Weekly Economic Commentary

December 22, 2014

Before and After
Monitoring the Effects of Falling Oil Prices

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Highlights

The impact of falling oil and energy prices on inflation, inflation expectations, the U.S. and global economies, and the global financial system received a great deal of attention at the eighth and final FOMC meeting of 2014.

Fed Chair Yellen's comments during the post-FOMC press conference seemed to have calmed fears regarding the negative effects of oil's drop on the financial system.

Our own analysis of the "before and after" impact of falling oil prices suggests that the U.S. economy can continue to grow in 2015 despite the drop in oil prices, keeping the Fed on track to raise rates by late 2015.

The impact of falling oil and energy prices on inflation, inflation expectations, the U.S. and global economies, and the global financial system deservedly received a great deal of attention at last week's eighth and final Federal Open Market Committee (FOMC) meeting of 2014 (held December 16–17, 2014). The statement released after the conclusion of the meeting mentioned the impact of falling energy prices on inflation. In the press conference that followed the meeting, Federal Reserve (Fed) Chair Janet Yellen also mentioned the impact of falling oil prices on inflation in her statement, and was asked several questions about the impact of falling oil prices on the U.S. and global economies and the global financial system.

We expected the Fed would view the drop in energy prices as having a transitory impact on inflation. (See last week's *Weekly Economic Commentary* from December 15, 2014, "Potential Outcomes of the Final FOMC Meeting of 2014," previewing the FOMC meeting.) Our view was largely confirmed by Yellen. When asked about the impact of falling oil prices on economies outside the United States and on the global financial system, Yellen expressed concern about the Russian economy; however, she also said the potential for any spillover to the U.S. economy from the financial and economic effects overseas was likely limited. The fear that the drop in oil could lead to the financial system seizing up (similar to the drop in housing prices in the mid-2000s) has permeated the market in recent weeks, and the answers Yellen provided on this topic seemed to help calm these fears.

What Does the Oil Price Drop Mean for 2015?

Despite Yellen's (and the Fed's) view on the implications of the drop in oil, concern around the rapid fall in oil prices in recent months is likely to persist, at least until oil prices can stabilize. Although there is likely to be less drilling activity and reduced capital spending plans in the oil and gas extraction area of the economy, our view remains that the drop in oil prices is a net positive for the U.S. economy, and should have only a transitory negative impact on the rate of inflation. As we look ahead to 2015, we want to better quantify what the sharp drop in oil may mean for key sectors of the economy.

Over the past 30 years, the price of oil fell at least 35% on a year-over-year basis seven times. In three of those seven episodes (the declines ending in September 1991, October 2001, and October 2008), the large drop in oil prices was associated with a recession; the dynamics for the other four

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were different. Each time there was a recession, the **Leading Economic Index (LEI)** (one of our Five Forecasters noted in our *Outlook 2015: In Transit* publication) already indicated a recession was either underway or imminent, with the year-over-year reading on the LEI turning negative. In the 12 months ending November 2014, the LEI is up 6.1%, indicating low odds of a recession in the next several years. As noted in our *Outlook 2015*, we do not think a recession is imminent.

For details on each of the indicators (highlighted in bold), please see the infographic on page 3.

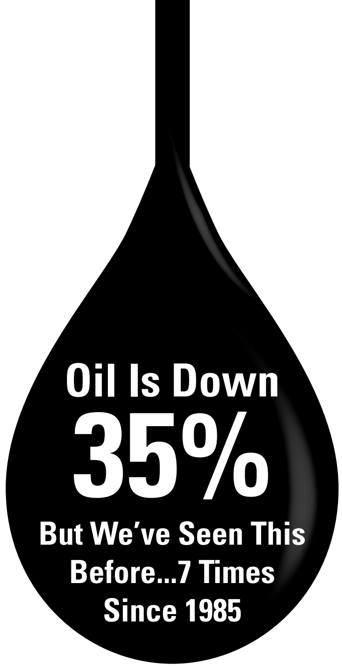
In the 12 months after oil fell at least 35%, oil prices have generally bounced higher, unless there was a recession. The median gain in **oil prices** in the 12 months after the 35% drop was 27%. **Gasoline prices**—which are down 34% from a year ago as of mid-December 2014—followed the same pattern and have posted a median gain of 13% in the year after oil prices fall by 35%. Fed Chair Yellen noted the drop in gasoline prices is likely to boost consumer spending outside of energy. However, history shows that **real discretionary spending** almost always decelerates, but does continue to grow, in the 12 months after a big decline in oil prices.

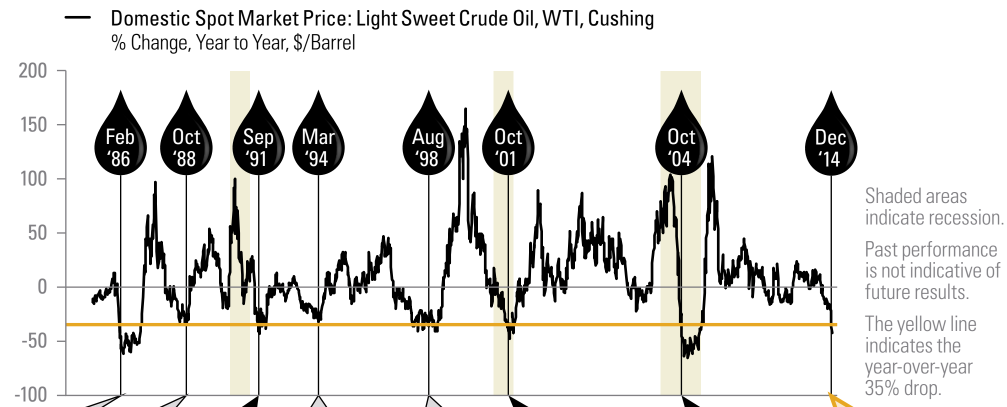
The impact of lower oil prices on stock prices and corporate earnings has already received a great deal of market attention, and that scrutiny will pick up as corporations begin reporting their earnings for Q4 2014 in January 2015. Market participants have already marked down energy sector earnings for Q4 by 25% based on the drop in oil prices, and energy equities (as measured by the S&P 500 energy sector) are now down about 20% from their recent peak set in June 2014. History shows that outside of recessions, the S&P 500 rises a median of 17% in the 12 months after a 35% drop in oil prices, and more often than not, the gains accelerated from those seen during the big drop in oil prices. The **S&P 500** is up 17% from a year ago, and we expect a 5–9% gain in the S&P 500 in 2015.*

