CRUDE DOLLARS

Monday, April 26, 2015

- First Quarter real GDP growth was disappointing, but the sluggish growth will prove temporary.
- Though the benefits of lower oil prices have been slow to materialize, consumers have built up their savings and in the quarters to come some of those savings are expected to find their way into the U.S. economy.
- The surging U.S. dollar is a threat to the U.S. economic outlook, not because of its level but because of the rapidity of its ascent.

The U.S. economy was notably slow in the first quarter (Q1) of 2015. Very bad weather probably subtracted about a half-percentage point of growth from Q1 annualized Gross Domestic Product (GDP). The now-settled strike at west coast ports cut an additional quarter-percentage point. The biggest culprit in slowing Q1 GDP was lower oil prices. No, you didn't read that wrong – lower oil caused economic stress last quarter. Sounds contradictory, or even wrong, right? But, in fact, negative fallout from the dramatic decline in oil prices did hit the economy hard, to the tune of about three-quarter percentage points from GDP.

Taken together, these three temporary (emphasis on "temporary") weights on the economy dragged down Q1 GDP by about 1.5%. Given that the GDP is tracking at about 1.0% for Q1, underlying growth is closer to 2.5%, which is closer to the expected growth rate for the entire year (after the negative affect of oil reverses itself).

The positives of lower oil have, so far, been trumped by the negatives. Energy-related payroll cuts were close to 30,000 last quarter, about half of the jobs created all of last year. And as active rigs for drilling oil and gas have been shuttered, new investment and expansion has been cut to the bone. The precipitous drop in oil prices has hit the economy hard, and it will continue to have elements that weigh on the economy, albeit to a lesser degree, over the next couple of quarters.

As these negatives fade, the economic benefits of lower oil prices will begin to materialize (though BMM believes the benefits will be significantly less than the consensus expects). Thus far, consumers have largely saved the proceeds from their lower gasoline bills. That is good news for the quarters to come as personal savings rates have jumped – for now. If oil were to stabilize around current prices, American households will spend close to $150 billion less on gasoline this year compared to last. So far, consumers are either a) saving up their savings to buy something bigger, or more likely, b) treating it like a temporary tax cut (tax rebates are typically saved; permanent tax cuts are typically spent).

The consensus expectation is that oil is now permanently (and dramatically) lower. And maybe they are, depending upon your definition of "permanently" and "dramatically". We believe the duration of lower oil prices is years. Maybe two. Maybe ten. We don't really know, but it's very likely short of permanent, however long it ends up being. Seeing how the experts who are now calling for permanently lower oil prices are the same ones who didn't see the massive decline in the first place, we are reluctant to believe the calls of yet another "new normal". But as far as how consumers act, it doesn't matter if it is permanent or not – it only matters that they believe it is permanent. We believe they (mostly) will below so, and, thus, will spend a lot of their savings.

As far as the expected range of oil, we can argue for something between $50 per barrel to $70 per barrel (which is not only 8.3% to 51.5% higher than the recent $46.18 low, but also argues oil has bottomed). Agreed, that range is dramatically lower than the $114 52-week high, but it's higher than the $15-$25 range for the 12 years from 1987-1999, and compares to the 100-year inflation adjusted average of about $50.

But did we just bury the lead? Did we just argue that the price of oil has bottomed? Yes, yes we did. Oil's price action looks very similar to the 1998 and 2009 bottom where, in both cases, the futures curve went into extreme contango. A contango reading simply means that the price of oil tomorrow is cheaper than the price of oil today. It is a sign of stress in the system. In the 1998 and 2008 cases, once the extreme contango positions began to reverse and found some traction, oil prices rallied by an average of 73%. If oil followed a similar path that would put it back into the high $70s by year end.

If it weren't for US oil supplies, we would declare affirmatively that the bottom is in, but today's excessive supplies call into play some level of caution not only to whether or not it is definitely a bottom (though we expect it is) as well as any alteration of a historically-similar bounce (i.e. maybe the price of oil not reaching the high $70s, or only doing so temporarily).

