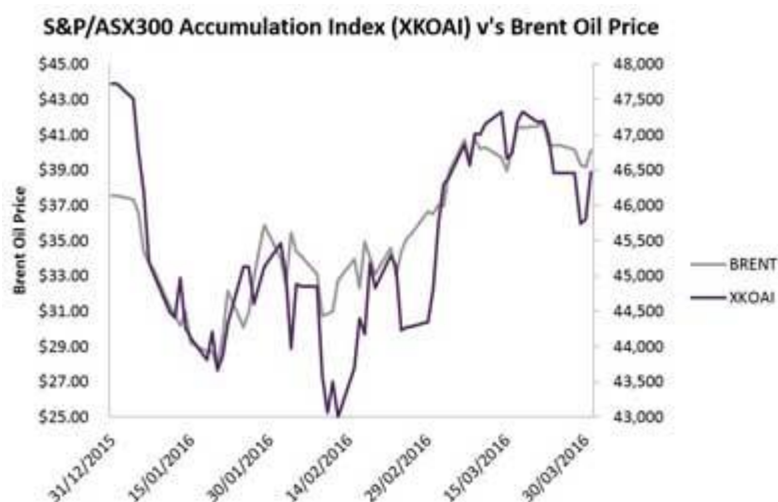
Deflating deflation, Reflating Oil and Pumping Productivity

Brian Thomas

We live in a world of very low inflation around the developed world with central banks seemingly terrified of the prospect of deflation and with good cause. Deflation is just plain ugly for an economy with falling prices deferring expenditure, consumption and investment. The antidote is also difficult and includes the possibility of very low or negative interest rates with a view to stimulate the economy and hopefully get wages and prices to rise (but not by too much as rampant inflation is also not a pretty picture!). Europe, Japan, Denmark, Sweden and Switzerland have joined the negative interest rate club and markets have become obsessed with the oil price. In the past a falling oil price in isolation was seen as a good thing for economies (so simplistically falling oil prices –unless they are falling due to a recession should be good for the stock market except oil stocks) however when it falls too far and the deflation bogey rears its head, markets suddenly and perversely yearn for higher oil prices.

This is one reason why our market is moving in lockstep with the oil price as indicated in the chart below that shows our S&P/ASX300 Accumulation Index (the Index) against the Brent Crude price. The other observation from the chart is the fact that our share market has recovered nicely from the negativity that pervaded markets in January and the first half of February. For 2016 to 31 March the Index is now only down around 2.6% driven essentially by a change in sentiment, US rates on hold, the European Central Bank's (ECB'S) bold actions and a stronger belief that China is not falling apart. Election issues in both Australia and the US will also dampen central banks desire for overly dramatic actions in these countries.



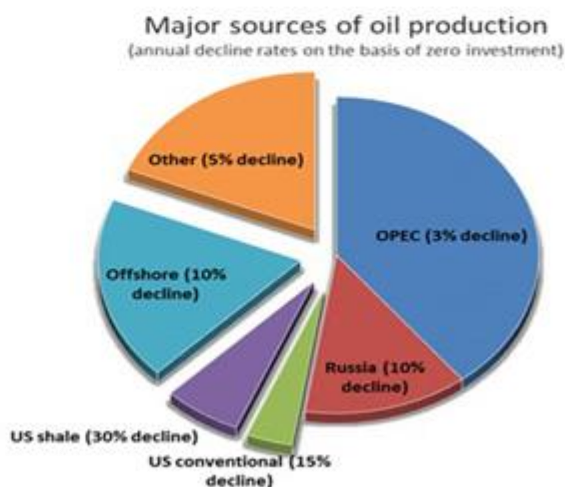
Source: IRESS, March 2016.

Discussions with several leading economic gurus (from Woody Brock in the US to Saul Eslake back home) suggest that these deflationary fears in the developed world (Japan aside) are perhaps overdone. In fact the full employment in West Germany, UK and the US has already started to generate some wage demands that, if continued, will see a nice pick-up in inflation.

This was intimated in “Super” Mario Draghi’s comments that he didn’t see the need to move interest rates lower that the dramatic package he announced in March including a cut in ECB rates (to negative 0.4%).

Returning to oil, Perennial undertook an interesting study that demonstrates the declining rates in oil production if there was no new investment. The study showed that the decline is around 7.7% per annum (or expressed daily 7 million barrels per day). This compares to a current global oversupply of around 1.5 million barrels per day. Of course investment will never go to zero but it has reduced substantially. In fact, UBS has estimated a 44.0% reduction in oil capex relative to 2014 levels. This reduction in capex has already started to have an impact, with US supply already falling particularly in shale. What is not discussed as often is the impact of reduced capital spend on conventional non-OPEC oil production which is dominated by larger, more capital intensive projects relative to shale, with lead times of up to three years from a final investment decision.

Overall we see a recovery in the oil price should occur in the next couple of years which will further allay the fears of deflation.



Source: Perennial, March 2016.

The other key theme that hasn’t been reported on is the massive and unrecorded increase in productivity (that leads to lower prices) due to the digital revolution and massive increase in supply chain efficiency connecting an increasingly urbanised world. As described by Dr Parag Khanna in his latest book, “Connectography”, 64 million kilometres of roads, four million kilometres of railways, two million kilometres of pipelines and one million kilometres of internet cables connecting major cities are driving productivity far more that the official statistics can cope with. Most statistics measure output but not quality. Woody Brock uses the creative argument that whilst official wages and productivity measures have been basically stagnant over the last few decades, what would people say about the utility or pleasure they derive from their current bundle of goods they consume now compared to their consumption bundle 20 years prior? People, when asked, tend to say that they prefer their consumption mix by around 30.0% more than decades ago implying a big increase in productivity that effectively goes unmeasured.

The above factors tend to make us a little more positive on the global and local outlook than many. Perhaps the biggest concern in the World is more political with the possibility of Donald Trump winning the American Presidency, a particularly worrying thought.

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