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GLOBAL IDEAS

Fed up with commodities?

The minutes of the US Federal Reserve's (Fed's) Federal Open Market Committee (FOMC) meeting of 29 July 2015, that were released on Wednesday (19 August), were more dovish than the market had expected. However, much has changed since the meeting took place (three weeks ago) and this in a direction that could only aggravate the concerns that were expressed around the stronger dollar and its impact on US domestic growth; in particular, the commodities rout should have deflationary effects that are both welcome and challenging. In what follows we discuss the Fed minutes and how the concerns expressed therein relate to commodity markets, particularly oil. We then consider the technological revolution taking place in US shale oil and the view that it may well result in break-even oil cost of $5-$20/bbl for next generation shale-oil producers. This relates to the question, also discussed below, of good and bad deflation. Lastly, we tie these discussions back to our views on the resources, consumer and financial sectors.

Perhaps the key concluding remark in the FOMC minutes was the following: "The Committee agreed to continue to monitor inflation developments closely, with almost all members indicating that they would need to see more evidence that economic growth was sufficiently strong and labor markets conditions had firmed enough for them to feel reasonably confident that inflation would return to the Committee's longer-run objective over the medium term." This is more dovish than the market had expected.

The fact that the Fed minutes were so dovish is concerning because the US economy, in our view, actually needs higher rates. Increasingly, there are signs that elite market participants' thinking about the relationship between interest rates and economic growth is changing. Bill Gross, for example, in his August letter, while discussing fiscal and monetary policy in the US, wrote that, "it is not the fiscal stance that appears to be morphing, however. […] It's monetary policy where the battleground for evolutionary ideas is taking place, as the Fed begins to recognize that zero percent interest rates increasingly have negative, as well as positive consequences." Gross proceeds to comment on the fact that, instead of being stimulated, as the conventional thinking about low rates would suggest, corporate investment "has been anemic." We note at this point the recurring and related theme of share buybacks, i.e. companies using capital to shrink shares in issue as opposed to investing in new fixed assets. Gross ends his newsletter by stating his view that, "absent a major global catastrophe," we are likely to get a rate hike in September. The reason for this being that "the central banks […] are wising up; that the Taylor rule and any other standard signal of monetary policy must now be discarded into the trash bin of history. Low interest rates are not the cure – they are part of the problem." While we agree with his analysis and sentiments, we wonder if he would still express such conviction in relation to the Fed, after having seen the July minutes.

Very similar ideas were expressed by the Bank of International Settlements (BIS) in its June 2015 Annual Report, in particular the bank commented on the "medium-term costs of persistent ultra-low interest rates," amongst which are the profitability and solvency of banks, insurance companies and pension funds[1].

In our view, the question is not whether the US economy can tolerate marginally higher interest rates: it surely won't make much difference if rates are 0.25% higher, as many credible commentators have pointed out. The key issue, rather, seems to be the ensuing US dollar strength that would follow on the heels of a rate hike.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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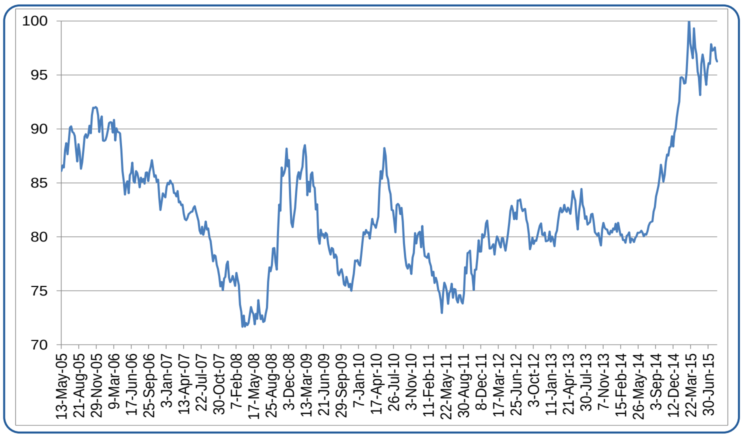
1. BIS 2015 Annual Report, 12.

Fed up with commodities continued… With China having joined the 'currency wars,' the whole world, it seems, is effectively trying to support GDP by currency devaluations against the US dollar. We believe this is very negative for the US current account and would be a drag on growth. And this is the key reason, we think, why the Fed is perhaps constrained and might not be able to hike rates in September, even if it wanted to.

