard of the "shale oil miracle," but this picture helps put it into perspective. Remember this chart as we will address its implications later. For now, it suffices to show that the US is now a very important competitor in oil production to the Saudis. When you consider that many feel that an $80 per-barrel price of oil, and below, is enough to crush US shale oil production, it's easy to see why the Saudis would be incented to flood the market with supply. It's estimated that the average cost of production of shale oil in the US is around $80 to $85. Wouldn't a lower oil price hurt the Saudis as well? Yes, but when you consider that it's estimated that their cost to produce oil is around $10 per barrel, it's obvious that they can engage in an oil price war and win it. This is the same strategy used by monopolists for hundreds of years - drop the market price of whatever you provide to a point where smaller competitors cannot continue operations and then allow the price to rise once the competition has been eviscerated.

So, it's possible, if not probable, that the Saudis are more concerned with their competition in the US than in being in league with NATO members to hurt Russia.

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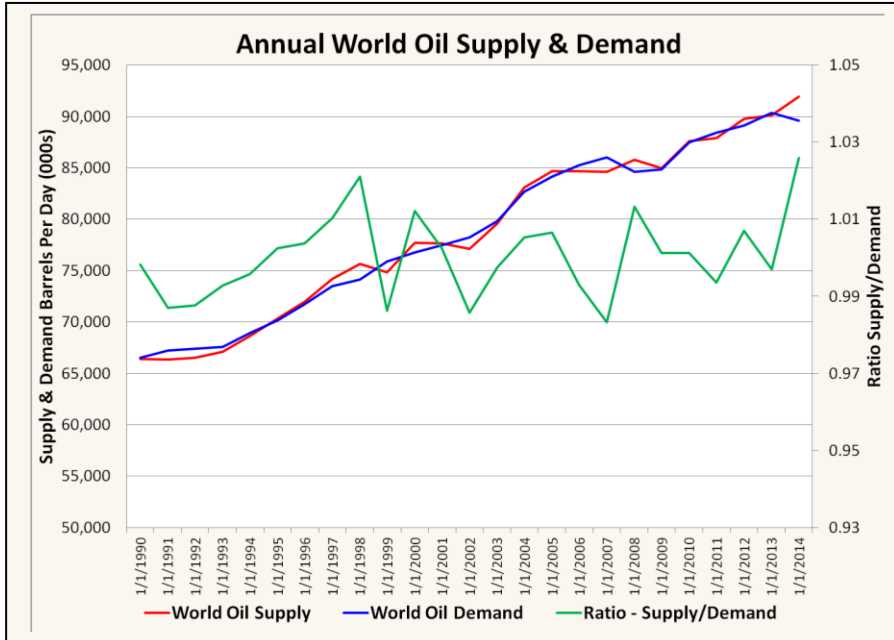
One factor pushing oil prices lower is fairly easy to identify and is universally accepted - the strength in the US dollar. A rising dollar hurts all commodities priced in dollars. A falling dollar helps all commodities priced in dollars.

The strong US dollar has also hurt gold.

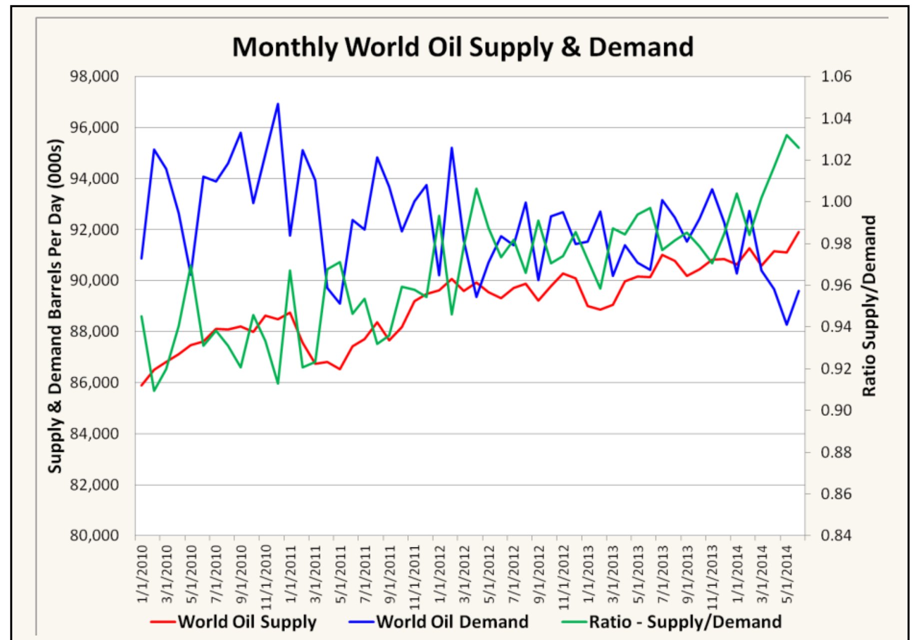
We've covered the relationship between the dollar and commodities in previous newsletters and we will not repeat ourselves here. For our purposes this month, it's enough to understand the inverse relationship between the US dollar and global commodities.

