

## MARKET CALLS

# 2015: Oil Change for the Global Economy, US Edition

Wednesday, December 31, 2014

**Donald Luskin**

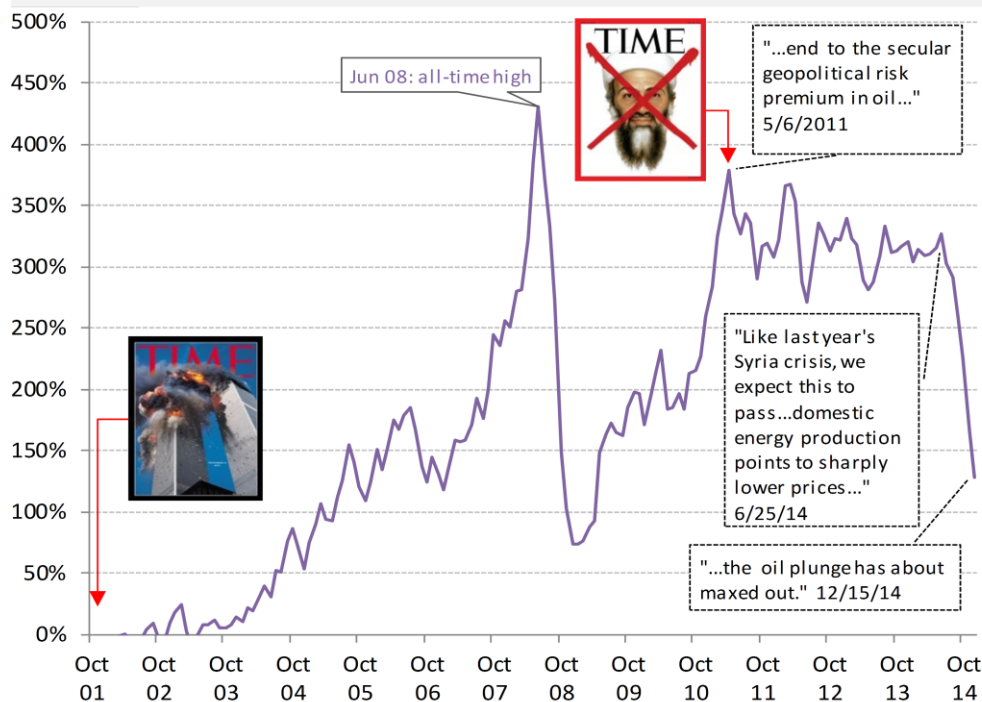
**We won the oil lottery in 2014. In 2015, we cash in the ticket. We expect a good year.**

At last year-end we set our main theme for 2014 -- a world free from the threat of financial contagion, with accelerating growth and shrinking equity risk premia (see ["2013: The Year of Living Not Dangerously"](#) December 31, 2013). As we'll discuss in this review, and its [companion for non-US markets](#), variations on that theme played out in the US and many emerging markets, but geopolitics and policy errors held back Europe and Japan.

*Our theme for 2015 will be another liberation -- the exit from an era of the highest oil prices in history. The game will be to pick the winners and the losers in this fundamental economic and geopolitical regime change -- and to avoid getting blind-sided by instabilities it may trigger.*

- We called the 2014 top in oil at the peak of the Islamic State scare, and predicted "sharply lower prices" (see the chart below, and ["The](#)

**Global crude oil price** Change from Oct 2011, with key TrendMacro predictions



Source: Bloomberg, TrendMacro calculations

## Update to strategic view

**US MACRO, OIL:** The game in 2015 will be to pick the winners and losers from the global economy's liberation from an era of high oil prices. The US economy will maintain its acceleration; 2015 real growth will have a 4-handle, with winners from lower oil prices far outweighing losers; the forecast risk on the upside. There will be some headwinds from some degree of retrenchment in the domestic oil industry, but that will put a floor under oil prices for a while -- the free-fall is about over.

**US BONDS:** Long-term Treasury yields will rise modestly -- nominal yields to 2.75%, real yields to 1.00%.

**US STOCKS:** The S&P 500 will rise by about 15%, for the seventh consecutive winning calendar year. The equity risk premium will move lower. The crisis era mean ERP is now the ceiling.

**US FED:** The Fed will "lift off" from zero at mid-year, but inflation will stay tame thanks to energy prices, so there won't be a locked in hiking cycle. The funds rate will hit a range from 50 bps to 75 bps.

[continued on next page]

[Stench of CrISIS](#) June 25, 2014).

- The almost 50% drop since June is the dramatic cascade phase of what we said would be a secular bear market for oil in the wake of the assassination of Osama bin Laden (see ["The bin Laden Commodities Crash"](#) May 6, 2011).
- We think the shock of oil at \$147 in July 2008 (\$159 in today's dollars) would have caused a recession even without the global banking crisis that followed the Lehman failure. And we think that after the trough of the Great Recession, high oil prices largely explain why global growth has been so much slower than normal in a cyclical recovery.
- *Now, the sudden relief from high oil prices will usher in a new phase in this business cycle, the evolving dynamics of which -- both positive and negative -- will be the predominant determinants of investment performance in 2015.*
- Indeed, these dynamics have already come into play in 2014.
- So oil will come up repeatedly throughout this report [and its non-US companion](#), as we review 2014 and look ahead to 2015.

