

"If you repeat a falsehood long enough, it will eventually be accepted as fact." In the financial markets, and economics, it is a common occurrence for the media and commentators to latch onto a statement which supports a cognitive bias. They then repeat that statement until it is a universally accepted truth. When such a statement becomes universally accepted and unquestioned, well, that is when you should probably question it."

Last week, I had a conversation with a friend of mine about the plunge in oil prices in recent weeks. One of the biggest fallacies about plunging oil prices, and subsequently lower gasoline prices, is that it is a huge windfall for consumers. Even President Trump stated as much last Wednesday morning. To wit:

Oil prices getting lower. Great! Like a big Tax Cut for America and the World. Enjoy! \$54, was just \$82. Thank you to Saudi Arabia, but let's go lower!

? Donald J. Trump (@realDonaldTrump) [November 21, 2018](#)

But is that really the case?



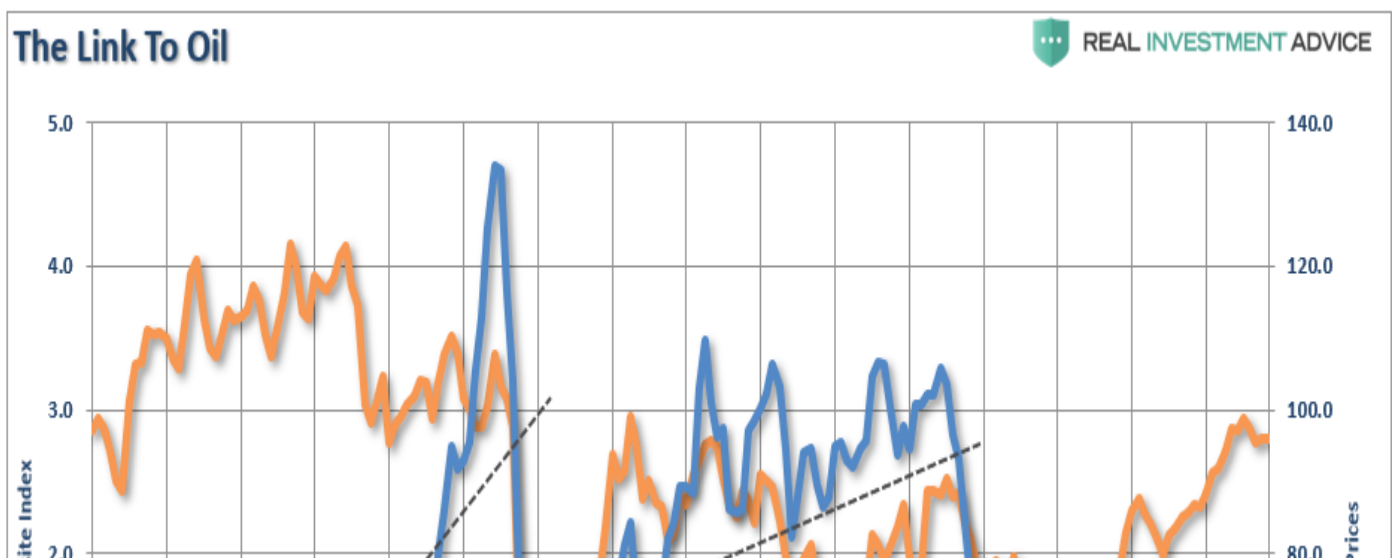
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Oil prices are indeed important to the overall economic equation and, [as I showed recently](#), there is a correlation between the oil prices and inflation, and interest rates.