The next, and final, factor affecting oil prices is the simple economics of oil - supply and demand. As stated at the start of this newsletter, the drop in the price of oil has been portrayed as a supply issue. And, certainly, given the OPEC decision to continue production at current levels, that would make sense. But the facts get in the way of that story. Look at the chart below. The red line is world oil production. Growth in supply has averaged 1.59% per year since the recession ended. It average 1.43% in the two decades prior to the Great Recession. Given the growth in China and other emerging markets, the recent growth rate in supply seems reasonable.



What sticks out in the chart is not supply; it's demand - which is the blue line. It had a significant downtick in 2014. The green line measures a ratio of supply to demand. When it's going up, more supply is reaching the market than there is demand for. When the green line is trending down, on the other hand, demand is stronger than supply. Since 1990, the ratio has never been higher, meaning that the world is providing more supply than demand warrants on a scale not seen in the past two decades.

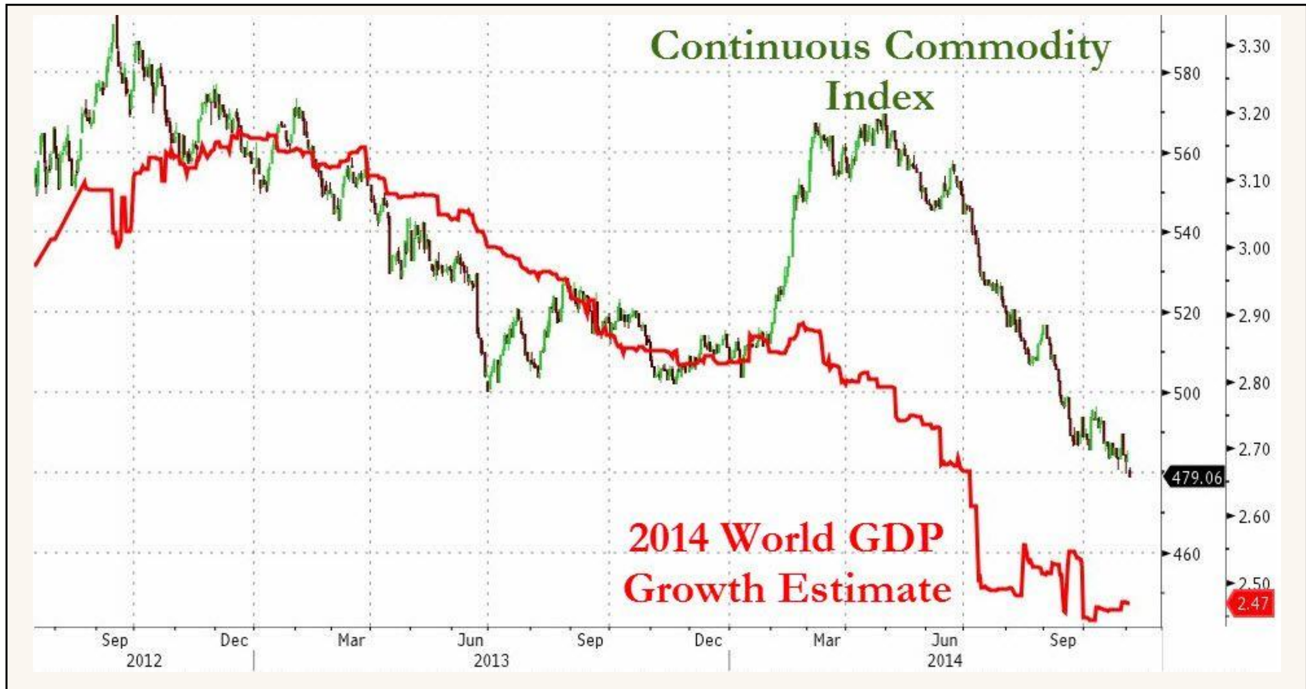
The chart below shows the same statistics, but rather than annually, the numbers are monthly. We do not have monthly numbers past June 2014, but you can see that in May, demand fell out of bed and supply spiked.



