Economic Optimism Abounds As Crude Oil Plunges
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New Year Forecasts Upbeat & Revised Higher

Each year at this time, we see a plethora of fresh forecasts for the New Year, and this year is certainly no exception, especially with the recent implosion in oil prices. There is widespread agreement that sharply lower energy prices will provide a boost to the global economy this year, especially for oil-importing nations including the US.

As a result, almost all of the New Year forecasts that I have seen in recent days have been upbeat and revised higher with regard to the US economy. With that in mind, I thought it would be a good idea today to revisit the recent developments in the oil and energy markets over the last six months. What we have witnessed since last summer has been nothing short of breath-taking, to say the least!

Crude Oil Prices Plunged 46% in 2014 & More Since

Oil prices ended 2014 with the worst annual price drop since 2008, reflecting the global supply glut caused by slowing demand from China and booming US shale production. US crude (West Texas Intermediate) ended the year at $53.27 last Wednesday, down from near $108 in June. That’s a drop of 46% for the year. Brent crude ended the year at $57.33, down 48% for the year.

On Monday and again this morning, crude prices plunged even more with the price of West Texas Intermediate falling to near $48 as this is written. That’s more than a 50% decline since June. Short sellers and hedgers are piling on. Short open interest on crude futures and options contracts more than tripled from 15 million barrels in August to 77 million last week.
In the past, the Organization of the Petroleum Exporting Countries (OPEC) has cut oil output to keep prices afloat in times of supply abundance. But the group, comprised of 12 oil producing nations, has been reluctant to lower the supply this year, fearing that its market share will simply be filled by US competitors.

While a Reuter’s survey last Tuesday showed that OPEC nations’ output fell by 270,000 barrels per day in November and December, that’s just a drop in the bucket. Most forecasters still predict a large excess supply to remain all year.

Despite the plunge in prices, US crude production accelerated to 9.14 million barrels a day by mid-December. That’s the fastest rate since the Energy Information Administration (EIA) began tracking this weekly data in January 1983.

Likewise, inventories of crude at Cushing, Oklahoma, the delivery point for WTI futures contracts, increased by 2 million barrels to 30.8 million in November, according to the EIA. That’s the highest stockpile level since February.

Sluggish global demand has been persistent for much of the year, and a new manufacturing report from China last Wednesday underscored the conditions facing oil producers. Activity in the country’s factories shrank for the first time in seven months in December, according to Reuters, citing a survey by HSBC Bank.

**Americans Saved $14 Billion as Gas Prices Plunged**

The national average price for regular unleaded gasoline peaked on April 28, at $3.70 a gallon and has slid almost 40% to the year’s low of $2.26 a gallon last Wednesday – also the lowest price since May 12, 2009, according to auto and travel group AAA. Last year’s average was $3.34 a gallon, down from $3.49 in 2013.

The slide in gas prices saved Americans an estimated $14 billion in 2014 versus their 2013 gasoline tab, according to AAA. Given that 320 million people live in the US, that’s $43.75 for every man, woman and child, or about $115 per household.

Most of the savings came in the final months of the year, after a rise in prices in early 2014. That means the savings were particularly pronounced in the run-up to Christmas. “Many drivers are saving $15-$30 every time they go to the gas station compared with a year ago,” AAA said in a statement.

The savings will be even bigger in 2015 if oil prices stay relatively low. AAA put the savings number at $50 billion to $75 billion this year, as compared to the $14 billion in 2014, or as much as $234 per person, or around $600 per household.

Prices at the pump have fallen for a record 100+ straight days, AAA added. The average price per gallon was below $2 in five states: Missouri, Oklahoma, Ohio, Indiana and Texas as of last week. With the continued plunge in crude prices this week, that could put at least another seven or eight states under $2 per gallon.
Should oil prices stabilize, gas prices could begin rising within a month or so as the maintenance season for oil refineries begins, thus reducing supply. AAA noted that gas prices typically rise by about 30 cents to 50 cents a gallon during the spring maintenance season.

The drop in prices at the pump has been credited with boosting consumer confidence, leading to a jump in retail sales during November and the strongest third-quarter economic growth (GDP up 5.9%) since 2003.

Some Analysts Now Predict $30 Crude Oil

The plunge in oil prices may not be over just yet. As noted above, oil took another hit on Monday with WTI crude falling below $50, a level last seen in the Great Recession, and is down to $48 at mid-day today. It’s hard to recall that crude oil traded for over $100 a barrel as recently as July.

Few, if any, forecasters saw an energy meltdown of this magnitude coming. Now that prices have plunged below technical support at $50, analysts warn that a further move lower is indeed possible as the momentum remains firmly to the downside. Of course, they always say that. The fact is that oil prices are critically oversold, and no one knows what will happen next.

In any case, today's sharply lower oil prices are good news for the overall US economy, especially consumers who are saving money each time they fill up their gas tanks. If oil fell to around $40 a barrel, that would translate to a national average gasoline price of roughly $1.80 a gallon.

I’m certainly not predicting $30 oil or even $40, but as I’ve always said, commodities have a tendency to overdo it in both directions. While the major producers in the oil market are so far unwilling to cut back output, if prices continue to fall, they will have to cut back at some point.

Crude Price Plunge Shocks the Oil Industry

The plunge in prices is pinching the oil industry big-time, including the high-cost US shale sector, Canadian oil sands producers and the up-to-now red-hot Texas economy. Several thousand layoffs in the energy sector have already been announced, and no doubt more are coming.

The oil price plunge has been fueled largely by excess supply caused by the North American energy revolution and more recently OPEC’s decision in early November not to cut daily oil production (more on that decision below).