Trade-weighted US dollar Index:



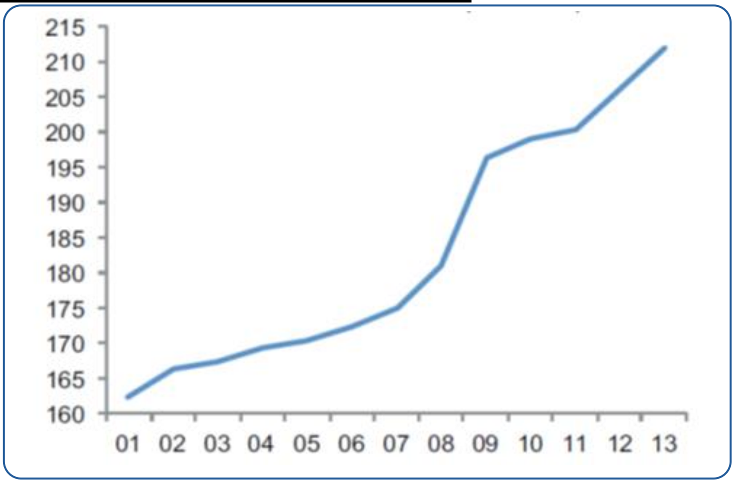
Source: Bloomberg Anchor Capital

Now, the recent commodities rout as well as the devaluation of the Chinese yuan, both represent deflationary winds to the global economy. To recap, deflation can be very negative for growth, but it is important to differentiate between the good kind and the bad kind. 'Bad deflation' is associated with demand deficiency which is a rather enduring concern about the new 'post-credit crisis' world. In such circumstances, stimulative monetary policy is intended to boost demand, thus closing the gap between demand and production capacity (this is the thinking at which Gross has recently taken aim). 'Good deflation,' on the other hand, is associated with technological improvements and is the reason why the cost of computer processing power has fallen exponentially. The US shale boom, we contend, could be seen in the second category (more on this below).

We note that deflation, of either kind, can have negative consequences, amongst which are: the fact that it reduces central banks' flexibility by raising the real lower-bound policy rate. E.g., if inflation is running at -1% and the policy rate is set at 0%, that equates to a +1% minimum real rate. With inflation, on the other hand, at say 1% and a policy rate at 0%, the lower bound real policy rate would be -1%. This is actually a crucial point at present because one of the reasons for deferring a rate hike is the absence of fiscal and monetary 'ammunition' to fight a recession. In other words, if something goes wrong, there is little policy flexibility to support growth. This worry showed up in the July minutes just released: "The risks to the forecast for real GDP and inflation were seen as tilted to the downside, reflecting the staff's assessment that neither monetary nor fiscal policy was well positioned to help the economy withstand substantial adverse shocks."

Secondly, deflation can be negative because it incentivises the deferral of consumption and investment, as prices are expected to decline even further. Thirdly, and perhaps most concerning from a structural perspective, deflation also increases the real value of debt. This is an acute worry because the debt/GDP ratio of the world economy has continued to increase. Post-credit crisis "deleveraging" is largely a myth and has only occurred in pockets of the economy, such as banks, while increasing substantially overall. This debt dependence is a key risk to the quality of global growth.

Global debt/GDP ratio (ex-financials):



Source: Luigi Buttiglioni *et al*, *Deleveraging? What Deleveraging?* (Geneva Reports on the World Economy, XVI, 2014, 20)

Turning now to the theme of US shale oil, we note that the technological revolution taking place in this area is profound and could result in break-even costs of $5-$20/bbl; such is the view of a very insightful report entitled "*SHALE 2.0 Technology and the Coming Big-Data Revolution in America's Shale Oil Fields,"* published recently by the Manhattan Institute. And the volume potential of this revolution is also significant, indeed it is the shale revolution which has pushed the US back into the leading position as the world's largest oil producer.

The report argues that, "shale companies now produce more oil with two rigs than they did just a few years ago with three rigs, sometimes even spending less overall. At $55 per barrel, at least one of the big players in the Texas Eagle Ford shale reports a 70 percent financial rate of return. If world prices rise slightly, to $65 per barrel, some of the more efficient shale oil operators today would enjoy a higher rate of return than when oil stood at $95 per barrel in 2012."[2] Further, they note that "the time it takes to drill wells is a critical component of cost. On this front, the speed of improvement has been remarkable: with virtually no increase in capital costs (in some cases, costs are down), the three key measures of drilling—time to drill, wells per rig, and total distance drilled—have improved by 50–150 percent in less than five years."[3] These are extraordinary efficiency gains.