[continued from first page]

**US ELECTION MODEL:** The GOP's victory in the 2014 mid-terms points to modest pro-growth policy improvements. Our presidential election model predicts the GOP will take the White House in 2016, a precondition for a substantive pro-growth rebalance. But a strengthening economy in the meantime erodes the GOP's chances by favoring the incumbent party.

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**US STOCKS AND EQUITY RISK PREMIUM:** Our 2014 predictions for the S&P 500 and the US equity risk premium were a little optimistic, but generally correct.

- On the surface we look totally wrong in our prediction that the equity risk premium (ERP) would fall toward its pre-crisis mean (see ["Regime Change for Equities"](#) November 26, 2013). In fact, it was already half-way there at last year-end, and has generally risen throughout 2014 (please see the chart below).
- *But our ERP forecast error is more than entirely due to a single factor -- the decline in long-term Treasury yields. The other inputs*

— S&P 500 equity risk premium (forward earnings yield minus 30-yr Treasury)  
--- Crisis era mean --- Pre-crisis era mean ■ Recession



Source: Bloomberg, NBER TrendMacro calculations

to the model -- stock prices and forward earnings -- both did about as expected, pushing the ERP lower if yields were held constant.

- Indeed, we estimated at last year-end that the S&P 500 would rise 18% on a price-only basis. We didn't make it -- as of December 30 with one day to go, the S&P 500 was up only 12.6%, and well below the total return of long-term Treasuries. But it was a better than average year -- in which the S&P 500 ended the year having just touched all-time highs, and outperformed all other developed economy equity markets. And it was certainly a surprise for the consensus that said it would be impossible for this bull market to add a sixth back-to-back positive-return calendar year.
- For what it's worth, the energy sector took 2.3% off the S&P 500's price change, and 39.1% off forward earnings growth in 2014.
- *But more important than quibbling about the inputs, despite a rise in the ERP over the year, the reality is that 2014 was not a very risky year. Perfect -- a higher than expected equity risk premium in a not very risky world.* 2014's worst correction for stocks was the one that ended in mid-October, with the S&P 500 falling slightly less than 10% from high tick to low tick.
- The climax of that correction coincided with the worst moments of the Ebola scare, with the World Health Organization predicting 5,000 to 10,000 new infections per week by December. The same day we published a research report calling the bottom in stocks, and revealing that by the WHO's own statistics the Ebola outbreak had been, in fact, in decline for six weeks (please see the chart below and "[Something You Probably Didn't Know about Ebola](#)" October 14, 2014). The bottom came the next day, after an inexplicable and quickly reversed morning buying panic in long-term Treasuries.

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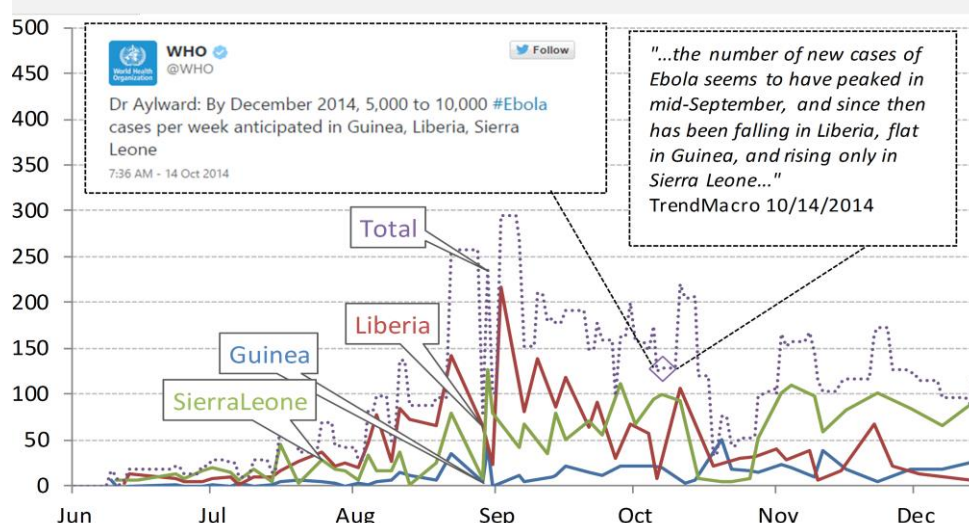
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## New Ebola infections per day



Source: World Health Organization, TrendMacro calculations

- At that climax, the ERP peeked briefly above its crisis era mean -- and then quickly pulled back as stocks rallied and yields backed up as Ebola dropped out of the headlines. A mere two months

