Northern Trust

WEEKLY ECONOMIC COMMENTARY

January 16, 2015

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

Asha G. Bangalore
Economist
312.444.4146
agb3@ntrs.com

- **Questions, Answers and More Questions about Energy Prices**
- **Fiscal Issues Facing the New U.S. Congress**
- **Translating Oil Prices to Gasoline Prices**

My wife had a last-minute addition to her Christmas list: a tank for the backyard that we could use to stockpile gasoline. A gift that would keep on giving, as she put it.

I offered that the local environmental authorities might not be enthusiastic about the idea, to say nothing of the neighbors. And I noted that gasoline might get even cheaper, so going long might be a losing trade. She made a nasty observation about my forecasting ability and then continued her Internet search for the tank.

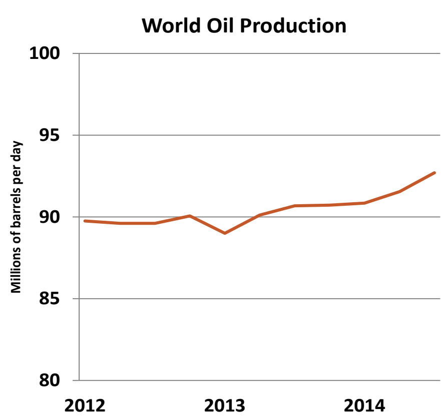
At home and at work, the topic of energy prices has dominated discussions. So we thought it might be helpful to offer answers to the questions most commonly asked.

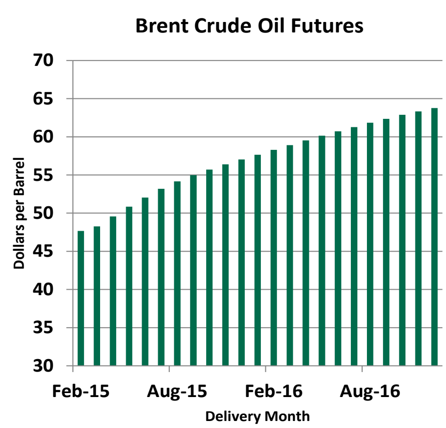
Why are oil prices dropping?

Supply and demand factors both are contributing to the correction. Soft economic growth in some parts of the world has reduced energy usage in those markets. Production, by contrast, has expanded modestly. Countries whose output had been impaired, such as Libya, have come more fully onto line. American contribution to daily supply continues to grow.

For the moment, OPEC has declined to restrict output in compensation. Within OPEC, the actions of Saudi Arabia are the subject of considerable conjecture. Is the goal to regain control over prices by pushing newcomers to the sidelines? Is tension within the group leading the Saudis to punish Iran and Syria by boosting supply? Is everyone ganging up on Russia?

The recent increases in demand and supply have been modest, though, and certainly not enough to support a 60% price correction. And it is hard to determine why the fall in oil prices began so suddenly last summer, given that many of the root causes are longer-running. Forward prices for crude oil suggest some reversion to higher prices.





Sources: Haver Analytics, Bloomberg

It is fair to say that some mystery remains around the origins and drivers of the realignment. That, in turn, makes anticipating the market's future direction very challenging.

Who will benefit most from lower energy prices?

Lower energy prices will be a huge benefit to global consumers.

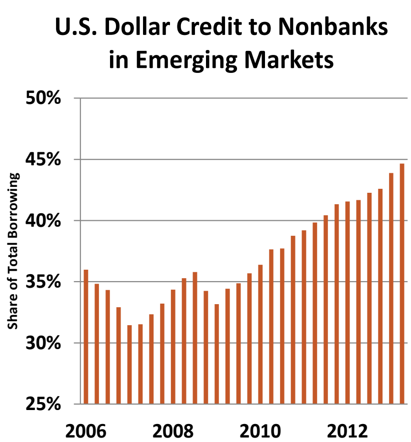
The International Monetary Fund recently estimated a lift of up to 0.7% for global gross domestic product (GDP) as a result of lower energy prices. That is a substantial number. Most of this will result from a dividend realized by consumers.

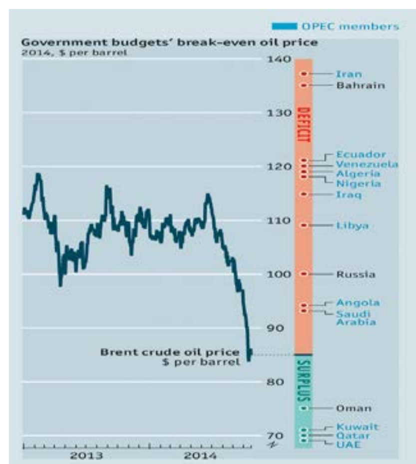
In the United States, households could see savings of $125 billion to $150 billion this year. Assuming a good portion of this is spent, GDP growth could increase by an estimated 0.5%. Holiday sales were disappointing, though; consumers may be banking the energy dividend for now. Nonetheless, if energy prices stay low, it must be viewed as a significant positive.

