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Current Economic Conditions

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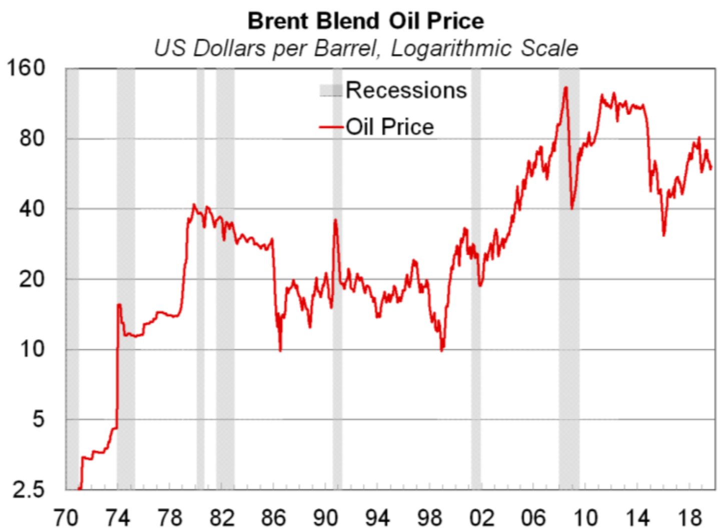
SHAKE IT OFF

A September 13 attack on Saudi Arabian oil facilities took 5.7 million barrels per day off the world oil market. This was the biggest oil supply disruption in history (in barrels, not as a percent of total supply), surpassing the Iranian Revolution (5.6 mmb/d in 1978-79) and the Arab Oil Embargo (5.2 mmb/d in 1973-74). The futures price of Brent Blend crude oil rose $8.80/barrel (14.6%) on September 16, the first day the markets were open after the attack; this was the biggest one-day increase ever. Fortunately, by September 17, half of the lost capacity had been restored, and Saudi Arabia had announced that the other half would be restored by the end of September. The price of crude oil fell $4.47/barrel that day.



Rising oil prices have "contributed to" each of the last six U.S. recessions. (In most of those cases, "caused" is not too strong a verb.) But these recessions followed doublings, triplings, and even quadruplings of oil prices. Unless there are further attacks – including counterattacks that disrupt oil exports from other countries – or it takes longer to restore lost capacity than the Saudis have indicated, the September 13 attack is not going to raise oil prices enough to cause a U.S. recession, but that doesn't mean that it won't have an impact on economies around the world, especially if the attack raises prices for an extended period by boosting the risk premium built into oil prices.

Major oil importing countries, including China, India, Japan, Korea, and most of Europe, will see their oil import bills go up. Germany, Italy, and the United Kingdom are already in or near recession. Year-over-year growth in Value Added of Industry, China's official measure of industrial production, slowed to 4.4% in August. This is the slowest growth rate since the first two months of 2009, at the bottom of the Great Recession, and the second-slowest growth rate since the data series began in 1997.

The U.S. is no longer a net oil importer, so higher oil prices no longer imply a huge transfer of wealth to oil exporting countries, mostly in the Middle East and Africa. The hit to overall economic growth isn't as big as it was in the past, but there will be winners and losers. Oil producers will benefit, and the drilling rig count, which has declined 18.1% since December 2018, could rebound if prices remain above September 13 levels. Consumers, who have accounted for most of the growth in the economy this year, will be hurt. Even though the U.S. is no longer a net importer, the net impact on economic growth will be negative.