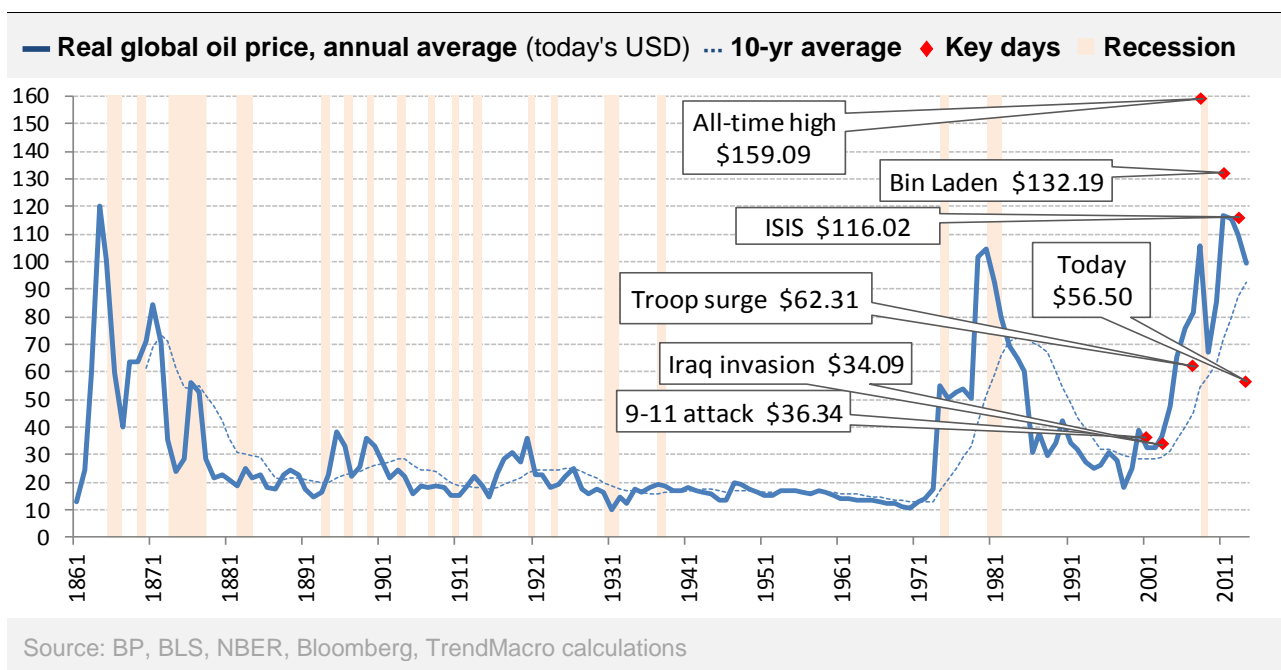
later it's strangely difficult to quite imagine how scary that threat seemed at the time ("[Something You Probably Didn't Know about Ebola](#)" was the most widely read report we've ever published). Perhaps that ability for investors to quickly put such risks behind them is a token of how resilient markets have become now, five-plus years after the greatest financial panic of any of our lifetimes.

- *While we are ending the year with the equity risk premium somewhat higher than it was a year ago, its mid-October spike -- and a slightly lesser one two weeks ago when it seemed that oil prices were going to zero, when we again called the bottom (see "[Oilimageddon](#)" December 16, 2014) -- demonstrates that the crisis era mean is no longer a mean, but a ceiling.*
- *We continue to believe that the world has exited the crisis era -- no, more than that: it has also exited the overlapping era of extremely high oil prices. Yes, we are respectful of potential instabilities arising from sharply lower oil prices. But our call is that the crisis era mean is no longer secularly appropriate as an expectation for the equity risk premium, and that through a combination of higher stock prices -- something similar to 2014's performance -- and higher bond yields -- which we will discuss in detail in a moment -- the ERP will be lower at year-end 2015 than it is today.*

**US MACRO AND OIL:** In mid-2013 we upgraded our long-standing post-Great Recession expectation for secular stagnation, calling for an inflection toward notably faster growth at some point in 2014 -- based primarily on the idea of exit from the crisis era -- with sharply lower oil prices in mind only as a possibility (see "[A Major Upgrade to our Strategic Outlook](#)" September 12, 2013).

- Even in 2014's first quarter, in which US GDP contracted by 2.1% -- before the steep oil price decline got underway -- the signs of accelerating growth were becoming evident. Controlling for what was one of the coldest winters on record, seemingly dismal macro data in fact was surprisingly robust (see "[On Q1 GDP](#)" April 30, 2014).
- Now the US macro data has overtly confirmed our prediction (see "[Data Insights: GDP](#)" October 30, 2014, "[Data Insights: Global PMI](#)" December 3, and "[Data Insights: Jobs](#)" December 5). The only question is whether it can continue.
- We think it can and it will. Even though we are now five and a half years past the official trough of the Great Recession, the US economy faces a tremendous output gap -- which is to say that there remains a great deal of human capital and physical capital that could be brought on line before capacity constraints start to bite.
- And now there is a substantive catalyst. The reality now -- not just the hope or the expectation -- of the exit from the era of prohibitively high oil prices adds significant power to the prospect for continued faster growth.

