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CAPITAL INSIGHTS

Economic Briefing • December 2014

Oils Well That Ends Well?

At least so far, this holiday season has already seen quite the generous gift bestowed upon the US economy. Although crude oil price levels have been falling more than noticeably for some months now, OPEC ministers met on Thanksgiving Day, declaring no cuts to their oil production at present. With no cut to oil supplies to come, immediately global oil prices resumed their holiday swoon in relatively rapid fashion, dropping below $70/barrel for the first time in four years. A certain “bah humbug” was apparently heard amongst the energy industry.

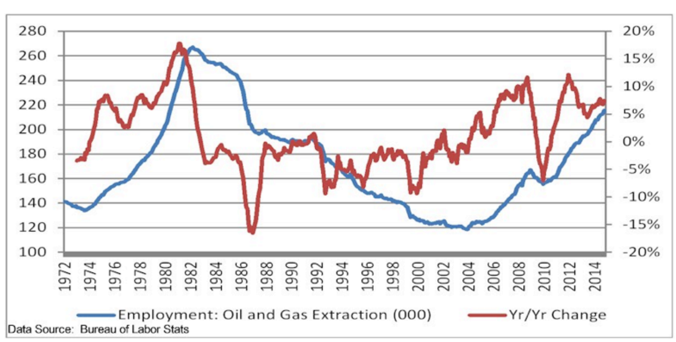
Why the drop in crude prices as of late? We are all well aware of the energy boom the US has experienced over the last half decade plus. Areas such as Eagle Ford (Texas) and the Bakken (North Dakota) have become household names. Shale fracking technologies have created a domestic energy supply boom, necessarily impacting the domestic US market share of OPEC members. Developed economies globally have been using less crude over the last few years while emerging economy demand has more than picked up the slack, but many an emerging economy is now slowing, China being a poster child example. With increased US domestic supplies and a slowing macro global economic backdrop pressuring crude prices, OPEC is simply acting to protect its global market share by refusing to cut production. As the world’s lowest cost producer, Saudi Arabia particularly has the luxury of price flexibility. For the Saudi’s, it’s not a question of making money, but rather one of how much. The pressure is on their competition.

Let’s get back to the holiday gift giving that is the drop in crude prices. The average US household uses approximately 1,200 gallons of gasoline annually. For those with teenagers or still footing the gasoline bill for their 20-something’s, you only wish. Every 50 cent drop in gasoline prices adds on average $600 to household coffers. Pushing below $3/gallon, retail gasoline prices are down 75 cents to a dollar from the highs of the last few years, most of that coming since late summer of this year. This is the equivalent of giving the average household an approximate $1,000 cash tax break. As per the 2013 Federal Reserve Survey of Consumer Finances, 47% of US households do not save. The simple math tells us the drop in gasoline prices due to the slide in crude prices is a direct shot in the arm to a primarily consumer driven US economy.

Just in time for the holidays! Is this the added spark the US economy needs to finally break out of the slow growth environment we’ve experienced for the last 5 years? Certainly this is very good news for retailers and for the holiday shopping season ahead. It is good news for airlines (lower fuel costs) at their busiest time of the year. Transportation related businesses such as UPS, Fedex, Amazon, etc. could not be happier. What’s not to like about the very meaningful drop in crude oil prices?

“Oils Well That Ends Well,” is the title of a 1958 Three Stooges short. The storyline involves the Stooges attempting to fund a needed medical operation for their father by prospecting for uranium on their father’s land. Of course they never find uranium, but do hit an oil strike and their money worries are over. In many senses, shale fracking technology has been a “lucky find” for the macro US economy during the current economic cycle and has been a key support to growth. Although the recent drop in crude prices is great for the US consumer short term, we need to think through the full impact of this occurrence and what it may mean for the broader US economy beyond the short term. We can assure you OPEC did not make their Thanksgiving Day decision lightly.

Let’s consider a few facts concerning the US tight oil boom. We’ve all heard the stories of housing shortages in the Eagle Ford, Bakken and Permian areas for good reason. The domestic oil boom has meant job and wage growth well above the average experienced by the broad US economy in the current cycle. The chart below shows employment in the US oil and gas extraction industries alongside the year over year change in this trend.



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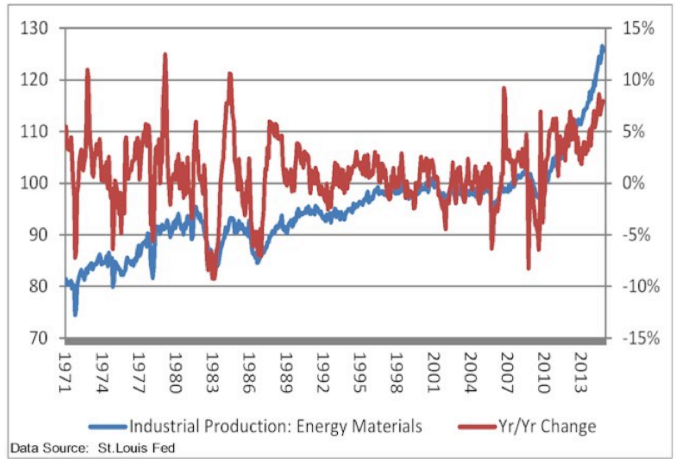
Employment levels today in the domestic energy extraction industry have not been seen since 1986, close to three decades. If we look at total US employment today relative to the prior cycle highs of 2007, we have gained 688,000 jobs. Of this, oil and gas extraction alone account for just under 10% of the total. As of the latest monthly data, year over year gains in energy industry employment register 7.5%. The only job category experiencing faster growth is temp employment. Total US job growth over the prior 12 months has been 1.9%.

