Cavelti

Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900
Website: www.cavelti.com

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To: Our Clients
From: Peter Cavelti

More Unintended Consequences

Dear Client:

To say that the fourth quarter of 2014 was eventful would be an understatement. Among economic developments, Japan unleashed the largest monetary experiment yet undertaken by any central bank, while Europe moved a few steps further toward deflationary depression. The emerging markets complex is in for new challenges too, as a strong dollar inflicts another wave of inflationary pressures and aggravates budget deficits. On the geopolitical front, the U.S. engaged against ISIS, virtually guaranteeing a war of "possibly many years" (as President Obama put it), while also aggressively pushing Ukraine and NATO toward deeper confrontation with Russia. And then, in late November, Saudi Arabia decided to flood the market with cheap oil, which has so far resulted in a decline of 50% in the price of WTI crude and pushed other raw material prices into a tailspin.

It is always easy to adjust thinking and strategy to what appear to be the logical outcomes of any of these changes. More difficult to assess are the unintended consequences that are unleashed. For example, it may have seemed a good idea in 2008 to trust the Federal Reserve to prevent a comprehensive meltdown of several key U.S. banks, and to the Fed's credit, they did just that. Unfortunately, neither the central bank nor the politicians foresaw that key parts of the economy would barely respond, even to larger and larger injections of liquidity. Today, six years later, the unintended negative consequences are apparent to all. The financial establishment is more powerful than ever; those who worked and saved hard are being penalized by close-to-zero interest rates; the middle class is rapidly shrinking; financial asset prices are badly distorted. And, worst of all, a withdrawal of the stimulus would guarantee a return to deep recession.

Looking forward, we are deeply disturbed by the likely unintended consequences of the oil price collapse. We all know that the idea of pumping more at much lower prices originated in Jeddah. The mainstream press makes it sound that this came about after a protracted argument between the Saudis, intent on curtailing the threat from U.S. shale energy, and Washington, which sternly opposed this. This is inaccurate, to say the least.

Other, rarely heard perspectives, offer different ideas. The one we find most plausible is that the U.S. did little to dissuade the Saudis, because lower oil prices were thought to achieve several key U.S. objectives—punish Washington's newest big enemy, the Russian Republic, pressure a belligerent Iran, and motivate cautious U.S. consumers to feel more confident.

It is probably accurate to say that the Obama administration never dreamed that the price slide would extend far below $80, the first price point talked about. But, by the time the scope of OPEC's cuts became apparent, opportunists and speculators were out in force, not only dumping energy proxies, but aggressively shorting them. The result is stunning: less than two months after the first open talk of a comprehensive engineered oil price drop, the U.S. looks foolish and irrational, as its shale miracle is visibly turning into shale bust. Saudi Arabia, meanwhile, has achieved much. It can still count itself as Washington's worthy military ally, has weakened Iran, and has effectively rid itself of the U.S. as an oil production rival. Intriguingly, even Russia's oil industry is looking relatively unscathed. The domestic (Ruble-denominated) oil price is almost exactly the same as it was before, because the country's currency has fallen dramatically. Moreover, Moscow has reduced oil export taxes, easing any pressure on the industry.

Where Cheap Oil Will Lead

The primary consequence of the oil price collapse is easily foreseeable: energy-producers across the world will have to deal with considerable instability, as most of them will be plunged into deep budget deficits. The press has extensively reported on Iran, Venezuela and Russia as the most affected, because it makes for such appealing reading, especially to the U.S. public. In reality, Russia is one of the lower price producers, with a breakeven threshold not much different from Saudi Arabia's, while many other, rarely mentioned countries will face far deeper carnage. The worst affected include Bahrain, Nigeria and Oman.