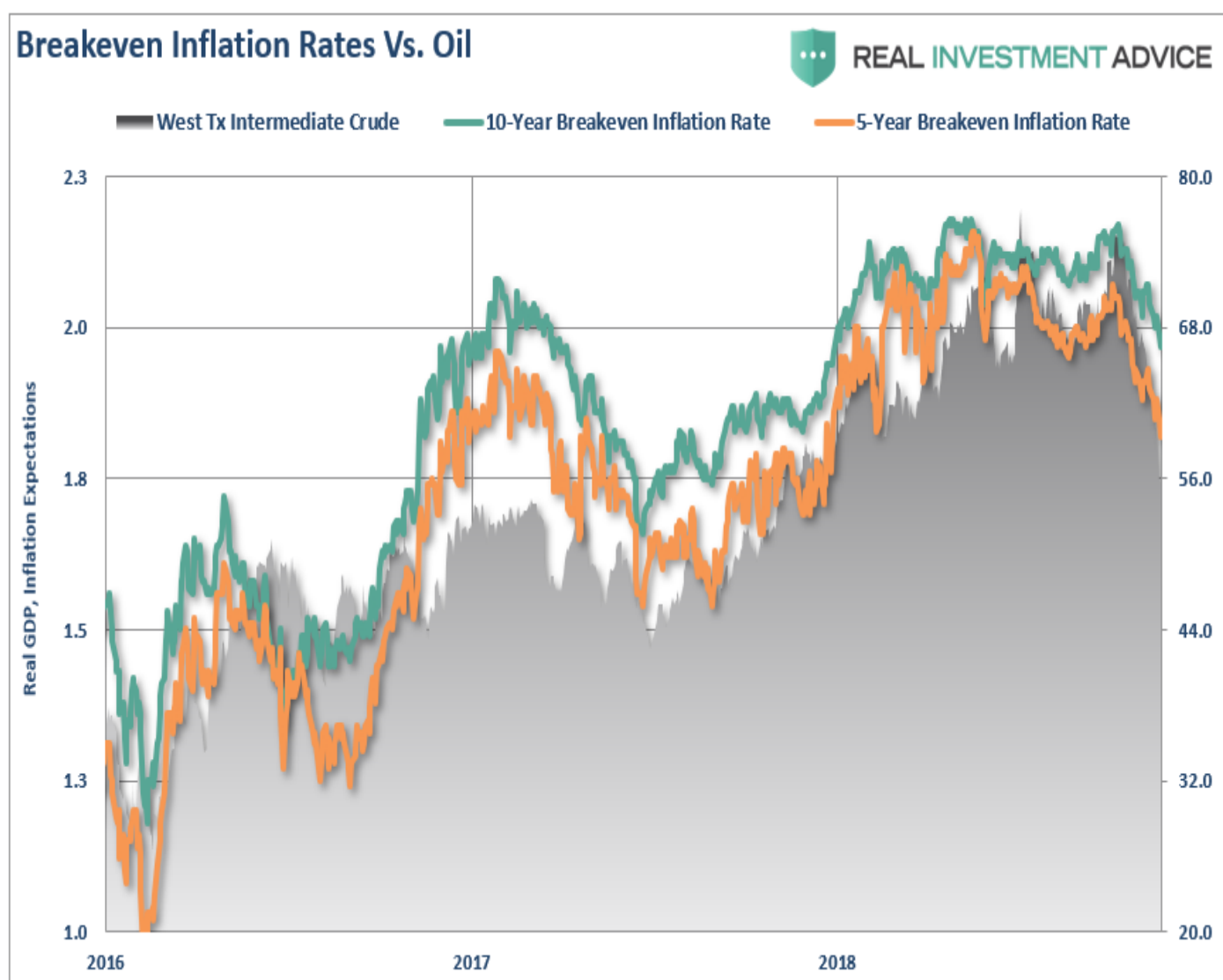
*"Oil is a highly sensitive indicator relative to the expansion or contraction of the economy. Given that oil is consumed in virtually every aspect of our lives, from the food we eat to the products and services we buy, the demand side of the equation is a tell-tale sign of economic strength or weakness...the chart combines rates, inflation, and GDP into one composite indicator to provide a clearer comparison. **One important note is that oil tends to trade along a pretty defined trend until it doesn't.** Given that the oil industry is very manufacturing and production intensive, breaks of price trends tend to be liquidation events which have a negative impact on the manufacturing and CapEx spending inputs into the GDP calculation."*



"As such, it is not surprising that sharp declines in oil prices have been coincident with downturns in economic activity, a drop in inflation, and a subsequent decline in interest rates."

