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# Advocacy Investing®

## OIL PRICES PLUNGE

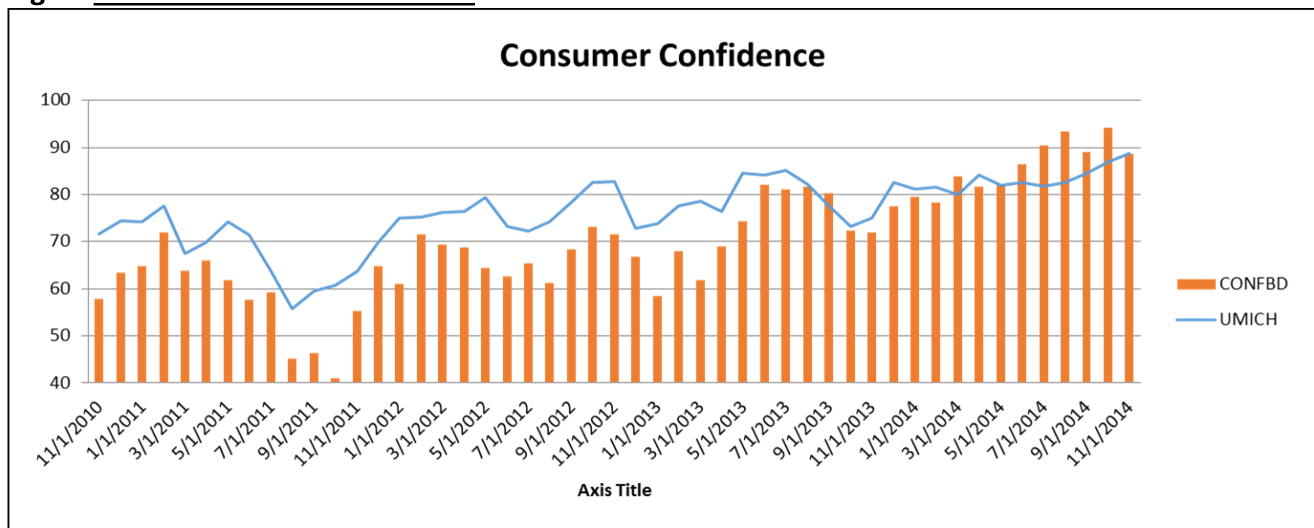
- **3Q14 growth is revised upward**
- **Oil prices are down almost 40% since July**
- **A strong payroll report for November translates into wage gains**
- **The US, UK and Canada become "consumers of last resort" in a weak global economy**
- **Main drivers of US growth remain tentative, but recent data boosts the case for faster growth**
- **Equity markets on target for a third year of triple digit growth after a strong November performance**

***GDP Revised Upwards:*** The first revision of 3Q14 economic performance led to an upgrade of GDP growth from 3.5% to 3.9% (annualized), thanks to improved numbers on personal consumption expenditures and non-residential fixed investment.

***The data releases stream underscored the continued strength of the US economy,*** although some weaknesses remain. Industrial production fell by 0.1% (month-on-month m/m) in October, but manufacturing expanded by 0.2% m/m. Automobile production reached new highs, but durable goods ex-transportation fell by 0.9%. Economic activity survey data remained positive. The early month surveys (Empire State and Philadelphia Fed) both improved, Empire State up to 10.16 from 6.17 the previous month, and the Philadelphia index rising from 20.7 to 40.8 over the same period. The ISM-Manufacturing fell slightly at the end of the month to 58.7 from 59 the previous month, and the broad-based Chicago PMI declined from 66.2 to a still-robust 60.8 over the same period. The services sector expanded, with the ISM-Non Manufacturing index rising to 59.3 in early December from 57.1 the previous month. The picture on the household side was mixed. Both major indices of consumer confidence (University of Michigan-Reuters and Conference Board) registered a slight decline. Personal Income and Personal Consumption Expenditures each rose by 0.2% (m/m) in October, while retail sales increased by 0.3% m/m. Exports grew by 1.2% m/m in October, after falling by 1.8% in September, but the weak global economy and the strong dollar are having a negative impact on export performance—the January-October outcome is only 3% higher than the similar period in 2013.