- Stop and appreciate the point from which this oil price decline is starting. Even on an inflation-adjusted basis, global prices have been the highest in history (please see the chart below). Surely oil at \$147 (\$159 in today's dollars) in the summer of 2008 contributed to the onset of the Great Recession, and lingering highest-ever real average prices since then have contributed mightily to so-called "secular stagnation." Against that backdrop, 2014's sharp decline in global oil prices really matters: it is substantive relief from the key factor -- and one that has been underappreciated by the consensus -- holding back growth.



- As we keep saying, the shock of suddenly lower oil prices holds out the possibility of various instabilities -- such as increased incidence of junk bond defaults, or bank impairments (see ["Don't Let a Good Oil Crisis Go to Waste"](#) October 21, 2014, and again, ["Oilmageddon"](#)). Investors cauterized by the horrors of the 2008-2009 crisis should be respectful of the potential systemic risks arising from such things. But our call is that the world is a far less fragile place today than it was in 2008, and that a few defaults would be very unlikely to be systemic.
- Of greater interest to us is the calculus of transfers between winners and losers in a new epoch of lower oil prices.
- It is useful only as the crudest first approximation to think of these transfers as moves in a zero-sum game between producers and consumers of oil.
- For example, over the last six months, annualized US gasoline expenditures have fallen by about 1% of GDP, or about \$170 billion dollars. For consumers, it's effectively a "tax cut" that frees up resources that can be used for buying things other than gasoline. But doesn't that just mean that gasoline producers lose \$170 billion that gets transferred to producers of something else? No net gain overall.



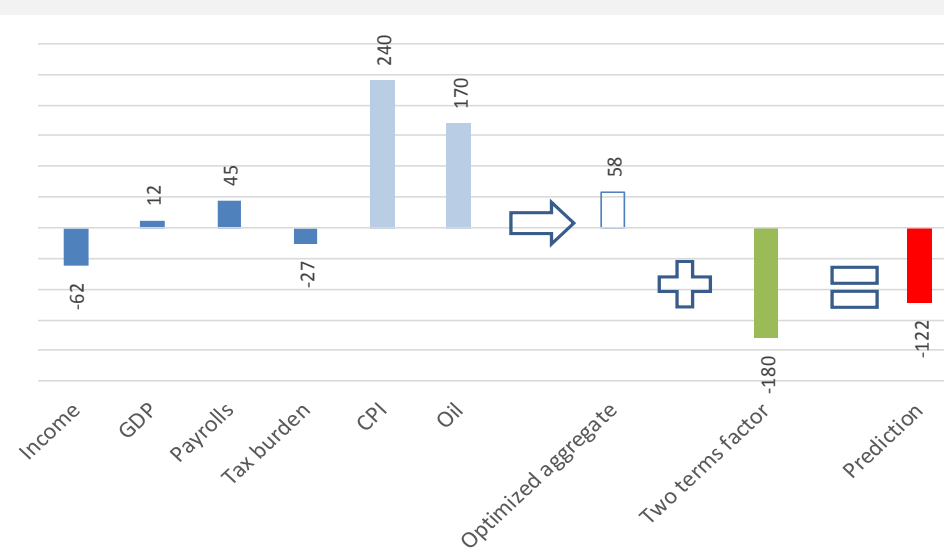
- But if it were that simple, then shouldn't we be indifferent to oil prices? Yet we are not. Surely we would expect large net negative impacts if the opposite had occurred over the last six months, that is, if oil prices had risen and annualized spending on gasoline went up by \$170 billion. Indeed, we would call that a classic oil shock, and expect a recession.
- Why the asymmetry of our intuitions? Why is a declining oil price only neutral, while a rising oil price is so obviously detrimental?
- Most critically, it depends on the cause of the oil price shock. If the oil price rises due to scarcity, then the real economic problem is not the price *per se*, but the fact that a critical input to production is too scarce. If the oil price falls due to abundance then, again, the real issue isn't the price, it's the abundance -- suddenly there's more of a critical input to production. Less oil means less growth. More oil means more growth.
- That's why we are not overly concerned that some degree of retrenchment in US oil production will produce the same kind of regional recession that we saw in the oil bust of the early 1980s, which fed into a broader financial crisis through the overleveraged savings and loans. The 1970s oil boom wasn't a production boom based on abundance -- it was a financial boom based on high prices resulting from a global scarcity. When the exogenous source of the boom -- the price -- was withdrawn, the bubble burst. This time around, high prices led to a production response, not merely a financial speculation response. So any price decline is an endogenous product of that production response -- and production can adjust accordingly.
- There is, at the same time, an entirely different and broader reason that upward oil price shocks are destructive while downward oil price shocks are stimulative.
- Consider the median US household, with a [pre-tax income of \\$53,880](#) and [1.95 automobiles](#). Clearly, for this household and the ones below it on the income ladder, gasoline is a "must buy" -- a strict necessity for commuting to work or school and shopping for the necessities of life. If the price goes up, there is no choice -- at least not immediately, and not without a great deal of dislocation -- but to pay the higher price and do without something else less essential. This effectively reduces the volume of voluntary exchanges in the economy, which reduces the signals to producers as to what to produce and how much of it to produce.
- And the consumer's attempts to otherwise adapt to higher gasoline prices are just as deleterious. It does the economy no good to "conserve" by turning down a better but more distant job, wasting time on public transportation, converting to a more fuel-efficient car that is less safe and less comfortable, or moving to a crowded urban apartment in which one has no stake rather than owning a suburban home.
- When gasoline prices fall, the median household experiences the change as a windfall both in money *and in choice* -- suddenly, decisions can be made as to what other than gasoline to buy, sending signals to producers about what consumers really want.