We can also view the impact of oil prices on inflation by looking at breakeven inflation rates as well. As I noted in ["Oil Sends A Crude Warning:"](#)

"The short version is that oil prices are a reflection of supply and demand. Global demand has already been falling for the last several months and oil prices are now waking up that reality. More importantly, falling oil prices are going to put the Fed in a very tough position in the next couple of months as the expected surge in inflationary pressures, in order to justify higher rates, once again fails to appear. The chart below shows breakeven 5-year and 10-year inflation rates versus oil prices."



Zero Sum

The argument is that lower oil prices gives consumers more money to spend certainly seems entirely logical. Since we know that roughly 80% of households in America effectively live paycheck-to-paycheck, they will spend, rather than save, any extra disposable income. Spending in the economy is a ZERO-SUM game as for each positive impact there is an equal and offsetting negative impact. Falling oil prices are an excellent example of this as gasoline sales are part of the retail sales calculation. Let's take a look at the following example:

- Oil Prices Decline By \$10 Per Barrel
- Gasoline Prices Fall By \$1.00 Per Gallon
- Consumer Fills Up A 16 Gallon Tank Saving \$16 (+16)
- Gas Station Revenue Falls By \$16 For The Transaction (-16)
- End Economic Result = \$0

Now, the argument is that the \$16 saved by the consumer will be spent elsewhere, which is true. However, this is the equivalent of "*rearranging deck chairs on the Titanic.*" So, let's now extend our example from above. Oil and gasoline prices have dropped so John, **who has \$100 to spend each week** on retail related purchases goes to the gas station:

- Big John Fills Up His Truck For \$60 (Used To Cost \$80) (+\$20)
- Big John Spends His Normal \$20 Per Week On His Favorite Craft Beer
- Big John Then Spends His Additional \$20 Savings On Roses For His Wife (He Makes A Smart Investment)

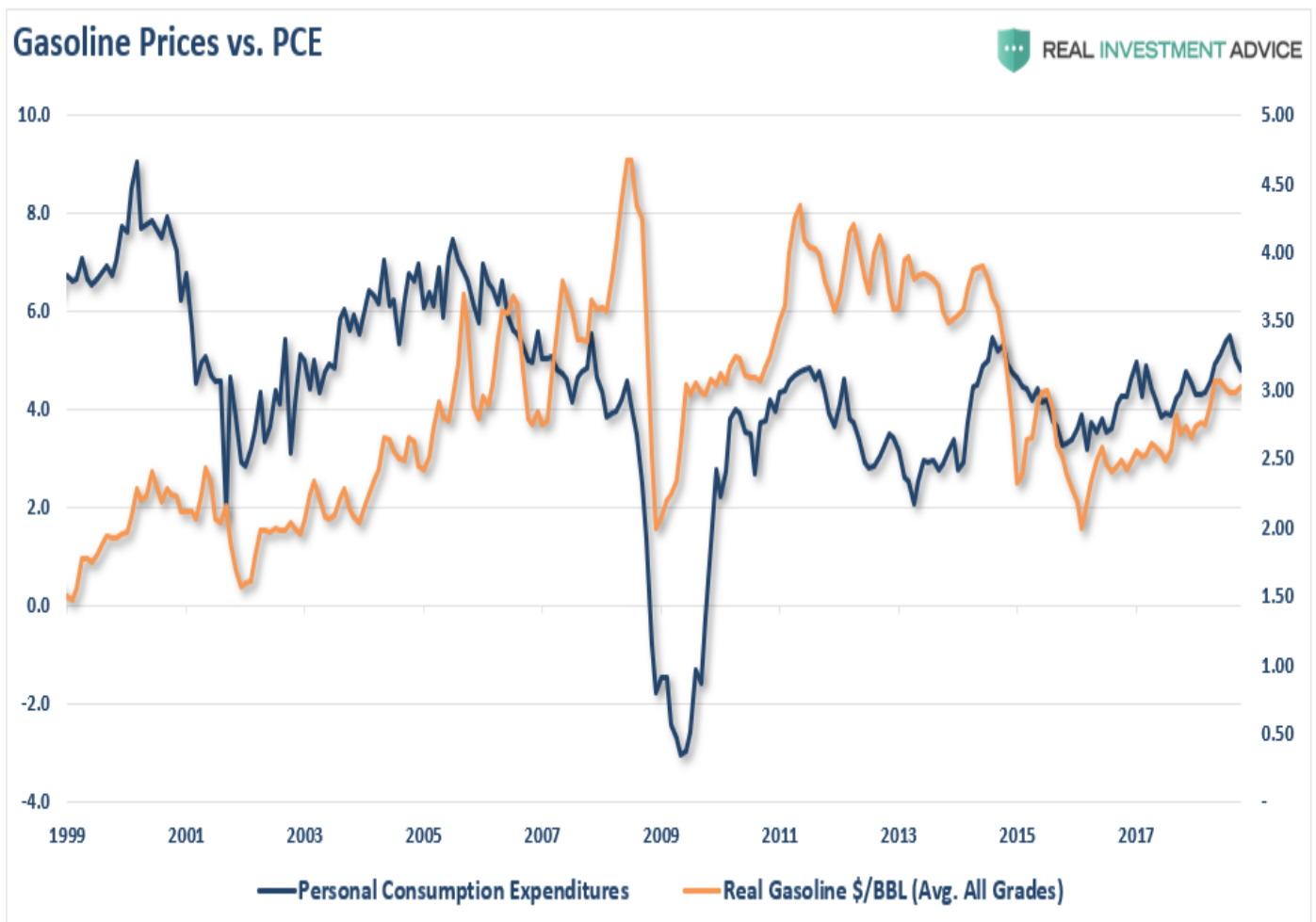
----- **Total Spending For The Week = \$100**