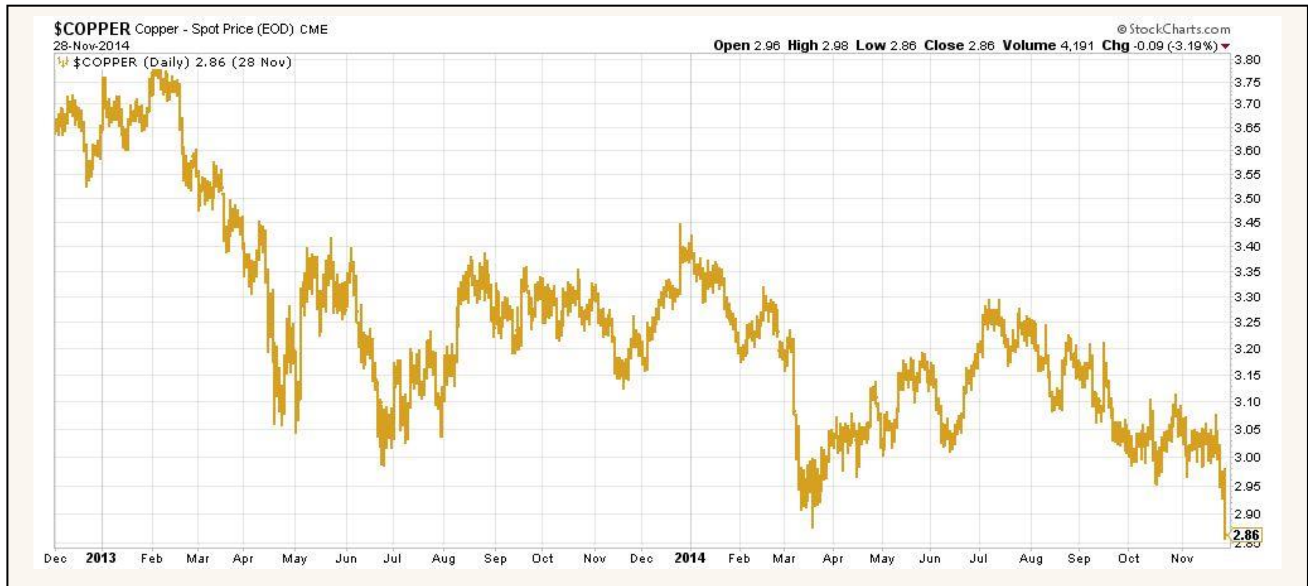
Our guess is that this condition has persisted since then, hammering the price of oil as one might have expected. The bottom line is that oil is not being over-supplied. *It's being oversupplied given the cratering in demand for it*. You may be thinking that such a distinction is academic. It's not. Because if you're not factoring in demand, you're missing one-half of the supply/demand story. More importantly, if you're not factoring in cratering demand, you're likely to misjudge global economic conditions, which have been deteriorating for some time. The only people who were taken by surprise at the drop in oil prices were precisely those people who were not looking at the global economic environment and its likely impact on demand. If they were, they were not taking it seriously.

Supply/Demand analysis is necessarily a two-part endeavor. Weakening global demand, given the same level of supply, is bearish for all commodities.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.