The big question now is, at what price is it still profitable to extract shale oil in the US? The cost varies widely depending on a variety of factors, with estimates as high as $95 a barrel to as low as $35 a barrel. The US Department of Energy estimates that the production of shale oil in this country would still be at least reasonably profitable for most producers, on average, as long as crude oil remains at or above $54. Other sources claim the number is higher.

The International Energy Agency estimates that the production of crude from Canadian oil sands would still be at least reasonably profitable for most producers, on average, as long as crude oil remains at or above $60. Here, too, other sources claim it is higher. In any event, oil is well below those levels this week.

What is clear is that if crude prices continue to fall from today’s levels, there will be many more layoffs and producer casualties. Many also worry that there will be widespread defaults in the high-yield energy debt space. That may be true,
but let’s put it in perspective.

It is estimated that there’s about $180 billion of high-yield energy debt, but only about $30 billion that is thought to be at some risk of default. That’s a tiny fraction of the $5.1 trillion in high-grade corporate debt and an even smaller fraction of the $28.3 trillion in US Treasury, corporate, and mortgage-debt market value.

That is not meant to imply that there will be no market implications if $30 billion in high-yield energy debt defaults; but it does suggest that this possibility likely does not represent a systemic energy banking risk that’s comparable to the 2008 meltdown, as many are warning.

Is Saudi Arabia Behind the Oil Price Plunge?

The over $55 drop in oil prices since June has led to rampant speculation that the plunge was a part of Saudi Arabia’s master plan. As the world’s biggest producer of crude oil, Saudi Arabia has had a lot of influence on prices over the years. One theory is that the Saudis are intentionally crashing the oil markets to undermine Iran and other competitors.

Many in the conspiracy crowd believe that Saudi Arabia is once again using oil as a weapon to weaken its political rivals. But here’s the catch: The health of the Saudi economy – the viability of the Saudi state itself – remains extremely dependent on oil.

Despite numerous initiatives and billions of dollars spent on efforts to diversify the Saudi economy, oil proceeds continue to account for 90% of export earnings, appx. 80% of government revenues and at least 40% of GDP. So why would the Saudis conspire to crash oil prices, assuming they could actually do so?

The Saudi government owns all natural resources in the country, including oil, and uses their sales to maintain its social contract with Saudi citizens – many of whom expect free or heavily-subsidized education, healthcare, housing, as well as government employment in return for their political acquiescence.

The government is the largest employer in Saudi Arabia. As a result, large segments of the young and increasingly better educated Saudi population now routinely express their frustration over their economic well-being on social media.

In late December, the Saudi Ministry of Finance announced its 2015 budget with an expected deficit of $39 billion, the largest in the country’s history. The budget and falling oil prices have dominated both traditional and social Saudi media.

The point is, it is unlikely that Saudi Arabia would risk disturbing this delicate domestic balancing act to undermine Iran, as some have suggested. Intentionally cutting oil prices by more than half is the equivalent of a self-inflicted gunshot to the head for Saudi Arabia.

It is true that Saudi Arabia’s decision in early November, vis-à-vis OPEC, not to reduce daily oil production did cause crude oil prices to fall sharply immediately thereafter, but this massive downturn in oil and energy prices was well underway months prior to that decision.

As discussed above, the current plunge in oil prices has little to do with the Saudis playing politics and almost everything to do with market fundamentals. While it’s true that Saudi Arabia has used oil as a weapon in the past, it was hardly a great success then and is not likely a major factor now.

2015: The “Breakout Year” For the US Economy?

There is little doubt that the latest collapse in oil prices will be good for the economy this year, although it will mean significant job losses in the energy sector as noted above. So is the US economy set to really break out of its slow growth pattern of the last several years in 2015, as some are now suggesting? That remains to be seen.

It is true that the economy turned in strong performances in the 2Q and 3Q of last year – up 4.6% and 5.0% respectively (we won’t see the first estimate of 4Q GDP until late January). It is also true that most forecasters now expect GDP growth north of 3% for all of this year.

November was the best year for job growth since 1999 and marked the 10th straight month of job gains over 200,000. Unemployment is now down to 5.8%. Manufacturing is up. As discussed above, energy production is roaring, even as oil prices are crashing.

Consumer confidence rebounded significantly in 2014 and by most initial estimates, holiday spending was up significantly
in November and December, although official figures are not out yet.

Most of my sources agree that 2015 should be a better year economically than 2014, barring any unforeseen negative surprises. We also have to keep a close eye on Russia which is facing not only a currency crisis (ruble plunged 40% against the dollar last year) but also a fiscal crisis due to cratering oil prices. I’ll have more to say about the possible implications of the Russian crisis in an upcoming issue.

Finally, the Obama administration just announced that it will soon issue at least six new major regulations directed at the oil and gas industry – an energy strategy that only the member nations of OPEC and Vladimir Putin could love.

The rules would, among other things, curtail methane emissions from natural gas and oil, place new restrictions on fracking, impose further limits on Arctic drilling and impose new safety standards on rail tanker cars.

Never mind that the oil and gas industry has to rely heavily on rail to transport petroleum because Obama has blocked the far cleaner and more efficient alternative of moving oil and gas through pipelines – like the Keystone XL pipeline which the president opposes.

More important, these are the kinds of mindless regulations out of this White House – including those crippling regs issued last year for the coal industry – that could trip-up the economy just as it’s showing signs of new life.

To learn more about these onerous and unnecessary new regulations that are coming, read the first link in SPECIAL ARTICLES below. Warning: it will make you mad!

Best New Year wishes,

Gary D. Halbert

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