Now, economists quickly jump on the idea that because he spent \$20 on roses, there has been an additional boost to the economy. **However, this is false. John may have spent his money differently this past week but here is the net effect on the economy.**

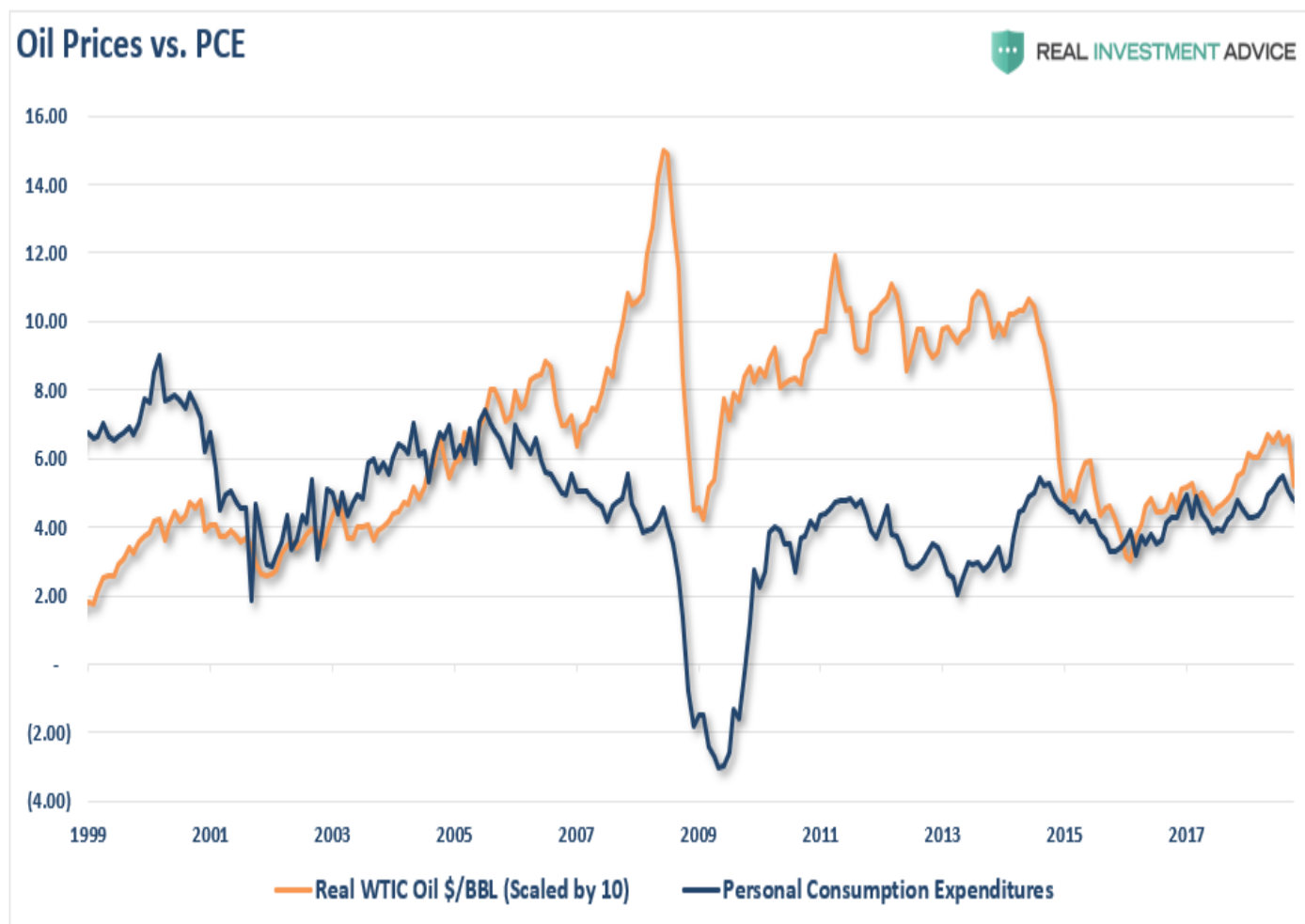
Gasoline Station Revenue = (-\$20) Flower Show Revenue = +\$20

----- **Net Effect To Economy = \$0**

Graphically, we can show this by analyzing real (*inflation adjusted*) gasoline prices compared to total **Personal Consumption Expenditures (PCE)**. I am using "PCE" as it is the broadest measure of consumer spending and comprises almost 70% of the entire GDP calculation.



As shown, falling gasoline prices have historically equated to lower personal consumption expenditures and not vice-versa. In fact higher oil and gasoline prices have actually been coincident with higher rates of PCE previously. The chart below show inflation-adjusted oil prices as compared to PCE.



While the argument that declines in energy and gasoline prices should lead to stronger consumption sounds logical, the data suggests that this is not the case. **The only thing that will increase consumer spending are increases in INCOME, not SAVINGS.** Consumers only have a finite amount of money to spend. They can choose to "save more" which is a drag on economic growth in the short-term (called the ["paradox of thrift"](#)) or they can spend what they have. But they can't *spend more*.

A Bigger Drag Than The Savings

Another important issue to this analysis is that falling oil prices are a bigger drag on economic growth than the incremental "savings" received by the consumer. In 2014, when oil prices were plunging, I discussed the issue of the impact on oil and gas production as it relates to oil prices and the economy. To wit:

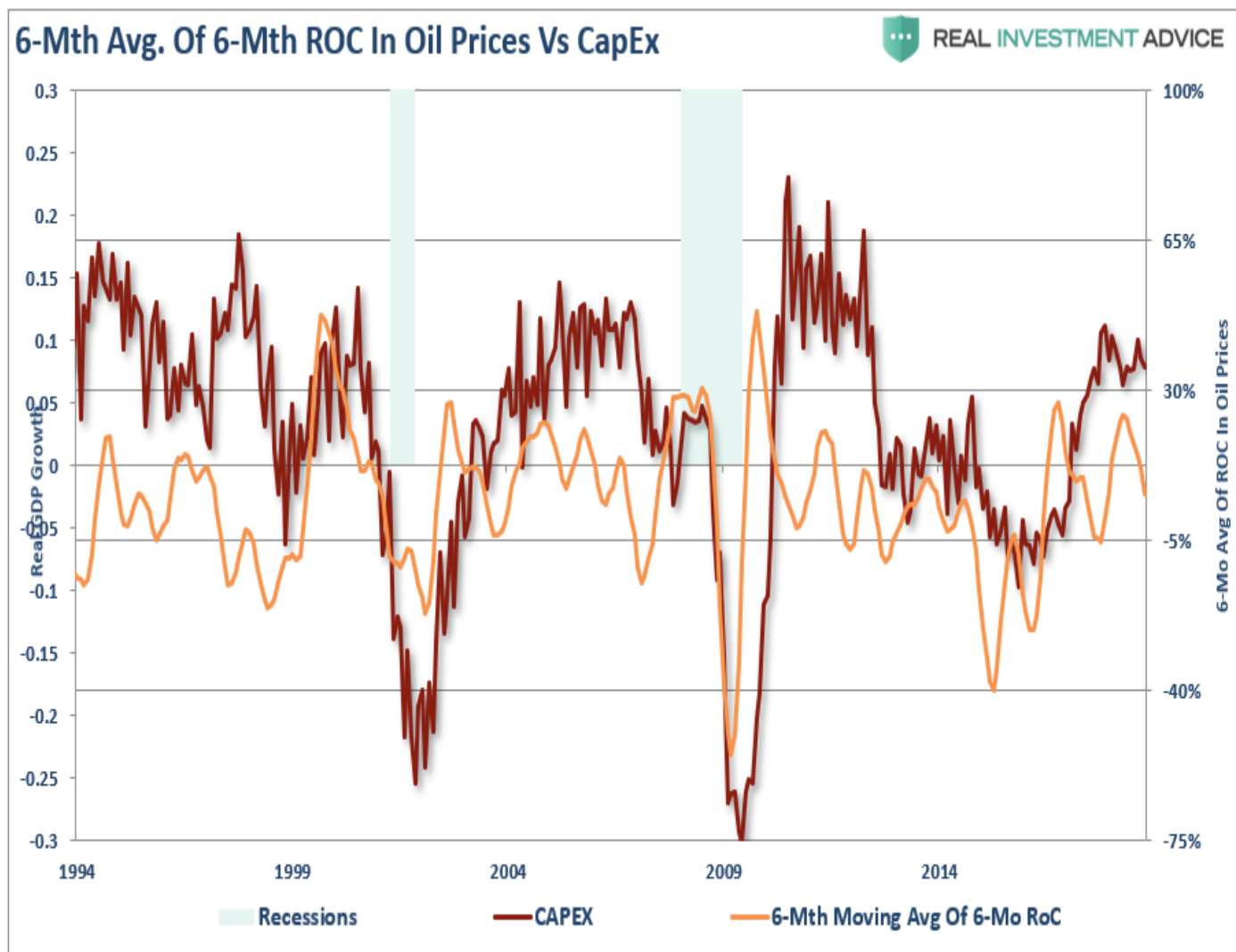
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