THE ROSE
Investment Management & Research

Compass Points

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Good News or Bad News?

Several economic developments are receiving lots of attention in the media. Often the catchy headlines pose the question, "Good New or Bad News?" We'll give you our thoughts on some of the more important issues where this question is deployed.

Crude Oil Price: Good News or Bad News?

We see a positive trend obscured by speculative talk in the press. Reduced petroleum costs and its impact on the economy is too complex a subject for 'sound bite' analysis. We are three months into 2015 and the good news vs. bad news debate continues.

If complexity is one issue, the timing of the benefits is another. One source we reviewed estimated that the consumer impact of crude oil prices at this level would result in an estimated 200 billion dollars in annual savings to U S households. (That estimate was based on the assumption that lower prices for crude oil held for at least a year.) The US Chamber of Commerce reported (March) that US households experienced a 10 billion dollar savings at the gas pump in February as compared to February 2014.

In general, price reductions are good news for the US economy. Reduced gasoline prices are widely recognized as the common man or woman's 'tax break.' Most sectors of the economy will benefit. Some of the biggest benefits will be experienced in manufacturing and distribution related businesses relying on petroleum.

For example, if you enjoy the reduced prices per gallon at the pump, imagine the positive impact on Walmart, UPS or FedEx. Clearly there will be adverse impacts on a few sectors of the US economy. Oil and Gas exploration, refining and distribution related companies will suffer.

Others such as airlines will take advantage of the opportunity to improve margins. We are not likely to see reduced summer airfares attributable to lower petroleum costs.

The global picture is also complicated, but we think the impact is largely positive. Here the economic situation and political realities often merge.

The US is required (we believe since the end of WWII) to maintain strategic petroleum reserves. Several sources report that those reserves are now at the highest level in thirty years. The nation has taken advantage of reduced prices to build those reserves.

Attempting to unpack the economic and political implications of lower prices of oil and natural gas in places such as the Middle East and Africa is beyond the scope of this newsletter. Russia is a clearer case of largely damaging impact. Some estimate that over a third of the GDP of Russia is petroleum based. Russia will find it increasingly difficult to maintain a posture of global saber rattling, resist economic sanctions from the West and finance a war in Ukraine.

Will It Last?

Yes. We think the lower prices will last for at least a year and probably longer. We base this conviction on two observations. The first is reduced demand for petroleum.

This is a trend that receives little attention in the current discussion. Improved efficiency across the petroleum-consuming spectrum is a matter of fact. Virtually everything in daily use in the developed world (heating, cooling, lighting, automobiles, locomotives, etc.) is more efficient than prior generation technologies.

We admit to being 'tree-hugging' Prius drivers. The Plug-in Prius we use in CA routinely gets 70 – 80 miles per gallon of gas. Our last fill-up registered 83 mpg on the prior tank of gas.

The increased efficiency is evidenced across the consumer spectrum. You do not need to be a tree-hugger to participate. Virtually any contemporary muscle car gets vastly better mileage than the same model of ten years ago.

The second consideration driving our opinion about future prices is a matter of political will. Actually it is the apparent lack of political will. In times of surplus supply and reduced demand common sense dictates that those who can control production will begin to reduce output until prices stabilize.

Most of the petroleum producing centers of the planet continue to produce at levels sustained in the past. It is no stretch of the imagination to argue that OPEC is in 'denial.'

Every country and region has its own revenue demand and/or reason to continue pumping. At the moment, it looks as if major petroleum producers are attempting to solve the problem of decreased revenue by pumping more product.

In Economics 101 one can study the business plan of two partners who hauled watermelons from the South to the North for sale. After a few round trips they tallied income and expenses concluding that they were not making any money. Failing to recognize that the problem was a matter of pricing, one partner argued that the solution was a 'bigger truck!' 'Bigger Truck' thinking appears to dominate – for the time being – the political decision-making process in many of the petroleum producing centers of the world.

Globalization of the S&P 500 Index: Good News or Bad News?

The S&P 500 ended 2014 up 13.69%. This was another solid year of performance for the index.

A growing percentage of that return is generated outside the US. The following table is the 2013 analysis of revenue for S&P 500 companies by regional source. The data comes from The Economist magazine.

2013 Source of earnings for S&P 500 companies by region:

North America	68%
Europe	11%
Asia	10%
All others	11%

The Dollar vs. Other Currencies: Good New or Bad New?

The dollar is firming relative to other currencies. This situation is analogous to the earlier question about the declining price per barrel of crude oil. The situation is complex and demands more than quick, easy answers. In fact, the question itself, "Good or Bad news?" is a poor question. Clearly this is the domain of headline authors.

If you are traveling abroad, this is good news. The Euro currently trading at $1.09 is roughly at parity with the dollar. If you remember traveling three years ago versus your today, you will clearly notice the benefits of increased purchasing power.

If you are one of the S & P 500 companies whose revenue is increasingly dependent on revenue from abroad, the situation is different. The firming dollars may mean that your goods and services sold abroad and denominated in US dollars are more expensive relative to your competitors selling into the same markets.

Still, none of this is "good or bad" in some ultimate sense. The fact that the dollar is firming simply describes the current moment. Globalization for companies brings the opportunity to manufacture goods and services in multiple markets denominated in a variety of currencies. Most multi-national corporations have years of experience employing sophisticated strategies for managing currency fluctuations.

QE (Quantitative Easing) Beginning & End

QE is over in the US. Lower unemployment and demonstrable economic growth laid the groundwork for the Federal Reserve to begin increasing interest rates. They may begin as early as June of this year. (Admittedly there is more to QE than setting interest rates.) That said, it is clear that a change in the interest rate environment is near.

This is another instance of fretting and gnashing of teeth in the press. Once again the 'good vs. bad' question in bantered about.

Part of what drives the bantering is the conviction held by some that the rise in common stock prices is something of a bubble solely attributable to -and in effect subsidized by -the Federal Reserve policy of maintaining low interest rates. The presumption is that the bubble will burst when interest rates rise.

We do not share this view. We do expect increased volatility in asset prices (bonds and stocks) as interest rates change. We also expect some pullback from record index highs in common stocks.

As QE ends in the US it is beginning in the EU. Behind the scenes of public drama over Greek debt and currency fluctuations, the EU is implementing a strategy similar to that employed by the Federal Reserve. They are buying bonds off the market in massive purchases and lowering interest rates.

The Question

'Good vs. Bad' analysis of economic news blunts the current situation with an emotional overlay inviting anxiety. It is the kind of question that invites us to rush toward an answer.

More often than not, the situation at hand is neither good nor bad. It is what it is. There is a reason economics has been dubbed the 'dismal science.' Economic analysis at best is dull and tediously complex. Most of the media attempts to deal with this reality by wrapping a thick layer of icing around the proverbially dry cake of facts.

When invited to reflect on 'good vs. bad' news our advice is to walk away. Recognize a bad question for what it is. The best questions are those that generate additional questions, identify new information and force us to think harder.

As always, we are grateful for your continued support.

Thank You,

Stephen & Susan