Many market participants are concerned that the large drop in oil prices may damage prospects for **S&P 500 earnings** growth in 2015. S&P 500 earnings per share (EPS) have posted year-over-year declines four of the seven times oil prices have dropped by 35% of more. Three of those four came amid recessions, but S&P 500 earnings also declined in the 12 months ending in early 1986, as oil prices fell 60%. In the last four quarters, S&P 500 earnings rose 12%, and we expect high-single-digit EPS growth next year. Historically, in the year after oil prices fall at least 35%, S&P 500 EPS sees a median gain of 12%, although S&P 500 EPS growth usually decelerates even when the oil price decline is not associated with a recession.

While overall manufacturing output is likely to accelerate next year, output of the nation's oil wells is likely to decline, if history is any guide. Industrial production for **oil and gas well drilling** has dropped in the year after a 35% drop in oil prices in each of the past seven episodes. In most cases, the decline in oil well output intensifies after the big drop in oil prices, and we'd expect the same in 2015. We continue to expect that despite the drop in oil- and gas-related capital spending (about 10–15% of total business capital spending), overall capital spending should be a plus for the U.S. economy in 2015.

*Historically since WWII, the average annual gain on stocks has been 7–9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5–9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.





	Feb '86		Oct '88		Sep '91		Mar '94		Aug '98		Oct '01		Oct '08		Dec '14	
	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.	Prior 12 Mo.	Next 12 Mo.
Oil Prices	-60%	16%	-35%	48%	-35%	0%	-35%	27%	-36%	61%	-37%	30%	-35%	0%	-42%	?
Gasoline Prices	-39%	3%	-5%	10%	-38%	0%	-18%	16%	-42%	60%	-36%	36%	-9%	13%	-34%	
S&P 500	25%	25%	15%	26%	31%	11%	2%	16%	8%	40%	-25%	-20%	-36%	-7%	17%	
S&P 500 Operating Earnings	-3%	4%	27%	9%	-16%	1%	25%	19%	1%	12%	-31%	19%	-40%	15%	12%†	
Unemployment Rate	7.0%	6.6.%	5.3%	5.4%	6.9%	7.6%	6.6%	5.5%	4.5%	4.2%	5.5%	5.9%	6.9%	9.9%	5.8%	
LEI	4.5%	4.4%	3.5%	-0.3%	-2.0%	5.1%	6.8%	6.0%	3.5%	2.0%	-9.1%	4.3%	-15.5%	-5.9%	6.1%	
Real Discretionary PCE	4.4%	4.6%	3.9%	3.7%	-0.3%	4.8%	4.4%	3.2%	6.5%	5.8%	3.6%	2.4%	-2.5%	-0.1%	3.4%	
IP Oil and Gas Well Drilling	-32.7%	-46.7%	-2.2%	-4.4%	-28.5%	-28.0%	32.1%	-1.3%	-13.7%	-17.3%	-7.8%	-15.1%	7.0%	-42.2%	8.2%	
Core PCE	3.8%	2.8%	4.5%	3.6%	3.4%	2.9%	2.3%	2.3%	1.3%	1.3%	1.7%	1.9%	1.6%	1.4%	1.5%	
					Recession Within 1 Year						Recession Within 1 Year		Recession Within 1 Year			

Source: LPL Financial Research, Energy Information Administration, Chicago Mercantile Exchange, Haver Analytics 12/18/14

†Through third quarter 2014.

Table shows year-over-year percent change for each indicator, with the exception of the unemployment rate, which is shown as the actual rate (percent).

As we have noted many times in this publication and others, the Fed will be watching inflation and the unemployment rate closely as it determines when (and by how much) to raise interest rates. The Fed's preferred measure of inflation — the personal consumption deflator excluding food and energy, or core PCE, is up just 1.5% from a year ago amid the 35% drop in oil prices, so there has been little spillover, as Yellen noted. **Core PCE** does tend to decelerate in the 12 months after a big drop in oil prices, although not by much; and when not accompanied by a recession, the pace of core PCE is little changed in the 12 months after a big drop in oil, relative to the 12 months before. We expect a potentially gradual pickup in overall inflation next year as the labor market continues to improve and wages begin to accelerate.

Indeed, the historical record shows the **unemployment rate** always falls in the 12 months after a big drop in oil prices when the price drop is not accompanied by a recession. The median unemployment rate dropped by a full percentage point during those four other non-recessionary periods noted above.

The Fed's comments around oil last week proved to be calming for financial markets — especially as it relates to the global financial system. Our own analysis of the "before and after" impact of falling oil prices on equities, earnings, the broad economy, inflation, and the labor market suggests that the U.S. economy can continue to grow in 2015 despite the drop in oil prices, keeping the Fed on track to raise rates by late 2015, and that the stock market should deliver solid gains next year. We will continue to monitor the recent drop in oil prices — and its impact on the U.S. and global economies, and the global financial system. ■

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