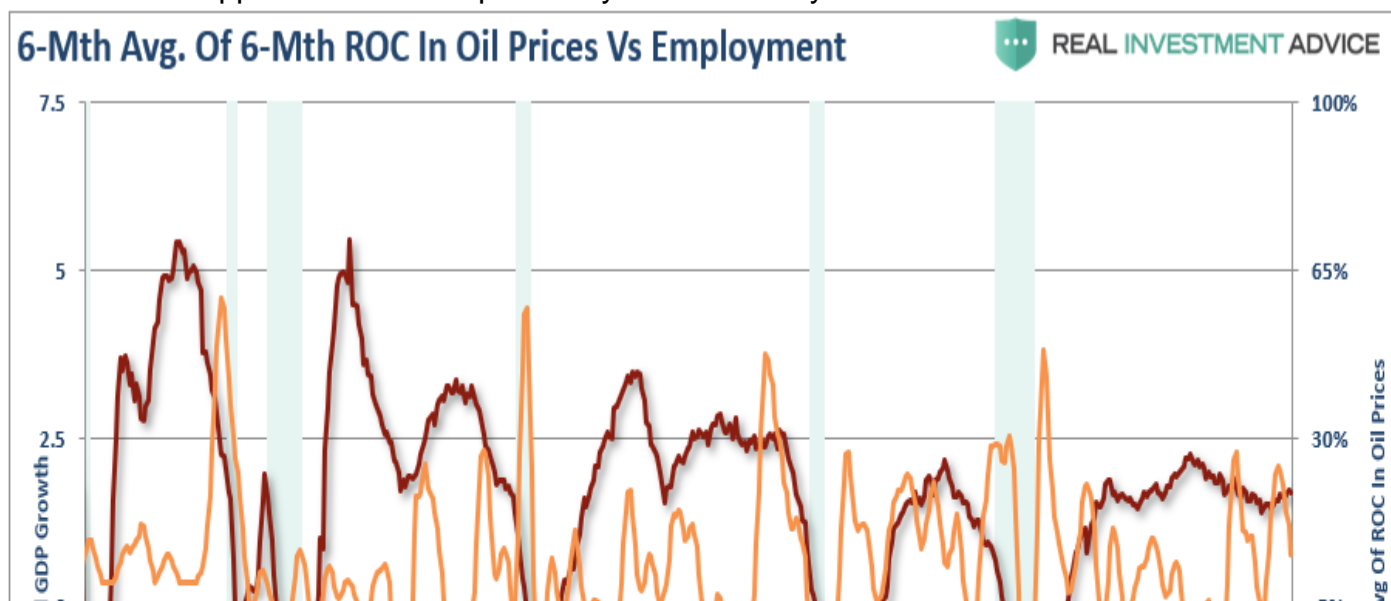
Employment Change by Wage Group Since 2000