This data is important in that the largest gains in jobs seen in the current cycle have been in leisure and hospitality (hotels and travel), eating and drinking establishments (bars and restaurants), and temp employment. These are all low paying jobs compared to the energy industry. As of the latest monthly data, average hourly earnings in the oil and gas extraction industry are 65% above total US average hourly earnings. We simply need to recognize that in the current economic expansion, the domestic energy industry has been one of the key sectors providing high paying job growth. The risk to the economy is this set of circumstances changes.

We have addressed the character of below historical average GDP growth experienced since 2009 in the US on a number of occasions. As you might guess, one of the very bright spots has been the energy sector. The boom in the sector has required not only bodies (employment), but also physical equipment. The following chart looks at the long term US Industrial Production numbers for the energy materials (supplies) sector. The growth since the 2009 lows has been approximately 30% over five years. We also saw this type of growth from 1971 through 1982, but that was over ten years. Suffice it to say that the energy sector has been a key leading contributor to US industrial production growth in the current historically slow growth cycle. What happens to macro US economic growth if this changes?



We have written many times about the lack of corporate capital spending in the current cycle, companies instead preferring to repurchase shares and increase dividends. The energy sector has been up to this point a domestic capital spending bright spot. The energy sector currently accounts for one-third of total capital spending among the S&P 500 companies.

So you can see the dilemma of lower crude prices. A great potential short term accelerant for US consumption, but a clear and present danger for growth in one of the most important domestic economic sectors in the current cycle. The US shale boom was borne of historically high global prices for crude oil. Efficiency has lowered breakeven costs over the last half decade, but it has been estimated that 50% of the US shale industry is uneconomic at $70/barrel for crude. Exactly the line we crossed immediately post the OPEC meeting.

The fact is that the vast majority of OPEC members have staying power. Again, they are acting to protect market share. Lower global crude prices are designed to negatively impact marginal players. The domestic US energy industry is not immune. For those old enough to remember, we have seen this movie before. In the mid-1980's when Alaska's North Slope and the North Sea areas came into production, OPEC allowed crude prices to fall meaningfully from $30.81 in November of 1985 to $11.58 eight months later, prior to an extended mid-teens to $20 price range rebound. Crude never saw $30

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again until Sadaam invaded Kuwait in the early 1990's. The question we need to ask ourselves is what would a prolonged downturn in crude prices mean for the US energy sector and its impact on the broader economy? Would the benefits of lower prices outweigh the macro negative of pressure on one of the brightest sectors in the US economy?

The real US economy is not immune from OPEC decision making and neither are the US financial markets. The domestic US energy sector has experienced spectacular growth over the last half decade. Much of this has been financed with very high cost capital given the risks of exploration and production. 16% of the total US high yield (junk bond) market is comprised of smaller tier energy names. The high yield markets now become a key watch point as leveraged balance sheets in a declining price environment can become quite the financial Molotov cocktail.

Stepping back a bit from focusing on the US economy singularly, meaningfully lower oil prices as we now experience are not a strict OPEC driven phenomenon. Oil is the most economically sensitive commodity in the global economy. As such, the decline in crude price is certainly a reflection of a slowing global economy. OPEC merely refused to support crude prices that had already fallen by artificially cutting back on forward production. As we've spoken of recently, declining oil prices signify rising deflationary pressures globally. We need to remember that oil revenues represent ½ of total government revenue in 20 countries. Russia is uniquely susceptible to lower energy prices. In recent weeks the Russian Ruble hit an all-time low versus the dollar. As economic pressures on a country like Russia increase, this may increase global geopolitical tensions.

In the global economy of the present, nothing occurs in isolation. We need to think through the full implications of lower crude prices as this applies to investment decision making. Rising deflationary pressures we are seeing on more fronts than just in crude prices imply that sustainable and growing streams of cash flow will continue to be an attractive investment theme. We need to watch the credit markets carefully. Providers of credit will be wary of lending into the domestic energy industry when prices are falling. Moreover, already highly leveraged balance sheets in this fast growth phase of domestic energy expansion are at risk.

For now, the "tax break" of lower crude oil and retail gasoline prices is a definable positive for the US consumer, just in time for the holidays. We need to enjoy it. Looking into the New Year, how lower crude prices influence growth, or otherwise, in the domestic energy industry will become a meaningful focal point for simply maintaining what is already below historic average US GDP growth. Oil's well that ends well? It's a matter of balance between the consumption and production sides of the US economy.

The entire team at Capital Planning Advisors would like to extend to you and your families our very best wishes for the holiday season and our hope for health, happiness and prosperity in the New Year.

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