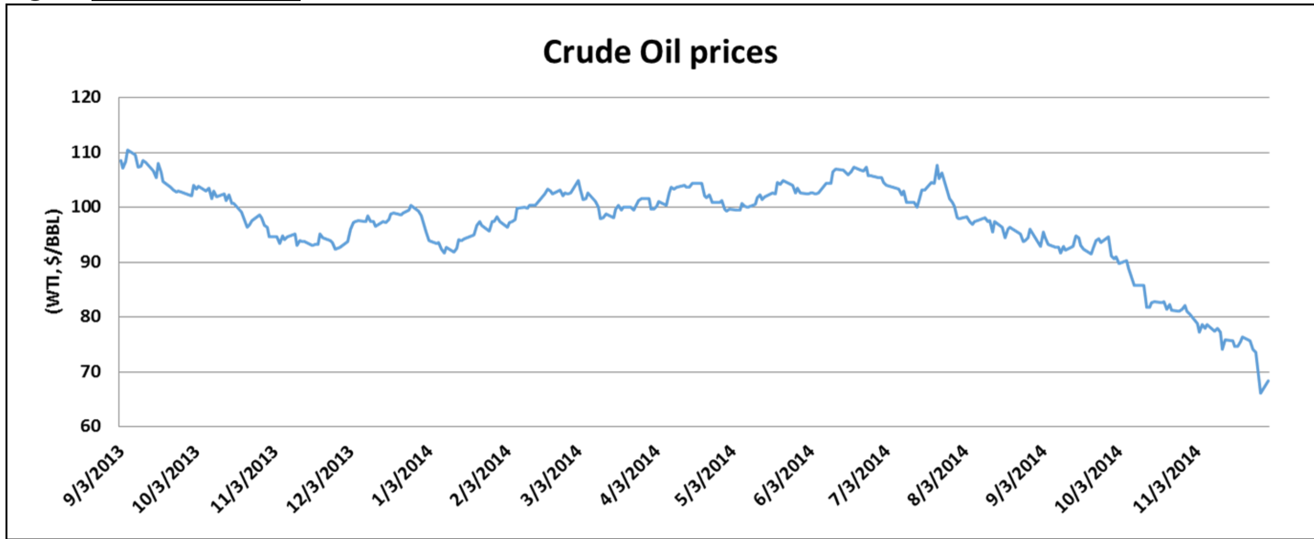
***Oil Prices Back to 2009 Levels:*** Oil prices plunged further in November, down 37% from their July peak to under $70 per barrel ($/bbl) in early December. Oil prices have been driven down to mid-2009 levels by a combination of factors: surging US crude oil production and resistance to production cuts by OPEC's main producers, in particular Saudi Arabia. (The latest OPEC oil ministers' meeting failed to agree on any production cuts.) Bearish pressures are expected to continue in 2015. U.S. crude production has reached 9 million barrels per day (mbd) in the past few weeks, closing on Saudi Arabian and Russian production levels. U.S. crude production is expected to increase by another one million barrels per day (MBD) in 2015.