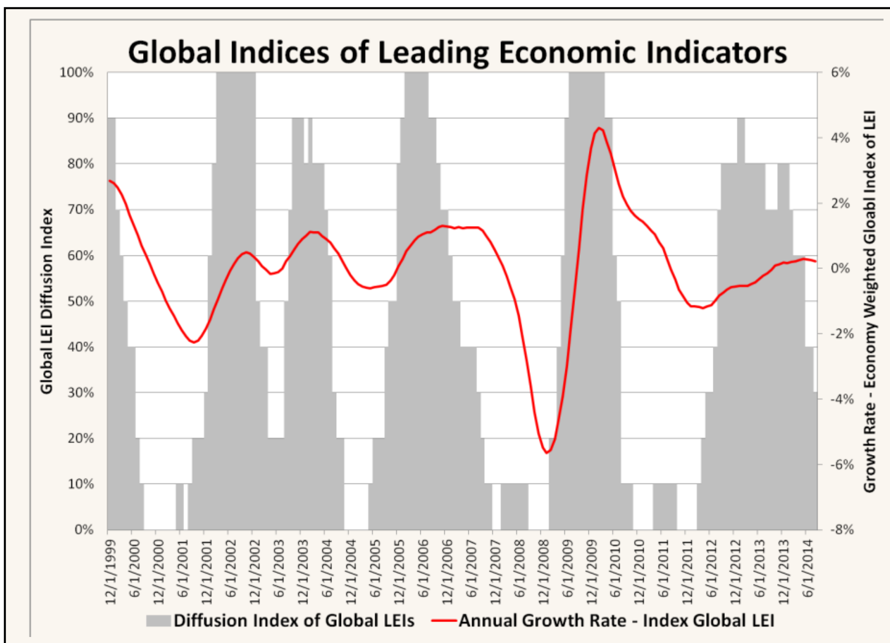
Our first conclusion is that the global economy is weaker than many believe. Many analysts have pointed to China as a potential savior for the global economy. We don't think so. If China was growing at all, let alone their reported 8% clip, would copper prices look like this?



Probably not. Certainly, iron ore prices would not look like this.

Oil prices would not be at 5-year lows, either. Neither would commodity indices be sitting on 26% pullbacks from 2014 highs.

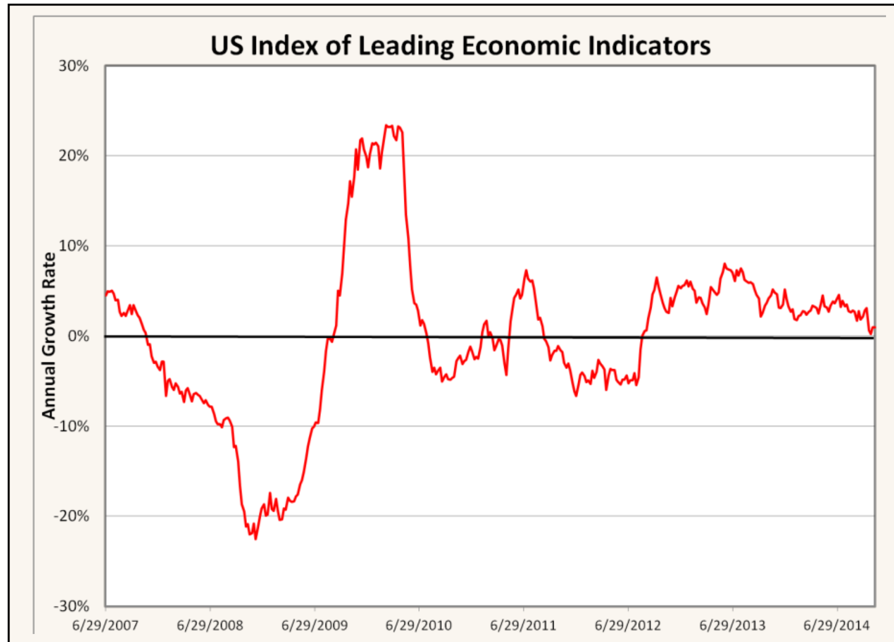
The bottom line is that the global economy is weak and the US may be the only developed economy not flirting with a recession. And it will take a resurgence in global economic growth for oil to regain a $100 per-barrel price. That would not appear to be in the cards. The global leading economic index is weak.