- And what some households may want is to use more gasoline to drive to a better job or live in a better home.
- And all that ignores all the analogous dynamics that operate upon producers in their capacity as energy consumers.
- Moreover, the zero-sum analysis of falling oil prices makes the false assumption that oil producers will be unable to preserve their margins by reducing their costs -- as semiconductor manufacturers have learned to do over half a century of exponentially falling prices, driven by the business dynamics underlying [Moore's Law](#). Already in the brief experience with the fundamental technological breakthrough of fracking -- which transforms oil production from a mining process to a manufacturing process -- the industry has moved significantly down the learning curve, both reducing costs and raising unit output significantly (again, see ["Oilageddon"](#)).
- Based on our belief that the crisis era of financial contagion is over, and that a new regime of lower oil prices is dawning, we stand by our prediction that the US economy will continue the acceleration begun during 2015. We think real GDP growth in 2015 will have a 4-handle -- and we think the forecast risk is on the upside.
- There will be some headwinds from some degree of retrenchment in the domestic oil industry. That retrenchment will put a floor under oil prices for a while -- we think the free-fall is about over. Oil will be far cheaper in a couple years, when the technology learning curve enables much lower break-evens than we see today.

**US POLITICS:** We are thrilled by our correct way-out-of-consensus prediction that the Republicans would take congressional control in the 2014 mid-terms -- a prediction made in the worst days of the 2013 government shutdown that supposedly destroyed the GOP brand (see ["On the Shutdown and Debt Limit Deal"](#) October 17, 2013). Now our formal quantitative presidential election model (see ["TrendMacro's Election Model"](#) September 28, 2012) -- which correctly predicted Obama's 2012 win within four Electoral College votes (see ["On the 2012 Election"](#) November 7, 2012) -- is predicting that the GOP will take the White House in 2016 by 122 Electoral College votes (please see the chart on the following page, and ["Modeling the 2016 Presidential Election"](#) November 12, 2014).

- We think the GOP's mid-term win in November shifts the balance modestly toward pro-growth policy, particularly in energy (see ["On the 2014 Midterms"](#) November 5, 2014) -- and that contributes to our positive outlook for 2015.
- However we note that if our positive outlook is fulfilled, that will act as a counterweight to our prediction that the GOP will take the White House in 2016 -- probably a necessary condition for a truly significant rebalance toward pro-growth policy.
- In our election model, falling oil prices modestly move the prediction toward re-election of the incumbent party. The faster output and income growth that we expect will come in the wake of falling oil prices move the prediction even further toward the Democrats. Since we first published the model in November, the

### Flow of variables in Electoral College votes for incumbent party

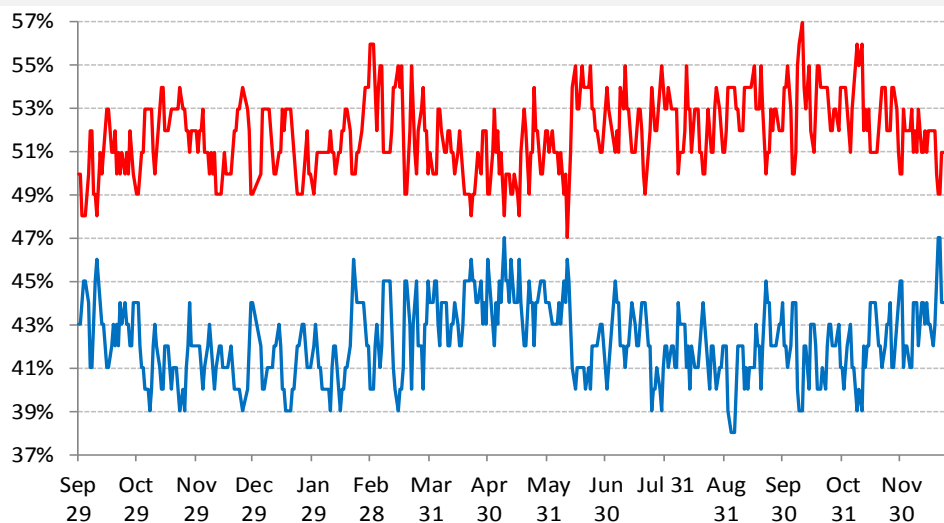


Source: Various, TrendMacro calculations

prediction for GOP victory has narrowed by 23 Electoral College votes.