**Fig. 1: <u>Consumer Confidence Stable</u>**



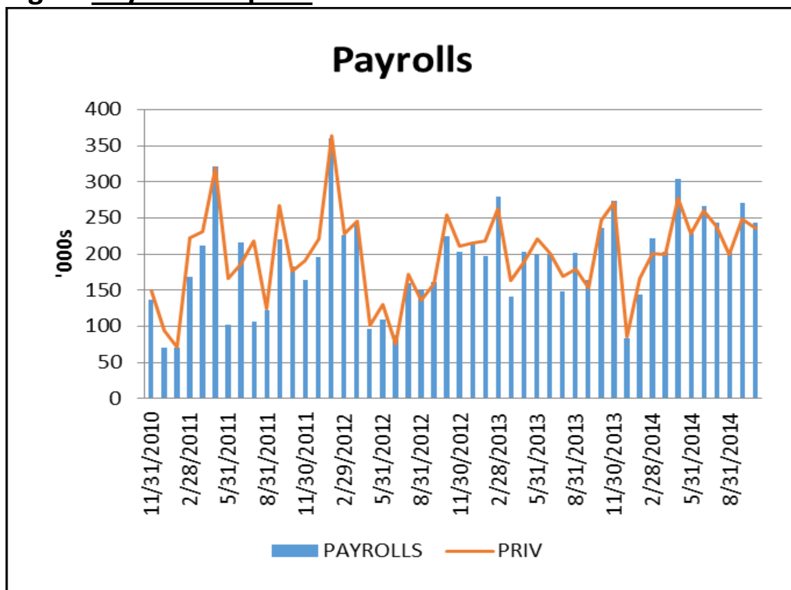

Other factors also could push global oil supplies higher. First, the recent agreement between the Baghdad government and Iraq's Kurdish regional government on oil revenue sharing could add another 0.5 MBD to Iraqi production. Second, successful nuclear negotiations between the P5+1 and Iran would also lead to a sharp increase of Iranian production to pre-sanction levels in 2H15. These bearish pressures have led to prediction of oil prices in the $60-65 range in the next few months. It is estimated that the 40% oil price drop, if maintained over the next few months, will result in a transfer of $1.3 trillion from oil producing to oil consuming countries. Such a massive shift will have a profound impact on currencies and global economic prospects. In the case of the United States alone, the sharp drop in gasoline prices should add an average of $500/year of purchasing power per household. Furthermore, oil prices will have a positive ripple effect throughout the economy, impacting transportation and energy costs, as well as a vast array of energy-intensive industries, petrochemicals and the like.

**Fig. 2: Crude Oil Prices**




***Housing Market Wobbly:*** The housing market stabilized after several weak months, but there is little forward momentum. Housing Starts, New Home Sales and Existing Home Sales were essentially unchanged in October. Housing prices recovered somewhat in September, with the Case-Shiller 20-City index rising by 0.4% after four consecutive monthly drops. Construction spending also recovered, rising by 1.1% m/m in October after a 0.1% fall the preceding month.

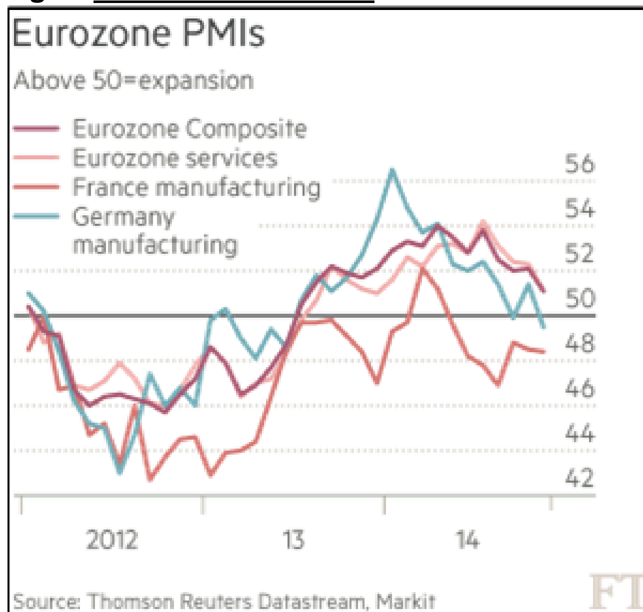
**Fig. 3: Payrolls Surprise**



***Labor Markets Steady:*** High-frequency data continued to underscore the improvement in the labor markets. First-time jobless claims, which had jumped to over 300,000 in the week of November 22, fell to 297,000 in the last week of November—they have been under the key level of 300,000 for 10 of the past 11 weeks. The significantly above-expectations non-farm payrolls report confirmed the labor markets' buoyancy, as the economy generated 321,000 new positions (including 314,000 in the private sector). Furthermore, payroll numbers for the previous two months were revised by an aggregate 44,000, bringing the three-month average level of job creation to almost 280,000. The gains were broad-based: private services (+266,000), goods-producing (+48,000) and government (+7000). Weekly hours worked increased marginally to 34.6, from an average of 34.5 in the past 8 months, and hourly wages jumped 0.4%, the first sign of significant wage income gains in 2014. The unemployment rate, which is derived from a separate household survey, stayed constant at 5.8% as the labor force participation rate has remained unchanged at 62.8%. Another encouraging sign has been the 1.1 million increase in the civilian labor force since November 2013. The U6 indicator, which measures underemployment as well as unemployment, fell to 11.4% from 11.5% the previous month (and 13.1% a year ago). Several indicators were less favorable, including the unchanged number of part-time workers seeking (but not finding) full-time positions. While the overall employment situation has improved significantly during 2014, we will need confirmation of wage gains over the next 2-3 months before declaring victory.

