Whimper or a Bang: How does this business cycle end?
Oil Prices and Recessions

• Oil price spikes are the bane of the consumer—but the salvation of the oil sector
• How will this business cycle end? With an oil shock? If so, when?
• Two approaches
  – Recession → Oil shock
  – Oil shock → Recession
Since 1971, every recession has been associated with an oil price shock. Will it happen this time around, and if so, when?
Oil Prices and Recessions

- Oil price spikes are associated with recessions as far back as 1946
- Arguably true for all 12 (13) recessions since WWII
Where are we in the cycle?

- The current expansion – if we date it from 2009 – is now almost eight years old.
- It is already the third longest expansion in the past century
- How long will it last?
US Economic Fundamentals are Sound

- Non-manufacturing employment and activity index show steady growth
• US consumption continues to rise at a healthy pace
Initial Unemployment Claims

- Initial unemployment claims are the lowest since 1973
But, Payrolls weak in March

- Hiring was weak in March.
- Was it a blip, the economy, or are we running out of labor?
Although the US unemployment rate is now 4.5%, the country still has 1-2% of its population in reserve to reach historically typical employment-to-population ratios.

About 1-2 years to ‘full employment’
Working Part Time for Economic Reasons

- There are additional reserves of labor
- 1 million part time workers would prefer to work full time, figure a reserve of about 0.5 million, or six months of incremental labor demand growth
• One of the most pernicious effects of the Great Recession was long term unemployment
• Still not fully resolved
But the cycle is evidently peaking

- March auto sales were dreadful
Auto Sales - Peaks can sustain for Years

- Probably at the top of the cycle for vehicle sales – but that doesn’t imply an immediate crash
Housing is a Key Driver of Economic Cycles

- Real house price appreciation is probably the most worrying US macro indicator.
- A bit of a bubble forming
No Bubble in Housing Starts

- Existing home sales back to normal
- New home sales continue to lag
- Still room grow for 12-24 months
And Household Financials are in Good Shape

- Household debt service ratio is near forty year lows
- Great Recession should end when deleveraging stops
What would a downturn look like?

- No Boom: US GDP growth has been anaemic since the end of the recession
- Will we begin to look more like Japan?
- Since 2000, Japan has seen recession (contraction) about 35% of the time
- No meaningful pattern of expansion or contraction is readily visible
Despite generally anaemic economic performance, Japan continues to operate at effectively full employment.

Upward wage pressure for part time, low wage labor.

Full employment without an economic boom.
• The 65+ year old cohort is surging in the US

• Medical expenses increase disproportionately with age

• But spending on seniors does not improve the health of the country or the strength of its economy. Spending prevents health from deteriorating.

• More and more of GDP is directed not towards making things better, but preventing those from becoming worse

Medical spending increases significantly with age, as people 65+ account for roughly 40% of total personal health spending.
• As more and more is spent on trying to maintain current productivity levels of incumbent infrastructure and human capital, productivity growth may be the victim
• Lower immigration and small family sizes have reduced population growth
• Together, low productivity and population growth imply low GDP growth rates
• On the other hand, these trends may also mean high employment, which is delinked from GDP growth
• Not much boom, not much bust – hard to create price spikes without a boom
• Technical recessions and recoveries without much cyclical impact on oil prices
Killing the Business Cycle
This business cycle could very possibly die an unnatural death

- eg, 1991 Gulf War and oil shock

Likely causes

- Poor macroeconomic policies
- Nationalism
- War or Embargo
- Production outages
Trump Rhetoric tanked the Peso

USD/MXN (inverted)
18.70 / +1.74%

The Daily Shot®

Source: EIA

Trump elected
US Real Estate Loans

- US real estate lending has collapsed since the election
Commercial and industrial loan growth has also collapsed.

US consumer confidence notwithstanding, Trump’s rhetoric has destabilised the business community.
Adverse effects may not be permanent

• Mexico’s consumer confidence and the value of the peso has particularly recovered as rhetoric has eased

But the mood can change quickly
• US GDP outlook is pretty weak just now.

• Given the maturity of the business cycle, might not take a lot to knock it into recession
• US consumer looks quite sensitive to pump prices.
• Flee gasoline consumption when oil prices are much above $50 WTI
• Not clear US – or OECD – economies have much punch to move oil prices up
China’s Economic Growth

- China is not the country it was before the current Xi government
- Capital Economics China GDP proxy suggests GDP growth has fallen to around 4% per year
- Despite recent short term performance, GDP growth is expected to languish in 2017/2018
• Growth is weak despite large budget deficits
• Even as other countries’ finances have mended after the Great Recession, China’s continues to deteriorate
Exploding Levels of Private Credit in China

- And it’s not just the government.
- China corporate and household borrowing has rocketed up since 2009 as the government attempts to stimulate the economy.
Xi’s authoritarian and nationalist policies have frightened both China’s business class and foreign investors.

