Weekly Economic Commentary

April 11, 2015

by Carl Tannenbaum

of Northern Trust

Today's Oil Retreat Is at Odds with Long-Term Trends

April 10, 2015

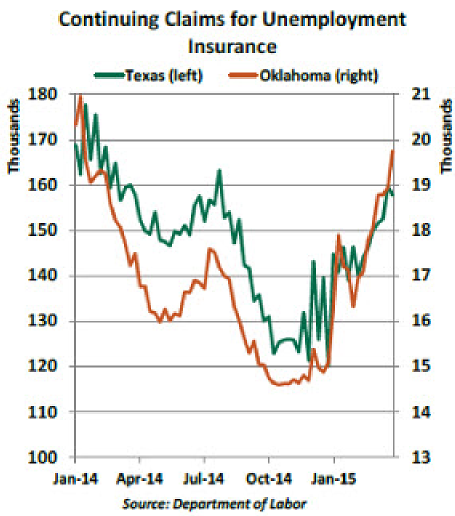
Editor's Note: The following observations emerged from discussions with Northern Trust clients and partners in Texas. Special thanks are due to Jackson Hockley of our Asset Management unit, who follows the energy business at close range and joined us as we made the rounds.

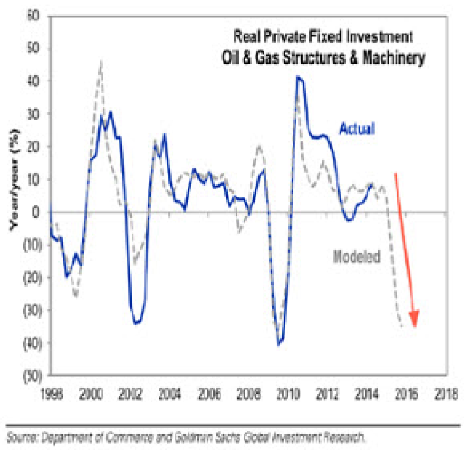
Texas is a unique area of the United States. It was part of Mexico until 1836, and it was a sovereign nation for almost 10 years thereafter. Even after becoming a member of the union, Texas retained an independent streak. Mavericks have always been revered there, and government of any kind is viewed with suspicion. The state still has no personal income tax, its legislature meets only every other year (for a maximum of 140 days), and it remains a breeding ground for iconoclasts.

Relatively few Texans are cattle ranchers and wildcatters, but the frontier spirit of those vocations runs deep in the state. Risk-taking is celebrated, even when those risks fail (and especially so if they fail epically). Staking claims and developing them is a persistent ethic, no matter how many times boom and bust cycle through.

A recent visit to Texas provided a close look at the recent bust in energy prices and its impact on economic activity. The irony that emerged from the conversations is that the current correction in the "oil patch" seems entirely at odds with long-term fundamentals.

It was clear to this observer that participants in the energy industry are not expecting a quick reversion to $100 per barrel oil. As firms have acted on this outlook, the correction in output, employment and investment has been swift and severe.





There are certainly scenarios that could lead prices back up into the triple digits quickly, especially those that center on an expansion of sanctions and conflict in the Middle East. But for now, demand in the near term remains contained by slow global growth. While U.S. production seems poised to retreat, supply could get another boost over the coming quarters if the tentative agreement with Iran allows the full marketing of that country’s oil output.

Some American drillers are very efficient. Yet with oil prices below breakeven (plus some reasonable allowance for profits), rigs and technicians are being idled in expanding numbers. Some locales in energy-producing regions have a degree of economic diversity, but others are deeply concentrated and are seeing the correction extend to real estate and retail sales.

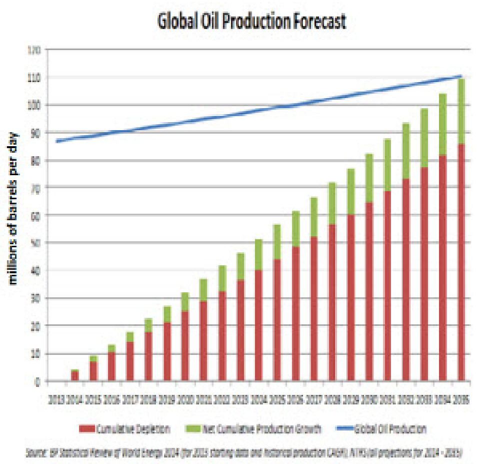
This is very consequential for the affected communities. But the impact on the U.S. economy as a whole is much more modest. Estimates vary, but energy output represents only about 3% of U.S. gross domestic product (GDP). And because the industry is very capital-intensive, it represents an even smaller fraction (about 1.7%) of U.S. employment.