***Forward Guidance:*** The Minutes of the October 28-29 meeting of the Federal Open Market Committee (FOMC) underscored the debate within the Fed regarding "forward guidance." While analysts and markets widely expect the Fed to start tightening monetary policy at some time after mid-2015, the path to a more conventional monetary policy remains uncertain. The FOMC participants were divided between those who wanted to keep things vague by continuing to use the phrase "a considerable time," and those who felt the need to be more specific and tie the monetary tightening to data benchmarks. In any case, with strong deflationary pressures looming and below-potential economic growth, the Fed (and other major central banks) are likely to keep the benchmark interest rates below "normal" levels for at least two years after the first interest rate increase. Bond markets remained subdued: the 10-year bond yield fell further to 2.25% at the end of November, 30 basis points below the end of 3Q14 level, and the yield curve flattened further.

**Fig. 4: Worrisome eurozone**




***Global growth indicators are mixed.*** The eurozone recovery remains sluggish, with the eurozone Composite PMI falling to 51.1 at the end of November from 51.4 a month earlier. Overall, the eurozone is expected to grow by 0.1% (q/q) in 4Q14, and is dangerously skirting deflation and another recession in 2015. Meanwhile, unresolved disagreements among the major governments have delayed the introduction of the first major round of quantitative easing by the European Central Bank. The Chinese economy also shows signs of weakness, with the Markit PMI-manufacturing dropping to 50 in November. The Japanese economy is struggling with recession, and apart from China, the other BRICs are either in recession (Russia) or experiencing slow growth (Brazil and India). The sharp drop in oil prices is expected to result in a transfer of $1.3 trillion in purchasing power from producers to consumers. This is particularly welcome news for the eurozone, Japan and China, as well as other major emerging market oil importers such as Turkey and India. All-in-all, the United States, Canada and the UK are the bright spots in a multispeed global economy, and for all practical purposes are the global “consumers of last resort.” It remains to be seen if such a situation is sustainable.

***Political Economy:*** A major concern over the next two years will be policy uncertainty. While the mid-term election handed control of the Senate to the Republican Party, President Obama has struck a defiant pose. While it is likely that the political calculus by the GOP will prevent another government shutdown—Congress voted to fund government through the end of the current fiscal year next September—we can expect a worsening of the policy gridlock that has been the norm since 2008. This means that key areas of tax reform, regulation, energy and infrastructure will remain in limbo, delaying much-needed structural reforms and adding to the uncertainties facing the business community.

***The US economy is in its sixth year of economic expansion,*** with an average output growth of 2.3% over this period. In the past two quarters, the economy has registered two quarters of solid, above-trend growth. The key question remains: is the US economy reaching take-off velocity to graduate from 2.0-2.5% growth to 3.0%+? The conditions for takeoff are there, but remain tentative:

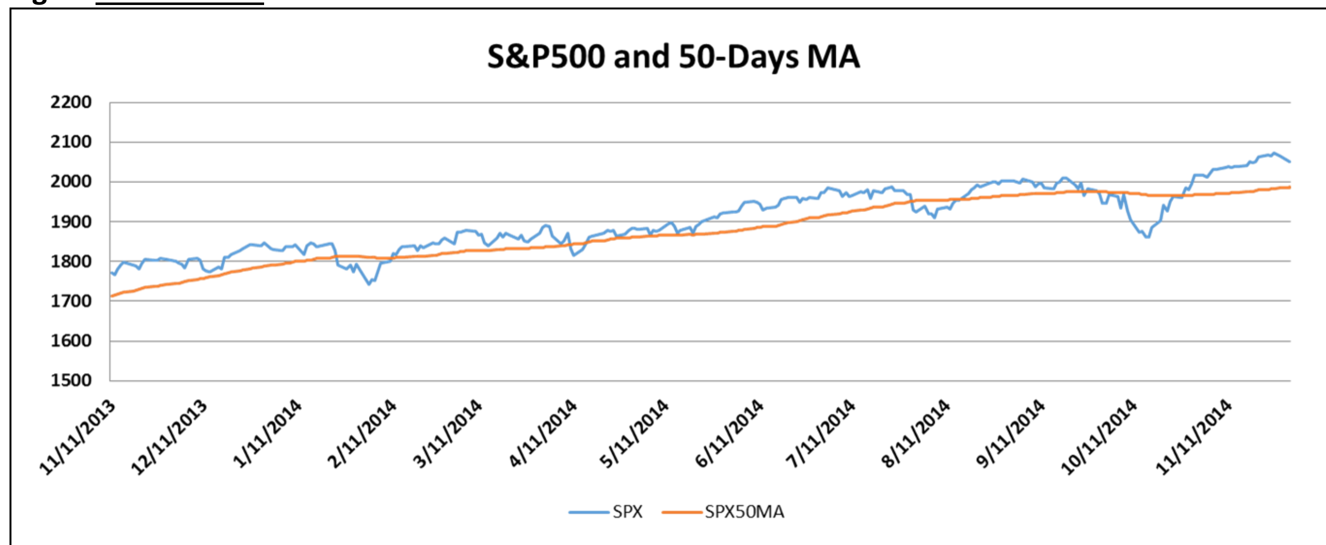
- Gains in income, pent-up demand and record levels of household net worth have yet to translate into faster growth in personal consumption expenditures, which constitute 70% of GDP.
- The corporate sector is in good shape, with record levels of cash and earnings. Financing costs are low and credit is available. However, business fixed investment remains subpar.
- The fiscal drag has faded and the budget deficit has fallen to below 3% of GDP, but we do not expect any fiscal stimulus, especially in the current political environment.
- There is a large amount of pent up housing demand, but investment in new housing and mortgage originations remain low.

Nevertheless, the sharp drop in oil prices is expected to provide a welcome boost to US growth. In combination with the sustained improvement in labor markets and potentially faster labor income gains, we could see the economy finally moving to a higher pace of expansion.

In the medium and longer term, however, a faster pace of economic growth cannot be maintained without addressing some of the structural problems facing the economy, in particular the widening of the economic gap between the top and bottom half of US households.

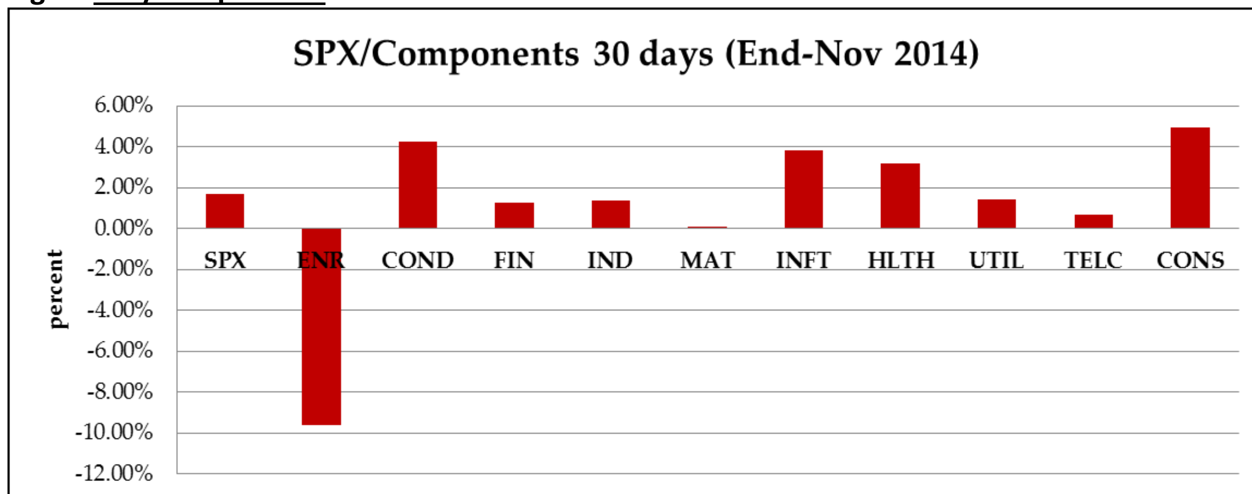
***Bullet-Proof:*** The markets continue to defy gravity. After a short bout of volatility in October, the main market indices have continued on their upward trajectory. The S&P500 has been breaking record after record, gaining 10% between its low on October 15th and the end of November. The S&P500 gained another 0.9% in the first trading week of December. Overall, the market has gained 10.2% since the beginning of the year and is on track for a third year of double-digit growth. Once again, defensive sectors led the bull on both month-to-month and previous three months basis, with cyclical sectors lagging.