- At the same time, the growing sense that the economy is improving has bolstered President Obama's approval ratings (please see the chart below) -- deservedly or not. An alternate unpublished version of our model includes presidential approval as a factor -- and as you'd expect, Obama's growing approval is confirming the model's move in the direction of a Democratic win in 2016, narrowing the GOP's expected victory to 114 Electoral College votes.

### Obama daily ratings — Approval — Disapproval



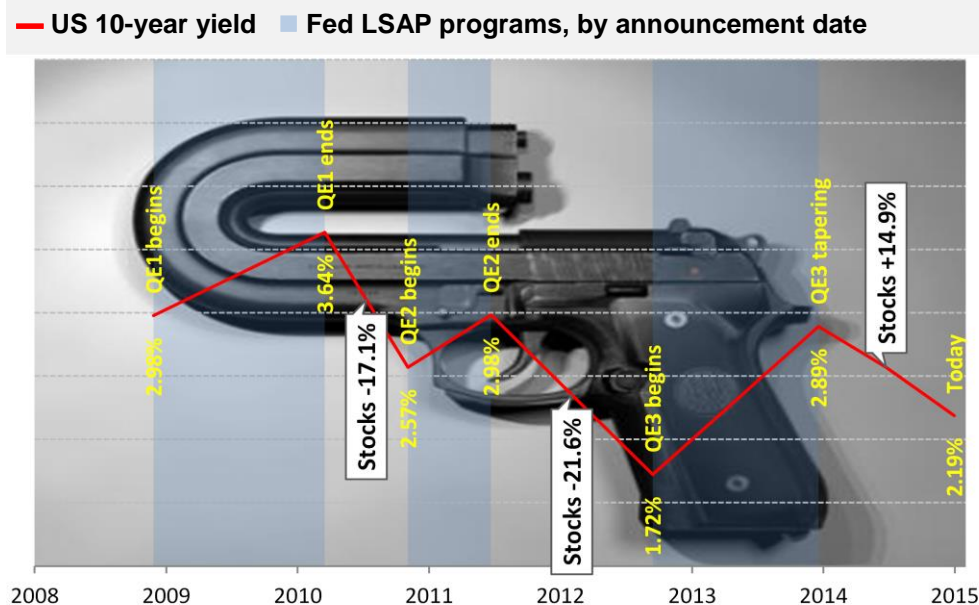
Source: Gallup, TrendMacro calculations



- All that said, both versions of the model still predict a GOP win. But we expect that in 2015 the flush of victory experienced in the GOP's big mid-term win will likely dissipate into uncertainty.
- So, ironically, we think a better growth outlook in 2015 to some extent may militate toward a weaker outlook in 2016 and beyond, to the extent that better growth deceives the electorate into electing anti-growth candidates.

**US BONDS AND FEDERAL RESERVE:** We are not proud of our predictions for US bonds in 2014. At year-end 2013 we were squarely in the consensus, expecting the 10-year yield to rise to 3.5% to 3.75%, from 3.0%. Ironically, looking back on it, we now see that Treasuries reacted rationally to developments in Fed policy and falling oil prices, both of which we had predicted correctly. We'll review our entire reasoning, the right and the wrong.

- We were out of consensus in correctly predicting the exact onset of tapering QE3 (see ["On the December FOMC"](#) December 18, 2013), and we correctly predicted that new Fed chair Janet Yellen would not interrupt the tapering program begun by her successor (see ["Bernanke's Last Big Call"](#) January 21, 2014). The prior two times the Fed had announced ending Large Scale Asset Purchases (LSAPs), yields moved lower, not higher as the marketplace had feared and expected (please see the chart below). We were the first to point out this "gun that shoots backwards" (see ["US Fixed Income Strategy: The Fed Irrelevancy Hypothesis"](#) July 2, 2013), but we still weren't bullish on bonds for 2014.



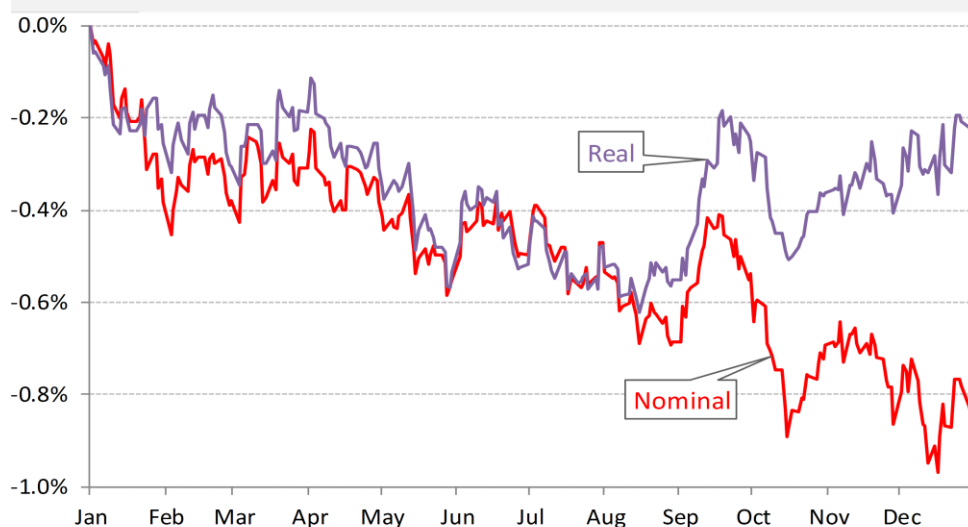
Source: Bloomberg, Federal Reserve, TrendMacro calculations