And this brings us to the secondary, or "unintended" consequences the oil price crash will unleash. If we had to project them, this is what we'd bet on:

> -Much of the oil-producing world is Muslim; growing social unrest will further radicalize society and groups like ISIS will proliferate. The radicalization of the Middle East puts the survival of America's regional allies, including Saudi Arabia, into question.
>
> -Many oil-producing countries have significant U.S. dollar denominated liabilities. This will stress the banking system, as the super-strong dollar and the low oil price will complicate the servicing of loans or even cause defaults.
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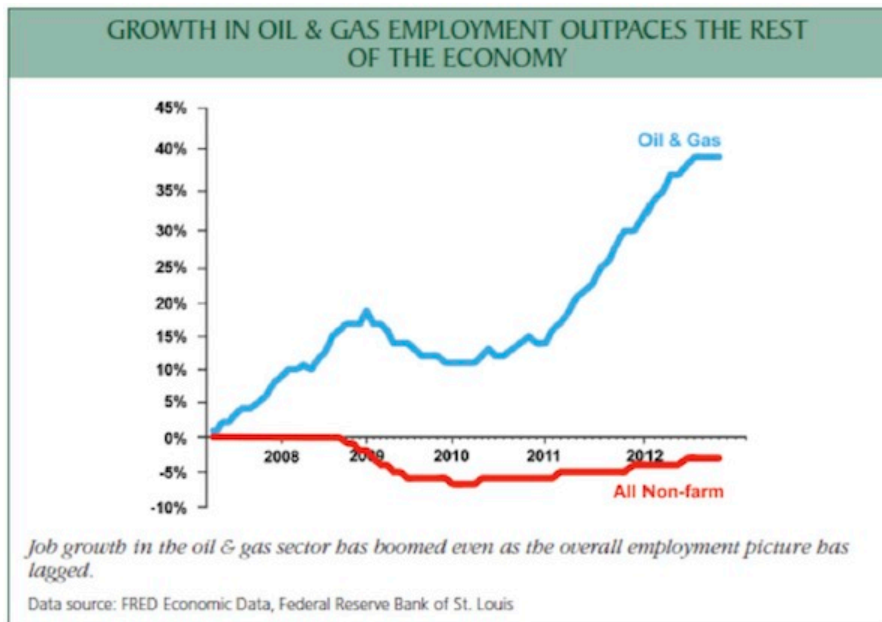
> -Even though Russia's oil industry is not severely impacted by the crude oil collapse, Moscow is starting to feel the sharp pain of Western sanctions in many other areas of the economy and banking system.
>
> -Russia's responses, already well underway, will hurt Europe far more than markets expect. As an immediate consequence, major exporters to Russia, like Germany, will see growing curtailment in orders. Further out, cutbacks in Russian energy supplies will be deeply felt throughout the continent.
>
> -America will not be sheltered from nasty, unintended consequences. The U.S. shale miracle will become known as the shale disaster, as numerous operators will find it impossible to turn a profit.

-Sharp reductions in U.S. oil output will negatively impact GDP growth, as a significant part of employment creation of the past several years occurred in the oil patch.



Job growth in the oil & gas sector has boomed even as the overall employment picture has lagged.
Data source: FRED Economic Data, Federal Reserve Bank of St. Louis

-Numerous shale ventures have been financed through junk bond offerings. Junk bonds, for some time, have been in bubble territory—a piercing of the bubble would have negative implications for other financial markets that are overvalued.

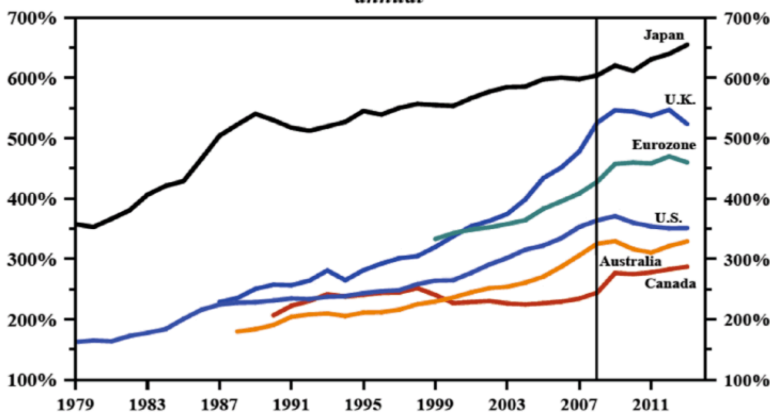
-Finally, if low oil prices are here to stay for an extended period of time, there will be supply destruction on a massive scale. Development of new oil assets will be put on hold, rigs will be decommissioned, and producers will cut back capacity at existing oil fields. Eventually, much lower supplies will cause a painful shortage, and an explosion in crude oil prices will logically follow.