**Fig. 5: Bull Markets**



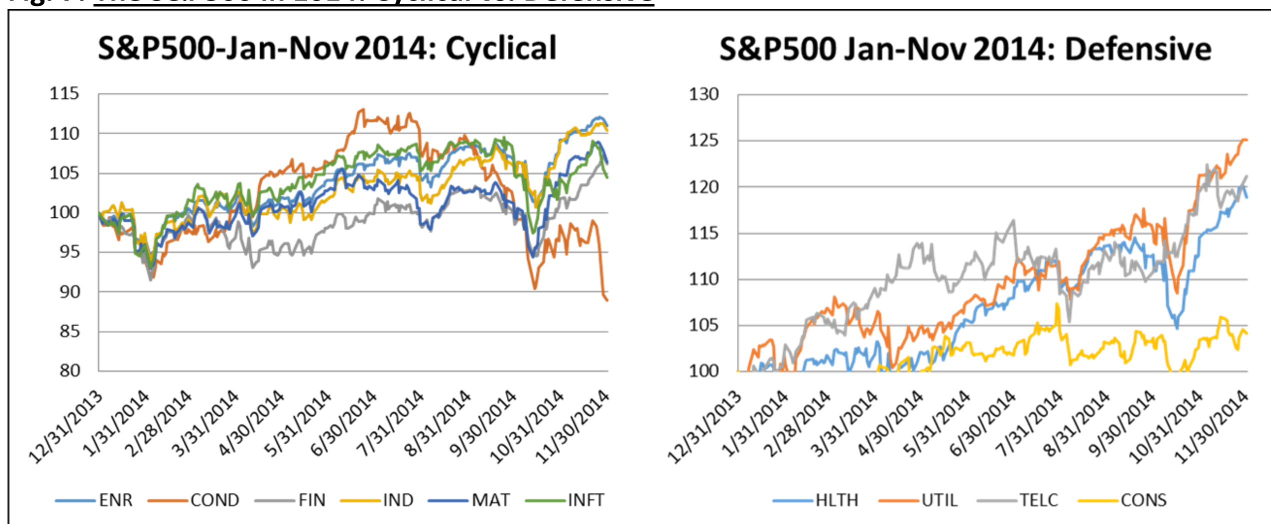

However, valuations continue to be at potentially unsustainable levels. The CAPE ratio (which compares stock prices to the average of earnings in the previous ten years) stood at 27.25 in early December, compared to an average of 22.57 in 2010-2013. While profits are at record highs, they do not explain the strong upward momentum of US equity markets. Moreover, top line growth remains weak and US corporations seem to have run out of room for significant cost-cutting (in itself often a self-defeating activity). So, much of the stock market momentum comes from the fact that US corporations continue to return record amounts to shareholders through buybacks and dividends. Companies sitting on a mountain of cash are still holding back on capital expenditures, instead, opting to return cash to shareholders. About one quarter of the S&P500 companies have bought back shares in 4Q14. Since 2010, $3.1 trillion has been returned to shareholders—$900 billion in 2014 year-to-date alone.

**Fig. 6: SPX/Components**




The markets are on a strong upward course and the S&P500 is within sight of the 2,100 level. Global indices are also on the rise, and the FTSE100 is at a 3-month high. In the short-term, the markets are looking to the last FOMC meeting of 2014, scheduled for December 16-17. In the longer term, whether the equity markets can continue for a seventh year of unmitigated growth remains an open question.