		Change in employment (thousands of jobs)	
Wage quartile	Hourly wages	Texas	U.S. minus Texas

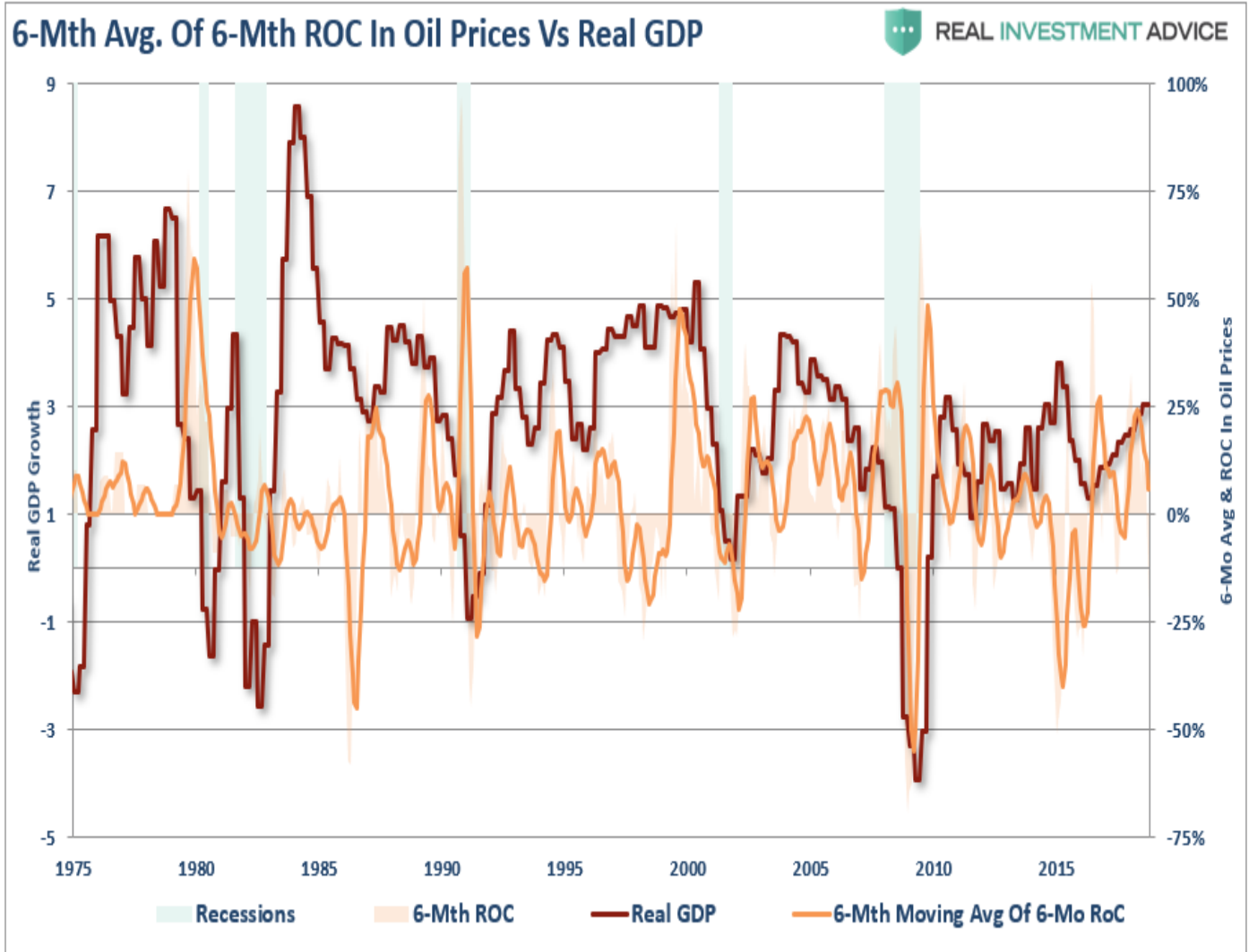
obvious ramification of the plunge in oil prices is that eventually the loss of revenue will lead to cuts in production, declines in capital expenditure plans (**which comprises almost 1/4th of all capex expenditures in the S&P 500**), freezes and/or reductions in employment, and declines in revenue and profitability. Let's walk through the impact of lower-oil prices on the economy. First, declining oil prices leads to declining revenue for oil and gas companies. Given that drilling for oil is a very capital intensive process requiring a lot of manufactured goods, equipment, supplies, transportation, and support, the decrease in prices leads to a reduction in activity as represented by Capital Expenditures (CapEx.) The chart below shows the 6-month average of the 6-month rate of change in oil prices as compared to CapEx spending in the economy.



Of course, once CapEx is reduced the need for employment declines. However, since drilling for oil is a very intensive prices, losses in employment may start with the energy companies but all of the downstream suppliers are also impacted by slower activity.



As job losses rise, and incomes decline, it filters into the economy.



Importantly, when it comes to employment, the majority of the jobs "created" since the financial crisis have been lower wage paying jobs in retail, healthcare and other service sectors of the economy. Conversely, the jobs created within the energy space are some of the highest wage paying opportunities available in engineering, technology, accounting, legal, etc. **In fact, each job created in energy related areas has had a "ripple effect" of creating 2.8 jobs elsewhere in the economy from piping to coatings, trucking and transportation, restaurants and retail.** If oil prices, a reflection of global economic demand, remains depressed for a considerable period of time, the negative impacts of loss of employment, reductions in capital expenditures and declines in corporate profitability could outstrip any small economic benefit gained from lower oil prices. For those of us who have lived in Texas long enough to remember the oil rout in the early 80's, the greatest fear going into 2019 is that oil prices remain low. Simply put, lower oil and gasoline prices may actually have a bigger detraction on the economy than the "savings" provided to consumers. Newton's third law of motion states:

"For every action there is an equal and opposite reaction."

In any economy, nothing works in isolation. For every dollar increase that occurs in one part of the economy, there is a dollars' worth of reduction somewhere else. President Trump should be implementing fiscal policy which would lead to stable oil prices at a level which supports healthy and robust economic activity. Unfortunately, he isn't.