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# Something to Think About

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COMMON CENTS

For most of my career, investors have thought low energy prices were good, generally speaking, for the US economy. As one esteemed economist told me back in the day: "the only things that really matter are energy prices and interest rates." This makes perfect intuitive sense: it is hard to have run-away inflation without energy playing a pretty significant role. It is almost harder still to have sky-rocketing interest rates without inflation, at least in the United States. I guess you could call them part and parcel.

However, that is antiquated thought today.

In 2008, the United States exported $67.181 billion worth of petroleum products. It imported $453.280 billion, for a deficit of $386.099 billion when rounded. This represented 46.5% of our overall trade deficit with the world, and was equal to 2.62% of GDP. In 2015, through October, the United States has exported $85.319 billion of petroleum based products, and imported $156.104 billion. This is a deficit of $70.785 billion, and represents 11-12% of the country's accumulated trade deficit through the first 10 months of the year.

What's more, it has been on a significant monthly and annual decline since 2008. In October of that year, the country's deficit in this area was $34.477 billion. This year, get this, it was $4.469 billion. If the last two months of 2015 are like the previous three, the US will run around a $82-83 billion deficit in petroleum and related energy products. This will be equal to about 0.45% of GDP, and the forecast for 2016 will be lower still.

In so many ways, we are weaning ourselves off foreign oil, and this has had global and regional impacts.

It is no secret economic growth has been mediocre for some time. To that end, the US economy grew an annualized 2.04% from 2011-2014, with roughly about the same rate of growth thus far in 2015. However, much of this growth, as soft as it has been, has been regionalized, and largely based in those energy rich states.

According to the U.S. Energy Information Agency, the top five states in proven oil reserves and current production are by reserves: Texas, North Dakota, Alaska, California, and New Mexico. While growth has been somewhat spotty in both Alaska and New Mexico, if you remove these five states from the mix, US economic growth for that time period was about 1.54%, annualized.

While I suppose this is better than a sharp stick in the eye, it isn't great. In fact, it is **so** not great I would venture the Federal Reserve would NOT be even thinking about a rate hike next week, let alone on the verge of enacting one. I mean it wouldn't be on the table. In fact, there are any number of states whose economies have grown less than 1% annualized over the last three years, 17 in fact (including D.C.). Is a rate hike good news for them?

Then we have the recent events in the Middle East. Why has everything gone haywire this year? Things have always been pretty volatile over there, but they haven't been quite this bad have they? While there any numbers of reasons why this is so, consider the following.

*Inside this issue:*

## *Something to Think About Cont.*

According to the Bureau of Economic Analysis (BEA), the US ran around a $98 billion trade deficit with OPEC nations in 2012. In 2013, we had reduced it to close to $68 billion. Last year, it had shrunk to $47 billion or so. This year, 2015, through November, the US has run a $4.3 billion trade SURPLUS with OPEC. That is a turn of over $102 billion in about 3 years. For grins, the deficit with OPEC in 2008 was, get this, $178 billion. You can do the math there.

Last week, OPEC held its semi-annual meeting in Vienna, and the group opted for basically the status quo. This shocked the oil markets, as many folks were expecting at least some lip service about cutting production. Energy prices have slumped since.

Instead of reinventing the wheel, let me cut & paste some very good sections from an article by a Benoit Faucan, et al, in the Wall Street Journal:

> "The meeting at OPEC headquarters dragged on for more than six hours and was marked by deep fissures within the group, as some members pushed hard for a production cut that might push oil prices up from their recent $40-$50-a-barrel range, less than half what they were 18 months ago.
>
> As in two previous meetings, however, the group couldn't overcome a fundamental divide. Members demanding output cuts, such as Iran and Venezuela, were unwilling or unable to offer production cuts themselves. Those most able to cut, Saudi Arabia and its neighboring Persian Gulf states, refused unless all members participate along with some producers from outside the organization.'
>
> 'OPEC's moves on Friday mean there is no end in sight for the glut plaguing the crude market. Supplies have outstripped demand by as much as 2 million barrels a day at times this year as OPEC, Russia and the U.S. pumped hard in a competition for market share. Stockpiles held by developed nations rose to a record of nearly 3 billion barrels at the end of September, according to the International Energy Agency.
>
> Those trends have kept oil at its lowest levels since the global economic crisis seven years ago and most investment banks and oil companies don't see the price climbing above $60 a barrel in 2016. Oil companies have slashed tens of thousands of jobs and delayed or canceled $200 billion in projects, while U.S. consumers have enjoyed the lowest gasoline prices since 2008.'
>
> 'The deadlock means OPEC members likely will continue to pump oil in near-record volumes for at least the next few months. Iran is also expected to emerge from international sanctions in that time allowing it to produce and export hundreds of thousands more barrels of oil each day.
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> That is likely to exacerbate tensions within the group further if it continues to depress global oil prices. None of the member countries can balance their budgets at current oil prices, and many of them need prices double what they are now to ease growing fiscal strains.'
>
> 'Still, geopolitical considerations could also continue to weigh against the pressure to cut production to push prices higher. An OPEC production cut wouldn't get under way without Saudi Arabia's leadership, but the Saudis are locked in a regional struggle for political influence with Iran, with both sides supporting opposing proxy forces in high-stakes wars in Syria and Yemen.

## *Disclosure*

## *Something to Think About Cont.*

> Saudi officials are keenly aware that Iran would be one of the biggest beneficiaries of a Saudi decision to withhold some of its production in an effort to push prices higher. And if a Saudi-led production cut occurred without non-OPEC-member countries reducing their production, even many OPEC countries believe it might not give prices a lasting lift, meaning Saudi would gain nothing even while creating an opening for Iran to boost sales."

There you have it.

Currently, Saudi-Iranian relations couldn't get much worse. So much so, it seems Saudi Arabia's real intention in keeping oil prices low is to starve Iran of much needed foreign currency reserves, as opposed to throttling US shale oil producers. After all, even with this year's low crude prices and strong dollar, the US has increased production to levels not seen since the early 1970s. So what would happen if and when the Federal Reserve raises the overnight lending target next week?

Such a move should make the dollar stronger. This will help put a more firm ceiling on crude oil prices. Couple this with increased global production, or at least the unwillingness to cut production, and you have an incredibly touchy situation in the Middle East and slightly lower rates of growth in the United States.

Is this what the Fed desires? Is this some kind of geopolitical game the average Joe doesn't understand? Starve the Middle East of petrodollars at the short-term expense of slower US GDP growth? What if everything over the last several years has been some kind of doublethink a la *1984*? What if Washington has engineered this whole thing to undermine the Iranians while driving the Saudis and Israelis closer together in some kind of weird mutual defense pact? What if the resistance to the Keystone pipeline project had/has absolutely nothing to do with the environment and EVERYTHING to do with fostering greater fracking in the US by keeping as much of that Canadian tar sand oil out as is possible? What if our getting out of Iraq prematurely was intentional, in order to set the stage for a greater regional conflict using a demilitarized, fragmented country as the battleground?

Nah….but there is a movie in there somewhere.

In the end, I have to admit: the mental gymnastics on this subject are pretty intense. You can tie yourself up in knots overthinking the energy sector and the Federal Reserve. However, in the end, economic growth has historically come down to energy prices and interest rates, at least to a large degree. Even IF the Fed raises the overnight lending target next week, interest rates in the US will be low in absolute and relative terms. As you know, energy prices are low and now promise to stay lower longer than just about anyone initially forecasted.

These things have always been good for economic growth, or at least not bad for it. Until this proves to be false, that is going to be my story and I am going to stick to it. The Fed should as well, and be careful not to be too clever or be too aggressive.