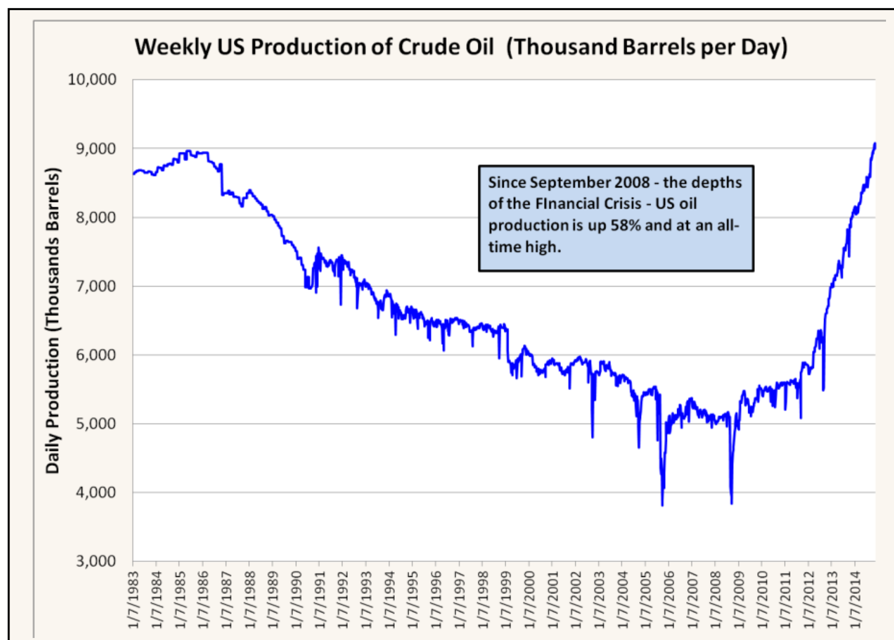
That means we can't expect much, if any, global growth over the next 12 to 18 months. By the way, the grey indicator in the background of the chart to the left is more important than the red line. It shows how many of the largest global economies have accelerating leading economic indices. Currently, that's only 30%. The red line is the global leading economic index and has only recently started to show signs of weakening. It includes a heavy weighting to the US economy. But even the US economy appears to be weakening as its leading index has deteriorated significantly.

The growth rate of US leading indicators is negative for the first time in two years, although it's hard to discern that in the chart.

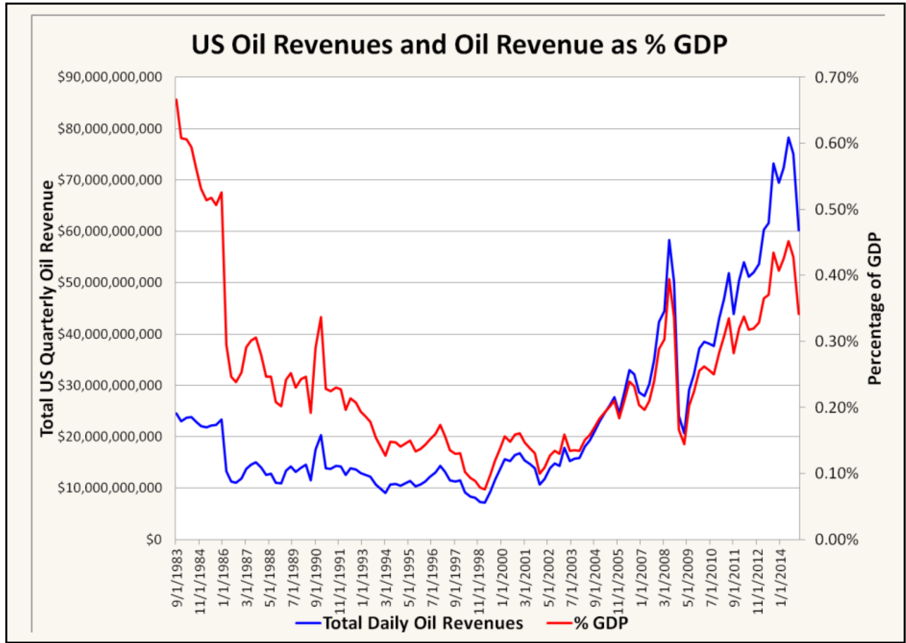
Surely, the drop in gas prices will stimulate consumer spending, which will in turn spark US economic growth, right? That's the theme that gets bandied about. To be clear, the money consumers will save at the pump is not new money. That money would have spent it on gas had prices remained high. Presumably, it will be spent elsewhere if gas prices are low. Either way, the money gets spent and the net effect on the economy is zero. But what market pundits and financial journalists want to convey is that consumers will buy, say, 50 gallons of gas every month, whether the price is relatively high or low. If prices are low, as they are now, money that used to go to buy 50 gallons of gas will go further and can be spread into other sectors. And the money not spent on gas, which hurts refiners and oil producers (previously largely foreign companies) will now go to the mom and pop shop down the street. The result? A booming economy.