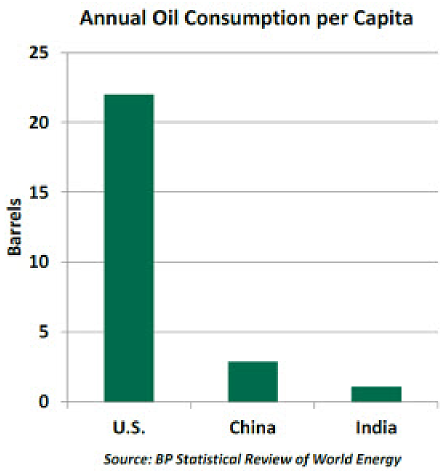
Large in our consciousness, energy is a small part of the U.S. economy.

Most models of the U.S. economy suggest that the fall in oil prices will be a sizeable net benefit over time. But for now, the supply-side contraction in energy production is front running the demand-side benefit of cheaper gasoline. That is among the factors that depressed first quarter U.S. growth.

A frequently asked question during our Texas tour was how long the relative depression in oil prices might last. That was a difficult one to answer, especially since almost all the long-term signals suggest that oil should be considerably more expensive than it is today.

While it is true that global energy production has exceeded expectations over the past decade, it is also true that known reserves are being depleted at a healthy pace. To replace them, producers will need to locate new sources that can provide more than 80 million barrels daily over the next 20 years. (Current global production is about 90 million barrels a day.) That may be a tall order and one that will be expensive to fill.





On the demand side, if energy usage among developing countries follows the same pattern seen in more mature markets, daily demand could grow substantially. In particular, if Chinese and Indian oil demand per capita approach levels seen in more developed emerging markets, it will result in a need for an additional 30 million barrels daily, a 33% increase from current production.

All of the long-term signals point to more expensive oil.

The possibility of developing alternative fuels has been raised and deserves investigation. But the relief that they might provide could be somewhat limited. A substantial fraction of global energy consumption is for transportation of goods and people. Vehicles of certain kinds currently use natural gas and electricity on a very limited basis. But substantial investments in technology would be needed to make this more than a niche solution.

Given this outlook, it seems a pity that energy exploration and research have been temporarily curtailed. Developers and those that finance them would be much better off taking the long view, and countries would do well to craft energy strategies that look past short-term price movements.

Those who might be pleased at the humbling of the Lone Star state should therefore note that the tide could turn in the years ahead. As they say, "Don't mess with Texas."

Asia's Battle of the Banks

On the face of it, it does not seem like the newly minted Asian Infrastructure Investment Bank (AIIB) should be the source of so much controversy. The bank is focused on addressing a gaping need in developing Asia – the infrastructure deficit. However, the newest addition to the world's alphabet soup of multilateral organizations has become embroiled in America's struggle with China for influence in Asia.

China has undoubtedly established itself as a world economic power and is now aiming to use its impressive financial resources to broaden its influence. The AIIB is actually one of a number of initiatives Beijing is promoting. In particular, the New Development Bank (also known as the BRICS bank) was organized to foster economic cooperation among five of the world's largest emerging markets.

Taken together, the new institutions form the core of China's response to the troika of the Asian Development Bank (ADB), World Bank and the International Monetary Fund (IMF). Western nations dominate governance of the latter organizations, which were an outgrowth of the 1944 Bretton Woods conference.

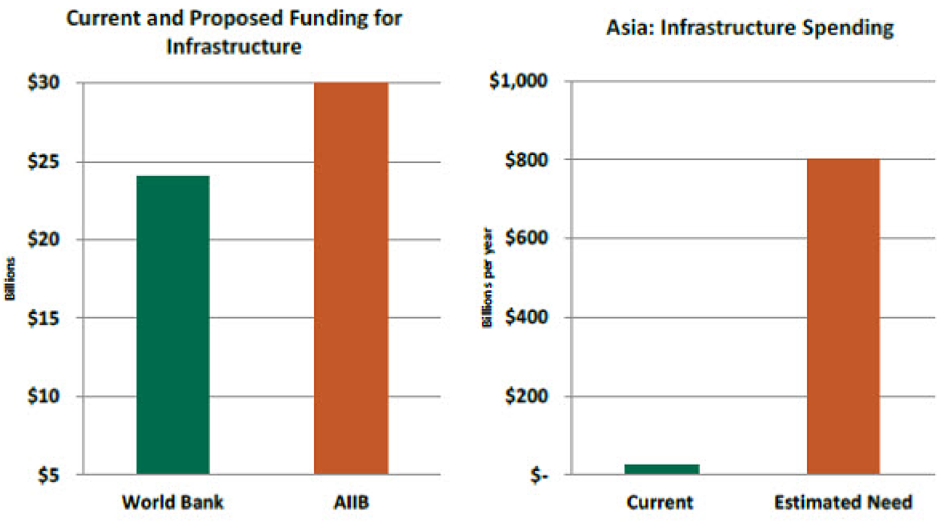
Considering the current geopolitical landscape in Asia, it is perhaps not surprising that the United States has aggressively raised issues about the AIIB. While there are valid concerns about governance and transparency within the AIIB, Washington’s stance has left it isolated and open to charges of hypocrisy.