The result: capital flight and falling reserves as China tries to prop up its currency.
Money cannot create Political Legitimacy

- China is reduced to using fiscal and monetary stimulus instead of domestic and international legitimacy
- A losing game for government dependent on meeting the growing expectations of its highly leveraged population dependent on maintaining real estate values
• Many of the countries around China’s per capita GDP are already weak democracies
• At the current pace of development, China will likely become a democracy within ten years, and very possibly, within five
• While China is an important component of incremental oil demand, it is unlikely to power another price spike in the foreseeable future
Other Countries
• European economy is looking up and has running room for some time – but not huge source of incremental oil demand

• India is becoming a real consideration in oil demand – now showing oil consumption increasing faster than China in some quarters

• India is still not at the phase where it is likely to cause an oil price shock
The Importance of US Shale Oil
From 2005 to 2010, the oil supply hardly grew—and all growth came from Canada and the US.


OPEC only started to really add supply once the oil price collapsed, and added 2.1 mbpd in the last two years.

Even today, oil sands and US shale oil are 2/3 of total supply growth since 2005.

What’s the outlook for shale?
• Horizontal oil rigs: 561, about half of Nov. 2014 peak
• Total increase in horizontal oil rig count from trough: +313 (↑126%)
• Perhaps 200 of these rigs – almost 2/3 – are not yet producing oil
And rigs counts are rising faster than the expected ‘call line’ – essentially the pace Saudi Arabia and other OPEC players anticipated when the OPEC deal was signed.
Even though more than half the incremental rigs yet to contribute to the oil supply, US production has been increasing at a 1.7 mbpd / year rate through Q1.

Models are not capturing production dynamism properly

Most analyst forecasts see 400-600 kbpd increase in US production in 2017. Could be twice that, or more.

And if rig count additions continue at the recent pace, 2018 supply additions will be even greater. The revolution is not over.
Excess Crude and Product Inventories

- Global excess crude and product inventories are currently estimated around 400 mb
- These could fall below 200 mb at year end by more aggressive estimates
- The EIA, some banks, and trading houses see a more gentle draw
- Neither case supports heady oil prices in 2017, and dove-ish forecasts don’t close the gap in 2018, either.
- Hard to make a case for an oil price spike in the next two years on inventories outlook.
Longer Term is Not Assured

- Oil discoveries in 2016 may be the lowest on record—and they were not healthy even at $100 / barrel

- We have left the world of extensive development, and entered the world of intensive development

- We are either running down known reserves (OPEC) or exploiting known resources more intensively through technological innovation (shales)
But that doesn’t mean we’re running out of oil (yet)...

- We will have nearly 40 years of oil reserves
- These will increase with technological development and some new discoveries
- But confidence that the oil boom-bust cycle is over, or that oil supplies are endless, is most likely misplaced.

*Source: BP Statistical Review, *excluding Canadian oil sands and Venezuelan tars*
Summing Up
When the oil supply is constrained, oil spend will average 4-5% of world GDP.

When the oil supply is unconstrained, the spend will average 1.5-2.5% of GDP.

There appears to be no stable position in between these two poles.

Today, oil prices are consistent with normal economic growth—but not particularly cheap by historical standards.
• If the futures curve proves correct, oil consumption / global GDP hovers around 2.2% of global GDP through the early 2020s – no oil shock, and maybe no recession

• If shales falter, an alternative scenario could see oil prices back around $90 in 2020
No real drivers of a surge in demand are visible

- The US expansion is now mature. A recession might be expected within 24 months
- US consumer not willing to hold oil consumption at high prices
- Europe still has room to run for several more years
- China has taken itself off the fast track. Not likely to return without a material change of leadership or ideology
- India may become the leading source of incremental demand growth
- Solid demand growth may be expected – but nothing game-changing

Supply and marginal cost will remain driven by US shales

- US shales will remain the backbone of global supply growth
- Not clear that all efficiencies have been wrung from the system
- Shale can respond in volume in a matter of months

Still plenty of excess inventory
• The next recession will be accompanied by a oil price spike if
  – The current expansion dies an unnatural death from war, some other supply outage, or a policy mistake (likely), or
  – The recession begins in the 2019-2021 time frame, after US shales have lost their resilience
• Demographic changes may be dampening the business cycle in the advanced countries
  – Toggling between modest expansion and modest contraction near full employment
  – Not easy to create on oil price spike under such a regime
• Overall, a lasting oil price spike looks difficult to generate in the next two calendar years, and perhaps longer.
Thank you

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