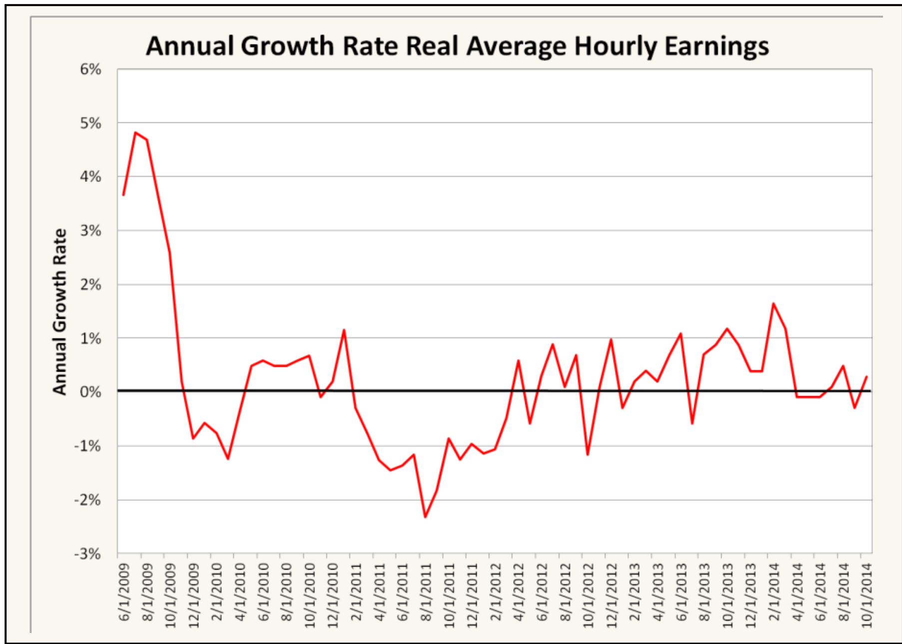


But that's not as set in stone as it once may have been. First of all, since the US is now competing with OPEC countries in terms of oil production, it's a pretty big part of the US economy. The US was not a major player as recently as five years ago. Look at the explosive growth in US oil production since September 2008.



Recent scholarship has estimated that the oil and gas boom has contributed only about .15% to annual GDP growth, which has averaged about 3.8% (in nominal terms - not adjusted for inflation) since the recession ended. This seems quite low. As the chart below shows, the value of the produced oil alone accounts for an increase in oil's contribution to GDP from 0.15% at the trough in 2009 to 0.35% currently. That means that even after the recent collapse in oil prices, the value of the oil we produce and sell accounts for 0.35% of GDP growth. And that figure doesn't include all of the investment and employment associated with the production of oil or its distribution. The oil industry itself estimates that it is now adding 2% to GDP growth annually. And although they have an incentive to err on the side of a higher estimate, it does seem more reasonable than a mere 0.15%.