- We thought this time would be different. We thought that in past episodes yields had fallen at the end of LSAPs because those programs had ended too soon -- the world was still in the crisis era

of financial contagion, and more central bank liquidity was needed. This time, our assumption was that tapering was simply irrelevant -- and that the lower level of risk in the world economy would dry up safe haven demand for Treasuries -- and would lead to faster growth that would raise the competitive price of funding.

- The hell of it is that we were right -- this time really was different. Tapering was irrelevant. The proof: in prior episodes, when LSAPs ended stocks had gone into major corrections, signifying a serious threat to growth from the Fed's failure to hedge against financial contagion (see ["Is the Fed Moving the Stock Market?"](#) March 11, 2013). This time, though as tapering commenced yields fell as they had before, stocks moved to new highs.
- *Our mistake was to fail to anticipate two critical new dynamics that evolved and transformed during 2014. These are revealed by comparing the path of nominal and real yields over the year* (please see the chart below).

#### 10-year Treasury, change in yield from year-end 2013



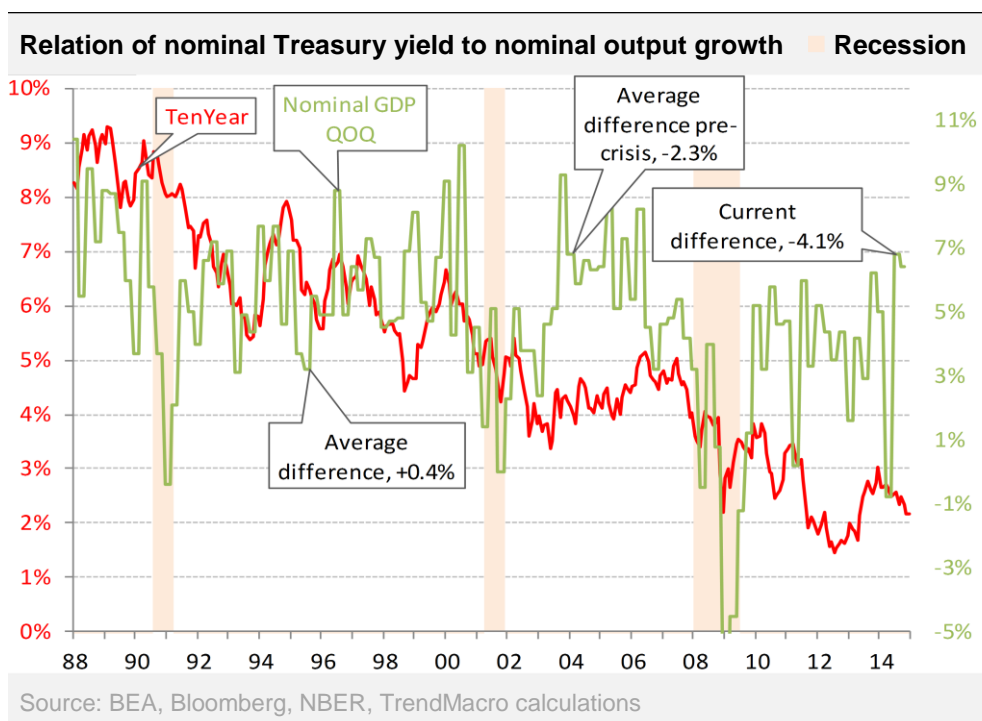
Source: Bloomberg, TrendMacro calculations

- There were two distinct phases in 2014 -- pre-August and post-August. These phases correspond to the two new dynamics. Up to August, in the first phase, the nominal yield moved in perfect synch with the real (TIPS) yield. At mid-August, with both about 60 bps lower than at year-end 2013, they parted ways -- in this second phase, the nominal yield kept moving lower, while the real yield moved higher. At this point the real yield has retraced more than half its move through August.
- *We think the first phase -- falling yields, both nominal and real -- is explained by the arrival of what we've come to call "The Yellen Rule" -- a new era of Fed policy designed to replace LSAPs.*
- "The Yellen Rule" was announced in Yellen's [first FOMC statement in March](#), and has been repeated verbatim at every subsequent FOMC meeting. It is a single 38-word sentence that told the marketplace more about the future post-QE post-ZIRP policy

environment than the Fed had ever done before. Those 38 words are below, with the essence of the policy message called out in red.