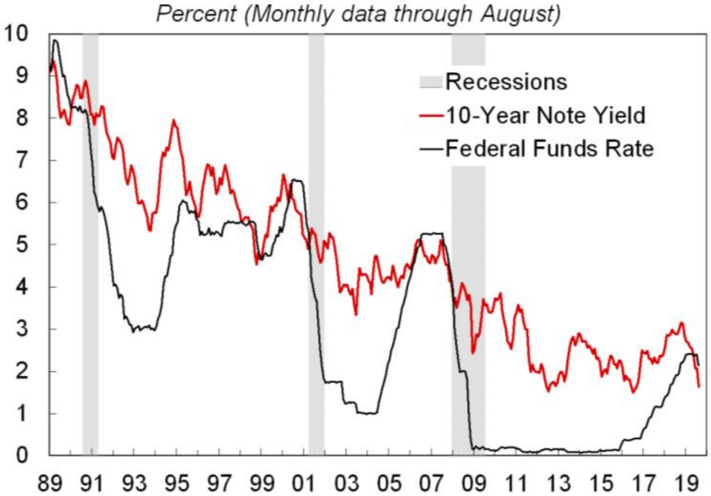
The impact of oil prices on inflation is likely to be more noticeable. The likely boost to inflation from higher oil prices follows a sudden upshift in measured non-oil inflation in June. In each of the four months before June, the Consumer Price Index excluding food and energy rose just 0.1%; over the four-month period the "core" CPI rose at just a 1.5% annual rate. In each of the last three months, the core CPI has risen 0.3% (3.4% annual rate). The overall CPI has not accelerated significantly because food and energy prices have been declining. The acceleration in the core CPI has been concentrated in the prices of goods. In the four months before June, the Consumer Price Index for commodities excluding food and energy fell every month. It has risen in each of the last three months. The timing of the upshift and the fact that it is concentrated in goods suggests that it is probably due to the pass-through of tariffs to consumers. Tariffs on $200 billion of imported **goods** from China were raised from 10% to 25% on May 10, just a few weeks before the upshift in monthly increases in the core CPI.

Fed Vice Chairman Richard Clarida has pointed out that the increase in a price index caused by increased tariffs is a [one-time] increase in prices, not an [ongoing] increase in inflation. (Tariffs **can** increase inflation on a sustained basis **if** they reduce competition or if the jump in prices gets imbedded into inflation and ultimately inflation expectations through cost-of-living adjustments, but Clarida's point is basically correct.) I'm sure Clarida's colleagues at the Fed also understand the distinction. Consequently, the Fed is not likely to raise interest rates in response to an increase in measured inflation that will reverse itself a year after the last increase in tariffs. In fact, they cut their target range for the federal funds rate by a quarter point this week, to 1.75-2%, the second time they've cut rates this summer.

The U.S. economy has slowed over the last year in response to last year's rate hikes, rising and expanding tariffs on imports from China, and slow growth in the rest of the world, but growth remains surprisingly resilient in the face of these headwinds. Retail sales rose 0.4% in August, on top of an upwardly revised 0.8% increase in July. Over the last six months, retail sales have grown at an 8% annual rate. Payroll employment rose just 130,000 in August (and job gains in the prior two months were revised down by 20,000), but aggregate hours worked, perhaps a better indicator of economic activity than employment, rose strongly. This was a harbinger of a surprisingly strong 0.5% increase in industrial production in U.S. manufacturing. Production fell 1.9% from December to April but rose 0.8% from April to August. Production is still below year-ago levels but is no longer declining the way it did **before** the last several recessions. Initial claims for unemployment insurance, perhaps the best weekly measure of economic activity, remain near 50-year lows, suggesting that growth has remained solid in September. Given the resilience of the U.S. economy, the only reason for the Fed to cut interest rates further is the inverted yield curve, but given the forecasting record of the yield curve, that's one mighty good reason. I think cutting the federal funds rate enough to get it below the 10-year bond yield is appropriate; anything beyond that would be overkill.

US Interest Rates

Percent (Monthly data through August)



Several of the leading indicators that I use to predict industrial production in manufacturing, including the yield curve, new orders, and the strength of the U.S. dollar, point to further weakness; I don't expect a strong rebound in manufacturing until a trade agreement is reached between the United States and China and the Fed uninverts the yield curve. However, one leading indicator has turned decidedly positive. Building permits for single-family homes, which are a better indicator of housing-market activity than housing starts, surged in August and have risen 10.2% over the last four months.

If the attack on Saudi Arabia had caused a bigger increase in oil prices, this newsletter would have been about an impending recession. An economy already threatened by an inverted yield curve, a trade war, and slow growth abroad would not have been able to withstand a big increase in oil prices. A quick rebound in production and adequate oil inventories around the world kept prices from exploding upwards, but if it weren't for the tremendous increase in U.S. oil and gas production attributable to horizontal drilling and hydraulic fracturing in shale formations, we wouldn't have been so lucky.