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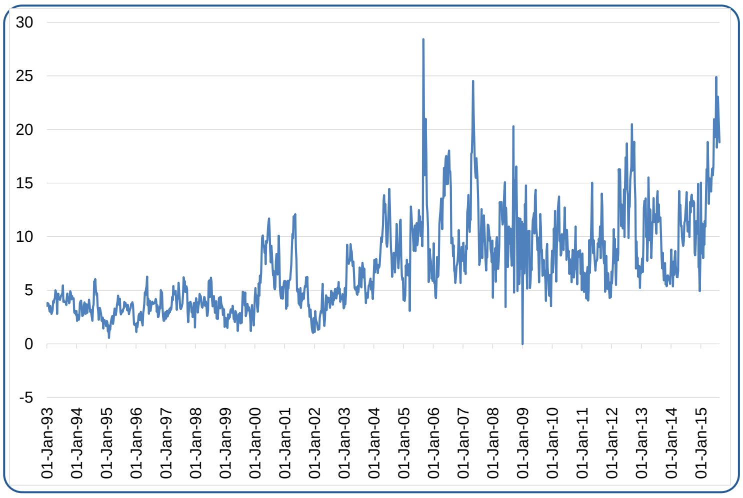
2. Mark P. Mills, "SHALE 2.0 Technology and the Coming Big-Data Revolution in America's Shale Oil Fields," *Energy Policy and the Environment Report, No. 16, May 2015,* Manhattan Institute, 3. *Ibid., 4.*

Fed up with commodities continued… Lastly, the report expresses the view that: “Once a well is drilled and 1–2 miles of horizontal pipe placed in the shale, the key factor that determines the well’s value is the effectiveness of the completion step (i.e., when hydrocarbon-bearing rock is stimulated to produce oil and gas). Spending on completion typically accounts for 50–60 percent of the total development cost of shale wells. Here, too, productivity gains have been remarkable, with a 400 percent rise in output during a well’s first month of operation; even two to three years into production, technological advances have boosted output by 200 percent in just a few years.”[4]

These views, which we think are credible, have a number of implications. We note, firstly, that this revolution in the oil market and the resulting “oil dividend” must surely be a welcome tailwind to global growth. Additionally, it appears to bolster the case for consumer discretionary stocks while further weakening the case for the resources sector, particularly the world’s major oil stocks (Exxon, Chevron, BP, Total, etc.). In our opinion, the share prices of these companies are being artificially supported by unsustainable dividends and an earnings stream that has been inflated by very high refining margins, the latter effectively masking the effect of the oil price collapse on the recently reported 2Q earnings. In relation to dividends, we note that even before the oil price collapse seen in the past seven weeks, free cash flows in the major oil companies did not support even half of their dividends. The situation is much worse now. In relation to refining margins, we note that these have been very strong of late and we expect some moderation going forwards, particularly in European refining margins. Total SA is a case in point: in its recently reported quarterly results, while upstream (oil and gas recovery) profit margins were down 49% in 2Q15 vs 2Q14, refining and chemicals’ operating profits were up 236% YoY, thus masking the effect of the price collapse on earnings.

European refining margins ($/bbl):



Source: Bloomberg Anchor Capital

So, while the developments in oil are most likely good for the consumer and bad for resource companies, the case for banks is more complicated. While these institutions are ‘creatures of the economy’ and therefore tend to track the business cycle, we note that the deflationary impact of weak oil prices, in pushing out the likely timing of the Fed’s first rate hike, is thus negative for one of the key drivers of valuation for bank stocks, i.e. the level of interest rates. Therefore, while we are still of the view that rates will rise gradually and that this will be good for banks (we remain overweight the sector in the offshore markets), the proximity of this catalyst has most likely decreased somewhat.

Lastly, there is a risk associated with the deferral of rate normalisation, which we note here. It is probably true that, in the short term, lower rates would be supportive of asset prices. But if such low rates are also negative for the underlying real economy (the view expressed by *Gross* and the *BIS*, mentioned above) then their perdurance comes with a risk of a developing disconnect between monetarily ‘supported’ asset prices and increasingly anaemic economies. The risk that rates remain low for longer is, *ceteris paribus*, negative for the risk/return outlook of financial assets.

Blake Allen

4. *Ibid,* 5.

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