**Fig. 7: The S&P500 in 1014: Cyclical vs. Defensive**



## November Data Releases

| *Economic Data Releases-November 2014* | *Prior* | *Consensus* | *Actual* | *Min* | *Max* |
|---|---|---|---|---|---|
| Macroeconomy | | | | | |
| GDP (1Q14, % Annualized) Second estimate | 3.5% | 3.3% | 3.9% | 3.0% | 3.8% |
| CPI (m/m) Oct | 0.1% | -0.1% | 0.0% | -0.3% | 0.0% |
| Core CPI (% m/m) Oct | 0.1% | 0.1% | 0.2% | 0.1% | 0.3% |
| Balance of Payments | | | | | |
| Exports (% m/m) Oct | -1.8% | | 1.2% | | |
| Imports (% m/m) Oct | 0.0% | | 0.9% | | |
| Trade Deficit $ billion) Sep | $43.6 | $41.0 | $43.4 | $40.0 | $42.7 |
| Current Account Deficit ($ billion) (2Q2014) | | | | | |
| Oil Prices (WTI, $/bbl, eom) Nov | $80.54 | | $66.15 | | |
| Corporate Profits (y/y) 3Q14 | 4.6% | 4.6% | 3.8% | | |
| Industrial & Manufacturing | | | | | |
| Empire State (Nov) | 6.17 | 10.30 | 10.16 | 7.50 | 15.00 |
| Philadelphia Fed (Nov) | 20.70 | 18.00 | 40.8 | 13.00 | 25.80 |
| ISM-Mfg Nov | 59.0 | 57.8 | 58.7 | 56.5 | 60.0 |
| Chicago PMI Nov | 66.2 | 63.2 | 60.8 | 62.0 | 65.0 |
| Markit PMI Mfg Nov | 55.9 | 55.0 | 54.8 | 54.5 | 55.2 |
| Industrial Production (% m/m) Oct | 0.8% | 0.2% | -0.1% | -0.1% | 0.4% |
| Manufacturing (% m/m) Oct | 0.2% | 0.3% | 0.2% | 0.2% | 0.4% |
| Durable Goods (m/m) Oct | -1.3% | -1.5% | 0.9% | 0.3% | 1.4% |
| Durable Goods, ex transp (m/m) | -0.2% | 0.5% | -0.9% | -0.3% | 0.4% |
| Factory Orders (m/m) Oct | -0.5% | -0.3% | -0.7% | -0.8% | 0.4% |
| Services | | | | | |
| ISM Non-MFG (Dec) | 57.1 | 57.3 | 59.3 | 54.4 | 59.3 |
| Consumer Spending | | | | | |
| Retail Sales (% m/m) Oct | -0.3% | 0.2% | 0.3% | -0.3% | 0.5% |
| UMich Consumer Sentiment (end-Nov) | 89.4 | 90.0 | 88.8 | 89.5 | 94.8 |
| ConfBd Consumer Confidence (end-Nov) | 94.5 | 94.1 | 88.7 | 94.8 | 98.8 |
| Personal Income (m/m) Oct | 0.2% | 0.4% | 0.2% | 0.3% | 0.4% |
| Personal Consumption Expenditures (m/m) Oct | 0.0% | 0.3% | 0.2% | 0.2% | 0.4% |
| Housing Market | | | | | |
| Housing Starts ('000) Oct | 1038 | 1028 | 1009 | 979 | 1100 |
| New Home Sale ('000) Sep | 467 | | | | |
| Existing Home Sales (MM) Oct | 5.18 | 5.15 | 5.3% | 5.00 | 5.25 |
| Construction Spending (m/m) Sep | -0.1% | 0.5% | 1.1% | 0.4% | 1.0% |
| Case Shiller-20 (m/m) Sep | -0.1% | 0.5% | 1.1% | -0.4% | 0.4% |
| Case Shiller-20(y/y) | 5.6% | 5.6% | 4.9% | 4.4% | 5.4% |
| Employment | | | | | |
| First Time Claims ('000) (Last week Nov) | 314 | 295 | 297 | 270 | 300 |
| Non-Farm Payroll Nov | 243,000 | 230,000 | 321,000 | 140,000 | 275,000 |
| o/w Private Sector | 236,000 | 225,000 | 314,000 | 205,000 | 260,000 |

*Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.*

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