The AIIB has attracted 46 founding members, including 14 of the G-20 countries. The United Kingdom, Australia and South Korea (among others) seem to have decided that a place at China’s table (and the potential for lucrative contracts for home businesses) was worth drawing the ire of Washington.

It is America's reluctance to give emerging economies a more-prominent role within the World Bank and the IMF that facilitated the emergence of rival institutions. The United States also did not offer China membership in the massive Trans-Pacific Partnership (TPP) trade negotiations. In response, Beijing is negotiating a rival trade pact to TPP and has decided to create international institutions in which it is the main power broker.

Ironically, U.S. policy may have contributed to the formation of the AIIB.

Fundamentally, there is enough development need for all multilateral institutions to play a role. The AIIB’s very narrow infrastructure scope keeps it out of direct competition with the ADB and World Bank. In addition, the AIIB’s initial capital base of $50 billion - $100 billion pales in comparison to the estimated $8 trillion of urbanization-driven infrastructure needed in Asia over the next ten years.



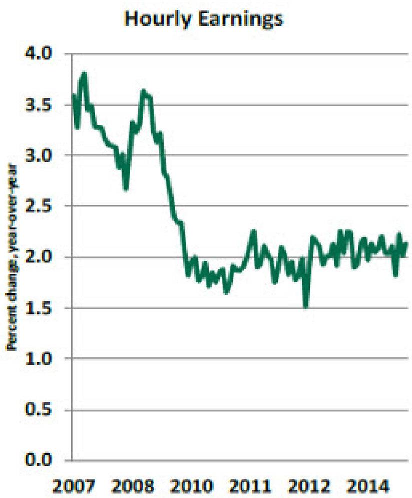
Sources: Financial Times, Washington Post, Asian Development Bank

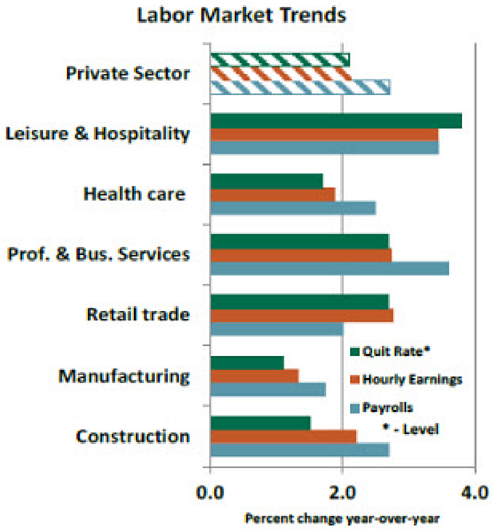
China’s interest in development aid is not new and shows little sign of tapering off. However, its funding terms to date have often been opaque and China has not actively enforced the environmental and governance standards that borrowers should be expected to meet.

The establishment of the AIIB will assist in improving lending practices and subjecting projects to international lending standards. That objective, combined with the insatiable appetite for development funding in Asia, suggests that the AIIB should be welcomed – and even supported by the United States.

The Mystery of U.S. Wage Growth

The economic recovery is nearly six years old, several states increased the minimum wage this year, and the unemployment rate is 5.5%. However, wage growth is holding nearly steady, contradicting to a large extent the message of strength from other labor market indicators. Our findings suggest that the composition of job gains is the key to solving the wage-growth puzzle.





Source: Haver Analytics

In the first quarter, private sector employment increased 2.7% from a year ago, and hourly earnings rose 2.1%. The quit rate in February was 2.1%. These averages hide the differences in trends among the major categories of employment.

The mix of jobs created is the key to solving the wage-growth puzzle.

At one extreme, the leisure and hospitality industry shows stronger-than-average hiring, a faster acceleration of wages and a rising quit rate. Average hourly earnings in this sector stand around $14, and a large percentage are minimum-wage employees. Compensation in the retail sector (average wage is $16) shows a noticeable increase, but this is also a low-wage sector.

At the other end, professional and business service employees earn an average of $30 per hour. The underlying momentum of hiring in this sector is noteworthy, and wage growth and the latest quit rate exceed the private sector average.

Nested in the middle are other high-paying sectors that show only moderate improvements. In the health care and education services sector, where compensation is around $25 per hour, the pace of growth in employment and wages is modest, and the quit rate is at the lower end. Wage growth in the factory and construction sectors, both of which are higher-paying sectors, is not impressive.

Putting these readings together, employment and wage growth are concentrated in low-paying sectors such as retail and leisure and hospitality, which make up about 25% of payroll employment. Of the high-paying sectors, most show below-average increases in wages. Therefore, it should not be surprising to witness lackluster wage growth overall.

That said, it is important to note that average wage growth accelerated in the prior two expansions a little after the official jobless rate hit the 5.5% mark. But in both instances, the broader measure of unemployment was significantly lower than the recent 10.9% reading. It may be a while before the Fed sees widespread increases in wages that are similar to the experience of prior expansions.