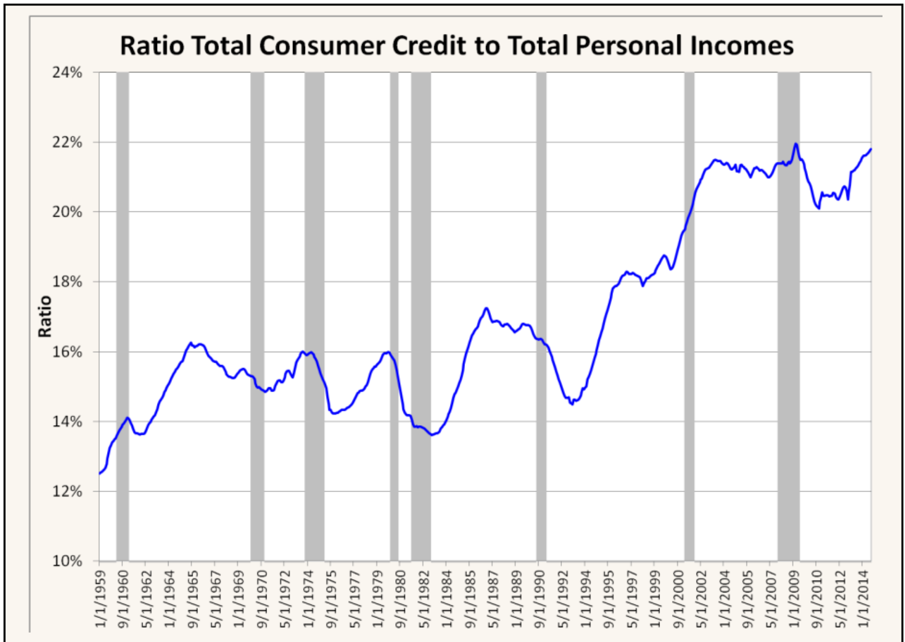


The point is this: lower oil prices may very well help the consumer at the pump, but it will have significant negative effects on an industry that has provided much of the economic growth post-recession. Every gain to the consumer comes at the expense of a hurtful blow to an industry that is largely responsible for keeping the US out of a technical recession for much of the post-2009 period. Which force will have a greater impact on the economy - the positive effect on consumers or the negative effect on an important industry - can be debated. We fear the negatives may outweigh the positives if consumers don't consume, and the consumer is in a perilous state.

First, consumers are not seeing much of a salary gain after inflation.

The growth in real (after inflation) wages has spent much of 2014 in negative territory. Keep in mind that the Bureau of Labor Statistics is using a measure of inflation that is probably severely understated to come up with these still-abysmal numbers.

Second, consumers are tapped out on debt. The ratio of total consumer credit (which includes autos but not real estate) to total personal incomes is a whisker away from all-time highs. Granted, the newest batch of debt that consumers have taken on is largely comprised of student and auto loans. That means that the former can be deferred and the latter was made at insanely low interest rates. This helps consumers navigate their debt burdens more easily. Still, debt is debt. Students graduating with $100,000 in loans will not be viable discretionary consumers. They will be paying off debt. And those taking on low-interest car loans will still be making payments, albeit less than they would have in a higher interest rate environment.



All told, the consumer is in a difficult position. He/she has seen little or no real gain in income recently and they've racked up debt. And we think the consumer is going to save the economy? Consumers may end up taking on more and more debt to finance purchases, and we may see a wave of accelerated growth in real earnings. But short of that, the meager savings from trips to the gas station will likely have a disappointing impact on the economy.

There is early anecdotal evidence that would suggest the consumer may be tapped out. To be clear, it's anecdotal and should not be used as a basis for analysis. Still, early returns on holiday shopping - Black Friday sales - were a flop. Shoppers spent $7 billion less in the 4-day shopping period starting Thanksgiving Day 2014 than they did in 2013. That amounts to an 11% drop in sales. Further, early returns on Cyber Monday sales were also a disappointment, coming in worse than expected and significantly worse than last year. Perhaps, as industry analysts tell us, consumers are simply spreading out their purchases over many more holiday shopping days than they used to. And it's possible that all sales targets will be met with additional and more severe discounts, but it's hard to rationalize such disappointing numbers from Thanksgiving through December 1. And if retailers must discount goods beyond what was originally planned, we're simply shifting the pain from the consumer to the retailer.

Finally, we will point out that some of the savings at the pump will be spent, some of it saved, and some of it used to pay down debt. That which is spent will surely add to retail sales numbers (other than gas station sales of course), but due to stagnant real wage growth and high debt loads relative to incomes, we doubt it will be the economic windfall many are counting on.

In conclusion, we should be careful what we wish for. Lower oil prices are a boon to the consumer but a bane to a US oil industry that has gained in its importance to our economy. And that "discount" at the pump may not amount to much of a pick-up in consumer spending. All of this comes against a backdrop of global economic deterioration and slowing, which would be a concern in an era before the advent of interventionist central bankers. Maybe the next quantitative easing program will feature the Fed buying barrels of oil instead of bonds. At this point, it would not be shocking.

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