Now, after reading that, you may be expecting us to increase the allocation of your growth investments to oil. Well, we're not. And not only because of the oil supply issue, but because the (obviously) volatile nature of prices in oil is better suited for traders, not investors. So then, wouldn't it make sense to buy stocks in the US energy sector? Well, as it turns out, historically outperformance by the S&P Energy Sector typically only lasts a few months, but then has faded.

The broader market, as measured by the S&P 500, has done well on an absolute basis following major oil price bottoms (a "major oil price bottom" defined as a 40% decline, followed by a 30% rise), going up an average of 14.5% one year after the bottom. In six of seven such cases, the S&P 500 had a positive return (the only losing year was in 2001, a recessionary period, which we do not expect to repeat this year).

Also, the broader S&P 500 index has been relatively positive compared to other S&P sectors following major oil price bottoms. So, frankly, per our Economic Outlook for 2015, we'd prefer to flatten sector allocation and use broader exposure –and this only further strengthens that argument.

The biggest threat to the economy is the aggregate consequences of a surging U.S. dollar. On a broad trade-weighted basis, the dollar is up about 15% from last summer, and up closer to 20% compared to the Euro and the Yen. It is rare for the dollar's value to move so dramatically or so broadly in such a short period of time.

The more expensive dollar is hurting American companies, especially large multinationals. U.S. exports are more expensive for foreign buyers, and multinationals don't make as much money in dollar terms on their overseas operations. The U.S. economy is strong enough to handle the dollar at this level, especially considering that in a historical context it really is not that strong (on a real trade-weighted basis, accounting for relative U.S. and global prices and nominal currency values, the dollar's value is only about average right now).

It's not only the dollar's value that matters, it's the rate at which a value is attained. It's simply more difficult to manage corporate operations with such a rapid ascent, especially when any pauses are relatively short-lived. BMM's concern isn't continued dollar strength, but the continued rapid ascent of the dollar. This is a significant risk given that financial markets do not appear to have yet fully discounted how quickly the Federal Reserve plans to normalize interest rates (which would make the dollar stronger relative to other currencies, especially those with central banks involved with easing monetary policy). Futures markets expect the federal funds rate to be near 1.5% at the end of 2017, seemingly disregarding the Fed's 3% forecast. If investors ultimately adjust their interest rate outlook, this could translate into a much stronger dollar.

Bottom Line

Temporary weights on the economy dragged down Q1 GDP by about 1.5%. Given that the GDP is tracking at about 1.0% for Q1, underlying growth is closer to 2.5%, which is closer to the expected growth rate for the entire year (after the negative affect of oil reverses itself).

The biggest culprit in slowing Q1 GDP was lower oil prices. The positives of lower oil have, so far, been trumped by the negatives. The precipitous drop in oil prices has hit the economy hard, and it will continue to have elements that weigh on the economy, albeit to a lesser degree, over the next couple of quarters. Oil is likely going through a bottoming process now, so as these negatives fade, the economic benefits of lower oil prices will begin to materialize.

Given the expected bottoming of oil prices, intuitively many investors may consider an allocation to energy stocks. However as it turns out, historically, outperformance by the S&P Energy Sector after a major oil bottom typically only lasts a few months, but then has faded.

The broader market, as measured by the S&P 500, has done well on an absolute basis following major oil price bottoms. Also, the broader S&P 500 index has been relatively positive compared to other S&P sectors following major oil price bottoms. So, frankly, per our Economic Outlook for 2015, we'd prefer to flatten sector allocation and use broader exposure –and this only further strengthens that argument.

The biggest threat to the economy is the aggregate consequences of a surging U.S. dollar. It is rare for the dollar's value to move so dramatically or so broadly in such a short period of time. The more expensive dollar is hurting American companies, especially large multinationals.

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BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

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For our marketing purposes— to offer our products and services to you	NO	WE DO NOT SHARE
For joint marketing with other financial companies	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your transactions and experiences	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your creditworthiness	NO	WE DO NOT SHARE
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