The Committee currently anticipates that, even **after employment and inflation are near mandate-consistent levels**, economic conditions may, for some time, warrant **keeping the target federal funds rate below** levels the Committee views as **normal** in the longer run.

- In essence, this means that the fed funds rate, while not zero, will be systematically lower than normal -- virtually forever (see ["The Yellen Rule is Taylor Minus Two"](#) May 19, 2014). This is more than just Yellen's personal ultra-dovishness. We can tell by looking at the FOMC members' "longer run" projections for unemployment, inflation and the funds rate that there is a broad consensus that, going forward, even a strong economy deserves a systematically lower funds rate than in the past (see ["The Fed's Growth-Friendly 'Dot' Gap"](#) September 19, 2014).
- This means, effectively, that while the Fed will raise the funds rate, it will never actually "tighten." Indeed, when "lift-off" from zero occurs in mid-2015, we expect the background economy to have improved enough so that policy -- even with a non-zero funds rate - - will be more accommodative than it is today.
- The arrival of that policy innovation meant that long-term bond yields had to fall to factor in lower-than-expected discount rates at every point along the yield curve. We think this explains the synchronized fall in nominal and real yields through August.
- Because inflation premia didn't change, we can say with confidence that falling nominal yields did not reflect the market's changing appraisal of inflation prospects. For real yields, It's harder to



disentangle the market's appraisal for growth prospects from the effects of the arrival of "The Yellen Rule." Our rough-and-ready analysis, though, indicates to us that implied growth prospects weren't substantially changed (again, see ["The Yellen Rule is Taylor Minus Two"](#)).

- *But now, in the second phase, the post-August phase, both growth and inflation prospects have changed. With real yields higher and nominal yields lower, the Treasury market is saying "growth higher, inflation lower."*
- This is a rational response to the effects on growth and inflation of a sharp drop in oil prices -- growth higher, inflation lower. And its August onset coincides with oil's definitive drop through the psychologically important \$100 level, just as the US began ["humanitarian bombing"](#) to turn back the Islamic State, with the approval and cooperation of virtually all Middle Eastern nations.
- Looking forward, the question is whether Treasuries are correctly discounting the realities of future growth and inflation. With the nominal 10-year yield more than 4% below the rate of nominal output growth (please see the chart on the previous page), we are confident that a good first-order approximation is that they are not.
- *Given our expectation for faster growth, we don't see how the real 10-year yield doesn't back up considerably in 2015.*
- *If it does, then unless inflation premia fall further, the nominal yield will get swept higher with it.*
- Can inflation premia fall further? We don't expect oil prices to keep falling in 2015 at the rates they have been over the last six months, so their immediate computational effect on inflation will be transient. But 2014's lower oil prices will seep with a lag into every corner of the economy, keeping inflation low in 2015.
- Other possible sources of lower inflation have probably run their course. Our thesis that we have exited the crisis era means that the usual deflationary suspects -- deleveraging, lingering unemployment, and all the rest -- will exert less pressure in 2015 than in prior years. We've never been advocates of the popular narrative that deflation fears and low yields in the euro area were being transmitted by arbitrage to the US market. Even if that is correct, we now expect the announcement of true QE -- that is, sovereign bonds purchase -- by the European Central Bank in January -- which could very likely reverse deflation expectations there (see ["Here Come Greek Elections -- and QE from the ECB"](#) December 30, 2014).
- So if inflation expectations don't have much room to fall, and growth expectations have considerable room to rise, we have to come down on the side of expecting higher bond yields, both nominal and real, in 2015. We take some heart from the intuition that the consensus now has flipped 180 degrees from where it was a year ago -- our take is that nobody expects bond yields to rise from here.
- *So our call is that yields move higher in 2015. Just to put some numbers on it, we'll call for a range of 50 to 75 bps on the funds rate, a nominal 10-year yield at 2.75%, and a real 10-year yield at 1.00%.*

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## Bottom line

The game in 2015 will be to pick the winners and losers from the global economy's liberation from an era of high oil prices. The US economy will maintain its acceleration; 2015 real growth will have a 4-handle, with winners from lower oil prices far outweighing losers; the forecast risk is on the upside. There will be some headwinds from some degree of retrenchment in the domestic oil industry, but that will put a floor under oil prices for a while -- the free-fall is about over. Long-term Treasury yields will rise modestly -- nominal yields to 2.75%, real yields to 1.00%. The S&P 500 will rise by about 15%, for the seventh consecutive winning calendar year. The equity risk premium will move lower. The crisis era mean ERP is now the ceiling. The Fed will "lift off" from zero at mid-year, but inflation will stay tame thanks to energy prices, so there won't be a locked in hiking cycle. The funds rate will hit a range from 50 bps to 75 bps. The GOP's victory in the 2014 mid-terms points to modest pro-growth policy improvements. Our presidential election model predicts the GOP will take the White House in 2016, a precondition for a substantive pro-growth rebalance. But a strengthening economy in the meantime erodes the GOP's chances by favoring the incumbent party. ▶