Commentary by Larry Goldstein

RIGHT MUSIC, WRONG KEY

In economics, there are plenty of dilemmas and challenging questions. As analysts, we are fortunate that oil markets present most of them. Nevertheless, understanding why prices move up or down is essential if we are to evaluate government policy. Clearly, prices move as buyers and sellers respond to signals. But this is only a part of the story. Analysts have been missing and misreading fundamental signals in both the oil and global economic markets.

The weakness in oil prices last year had everything to do with the spectacular growth in North American supply. Stories abounded last year about the weakness in oil demand in general and China in particular. They were wrong on all accounts. For example at the beginning of 2015, the IEA projected that oil demand would grow 900,000 barrels per day (B/D) and China would account for 200,000 B/D. By the end of the year they discovered that they had missed demand growth by 100% and China by 300%.

It has been our view since last October that the large stock build, which started with a vengeance at the beginning of 2015, would come to an end no later than the fourth quarter of 2016. While growth in demand is expected to slow, crude oil supply will decline sharply in response to market signals. For example, non-OPEC onshore production is anticipated to decline by more than 800,000 B/D by the end of 2016. Thus, as we suggested sometime ago in an earlier comment, when it comes to supply the Tortoise will win by a Hare, and the finish line is in sight.

While prices will bounce all over the place in 2016, markets should keep their eyes on the ball, i.e. 2017. We believe markets are starting to reflect that view. This view has less to do with OPEC than the fact that price is doing what it was designed to do. Stocks should tighten all the way through late 2016 into 2017 as Non OPEC production continues to decline.

As the decline in stocks becomes visible we believe markets will become more responsive to the very limited amount of spare capacity at major producing centers. Markets too will become more sensitive to the potential disruptions in countries like Venezuela, Nigeria, Libya, Brazil, Sudan, Yemen and transit issues in Iraq and Turkey, to name a few. The only dent in this armor is the new and unanswered question: Do the Saudis want a production war with Iran? Our judgment is likely “no,” but we do not have sufficient evidence to say “yes.”

So why do we still refer to the concept of “lower-for-longer” if we don’t believe it is applicable to the oil markets? Unfortunately, we believe that it does apply to U.S. projections of economic growth, which impacts almost everything else. In 2010 following the large stimulus package, virtually all government projections were looking to 3.5% growth in GDP for the next several years. These projections were supported by many forecasts in the private sector as well. We suggested at that time (and in fact named

the recovery "The Terrible Twos") that the recovery would feel like a recession to many Americans.

We projected that GDP growth would hover around two percent. The primary reason for the difference had everything to do with the assumption of the growth in productivity. Most projections assumed that productivity would continue to grow near historic levels. We suggested a more conservative view would be appropriate. We turned out to be too optimistic. There has been a total collapse in productivity. Its growth is less than a third of its historic rate, and this year it may be too small to measure.

We strongly believe that our recent experience of "lower-for-longer" in GDP growth is now the new norm. The weak economic performance is driven by an endless volume of legislative and regulatory constraints. If companies responding to economic signals remain reluctant to invest in their business, labor productivity falters and wages stagnate. Sound familiar. Tired of hearing this song? Nevertheless, we have no choice but to address the problem of "lower-for-too-long."

Hopefully, we will get the music right and stop singing in the wrong key.