Is there any chance we are seriously wrong in our assessment? Two factors could drastically change our negative view: a dramatic change in U.S. geopolitical thinking or a rebound in oil prices to, say $70/barrel. We would give the former scenario close-to-zero odds, but we believe there is a 50/50 chance of the latter outcome materializing, particularly if political opposition against the destruction of the shale economy gains momentum.

Market Opinions Highly Polarized

To reiterate, the oil price plunge and the Russia conflict make for only one dynamic that is in the process of unleashing a set of new unknowns. We still have to grapple with the numerous consequences of six years of monetary tinkering in the United States. Europe and Japan are meanwhile engaged in their own experiments, and China continues to pursue the tricky process of deleveraging its highly leveraged banking and construction industries without evoking an outright recession. Another serious issue is how the world will adjust to the fast and furious rise of the U.S. dollar, which has profoundly negative consequences for many countries. Most affected are commodity exporters like Canada, Australia and Brazil, and the many emerging economies whose lion's share of the imports trade is conducted in dollars and who have a significant part of their liabilities to foreigners payable in American currency.

Are there any bright spots left on this gloomy canvas? If one part of the world shines brighter than the rest it's, at least for now, America. Even though consumers and corporations are still cautious, the U.S. is the one major economy where economic growth is expanding at an impressive clip. Going forward, the question that matters most is to what extent lower oil prices and a stronger dollar will affect America's economy and financial markets. On the one hand, the high dollar/low energy equation will help consumers' pocket books and lower input costs in industry and commerce. On the other hand, as we've already mentioned, the low oil price will reverse employment growth wherever the shale revolution has taken hold and stress the financial system, at the very least in the affected regions and perhaps beyond. The high dollar, meanwhile, will negatively affect export earnings at America's multinationals from Coca Cola to Procter & Gamble to Harley Davidson. A mixed bag, in summary, in which positives and negatives may cancel each other out.



Outside of the U.S., there are a few rays of hope as well. If we are to believe the European Commission, a huge infrastructural initiative is in preparation, which could alleviate some of the continent's worst unemployment and reassure consumers. And in China, government initiatives to curb an out-of-control credit system and corruption may gain traction without throwing the economy into chaos, as so many analysts expect.

One thing we've learned during the past two years is that economic analysis will only get us so far. What will probably matter more than anything is what central banks will do next, and on that issue the spectrum of market opinions is becoming ever more polarized. There are those who feel we'll muddle along just as we did in 2014 for years, while others have convinced themselves that rising interest rates are right around the corner and a massive global recession lies ahead.

Perhaps the sanest voice in this discordant chorus is that of the International Bank of Settlements, whose mission is to promote monetary and financial stability and to foster cooperation between central banks. Here are two market-specific commentaries from the BIS' latest annual report:

> "It is hard to avoid the sense of a puzzling disconnect between the markets' buoyancy and underlying economic developments globally", and

> "...the trade-off is now between the risk of bringing forward the downward leg of the cycle and that of suffering a bigger bust later on."

It may seem absurd that the organization that is essentially the "central banker's central bank" articulates these points with such clarity, while the Federal Reserve, the Bank of Japan and the European Central Bank (who make up a good part of the BIS's board) continue along the very same path that has caused these dislocations. We view this as evidence that central bankers understand that their approach is not a prudent one and will eventually cause a "bigger bust", as they term it. Why, then, are they continuing on this course? Because it is the least socially disruptive among a host of horrible alternatives.

Your Portfolio

What are our opinions and how do we feel about the coming year? We've been pursuing a distinctly cautious investment policy for some time. Yes, we believe the negatives in the U.S. economy will in 2015 be outweighed by positives, including strong capital flows from abroad, where conditions are precarious. But, having said that, America is deeply interconnected with other major economies and continued domestic expansion is contingent on relative stability abroad. Europe and Japan are in deep trouble and China is struggling to maintain economic stability. Further deterioration in one or several of these spots could quickly derail U.S. progress, which is why vigilance is key. In the end, central banks may once again have to act to keep economic growth on track, but with interest rates already at zero and public confidence in their effectiveness at very low levels, they too move in uncharted waters.

All of this has led us to raise asset quality, keep durations on income offerings short, and maintain a reserve of cash and cash-like securities. The portfolio adjustments we've made during the past two years reflect the fact that we are less concerned with maximizing performance through risk-taking, but are solidly focused on downside protection.

Melissa and I hope you had a joyful holiday season and wish you a healthy, happy and successful New Year!