On a broader level, Japan, the eurozone and India should benefit. They are significant importers of oil.

Which producers are most vulnerable?

Relative fortunes will be determined by breakeven prices, which are relevant at two levels. The first is the cost of extraction. The second important breakeven is the price required to satisfy national spending needs, which is often much higher. The challenge for some nations is compounded by the presence of substantial dollar-denominated debt.





Sources: BIS, The Economist

Russia is already in crisis, as the triple whammy of oil, minerals and sanctions has exacted a severe toll on its economy and its currency. Cornered, Putin could come out swinging; a Russian invasion of Belarus, Georgia or another former Soviet satellite state cannot be ruled out as a means of accumulating bargaining leverage.

The impact on the U.S. oil industry is nuanced. Some producers are quite efficient and operate in areas where exploration and drilling is not as expensive. Others have higher costs to cover, including debt payments. Defaults in the high-yield debt market, some of which is backed by U.S. energy investments, could increase.

How will the energy adjustment affect inflation and central banking?

Central banks in the United States, Britain and the eurozone share a 2% inflation target. The Federal Reserve targets core inflation, which excludes energy prices. While the recent energy price decline will have some indirect influence at this level, it will be modest.

Such a large market correction could challenge financial stability.

By contrast, the United Kingdom has seen inflation of just 0.6% over the past year, and falling energy prices will almost certainly keep the eurozone in deflation for a while. Should this change the course of monetary policy? At some point, stability will be restored, and the impact of energy on inflation will diminish. Central banks are typically focused on the long-term inflation outlook, as opposed to monthly readings. The Bank of England and the European Central Bank would do well to discuss the situation in those terms.

But if the energy realignment kindles any kind of financial instability, either directly or psychologically, that would be a different matter. If energy prices remain depressed, this could become a bigger factor in central bank decision making as the year progresses.

We recognize that much about the situation remains very fluid, so we will strive to keep you posted the best we can. In the meantime, if anyone is in the market for a backyard gasoline tank, my wife can send you a link.

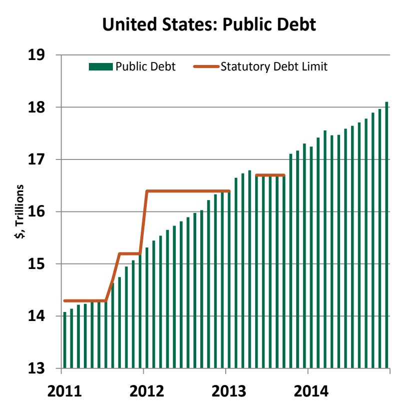
The Economic Agenda for the New Congress

The 114th Congress convened on January 3, with a Republican majority in the Senate and the House. There are deadlines the new Congress must meet, and there are broad reforms to consider. We discuss here a selection of key economic items Congress will consider in 2015.

Last year, the statutory debt ceiling was suspended until March 15, 2015. From there, the Treasury will have to make do without additional borrowing. The seasonal pattern of federal cash flow should prevent the debt limit from become binding until the fall of 2015.

A replay of the debt ceiling drama of 2011 and 2013 is unlikely. However, rhetoric forwarded by some Congressmen bent on preventing an increase in the debt limit could create uncertainty for markets. The United States is the only country with a debt ceiling, and we could certainly do without it.

Upcoming Issues	Deadlines
Funding of Homeland Security	February 27, 2015
Debt Ceiling	March 15, 2015
Doc Fix	March 31, 2015
Highway Transportation Fund	May 31, 2015
Tax Extenders	December 31, 2015



Source: Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

At the end of last year, Congress funded the Department of Homeland Security (DHS) only through February 27, 2015. Disagreement over executive action on immigration led to this step; the DHS is responsible for enacting the executive order. Failure to fund the department would result in a partial government shutdown.

Projected demographic changes in the United States during the next two decades suggest that a visionary strategy for immigration would help boost labor force growth. This may be a tall order to fulfill during the term of the current legislature.

The "must-address" issues will dominate legislation in 2015.

Highway spending is only authorized through May 31, 2015. At that time, funds will not be available for transportation projects, and revenue will be inadequate for current spending. Unless something is done, a $15 billion shortfall will occur in 2015, and it is projected to grow to $65 billion by 2025. It would be a pity to allow this to happen, given the sad state of American infrastructure and the potential returns from increasing investment in this area.

At the close of 2014, more than 50 temporary provisions known as "tax extenders" expired. They had been extended retrospectively for 2014 only at the 11th hour but will require renewed authorization for this year. Extending these expired tax provisions through 2015 is estimated to cost more than $40 billion, while a permanent extension would raise the amount to more than $750 billion through 2025.

Alternatively, Congress could consider comprehensive tax reform that would broaden the base and promote economic growth. There seems to be bipartisan support for overhauling the corporate tax code, but there is disagreement on the details and the use of any new revenues.

At the end of March 2015, there will be a 21% cut in Medicare payments to physicians under the Sustainable Growth Rate (SGR) formula. The SGR has been waived continuously through "doc fixes" since 2003 to maintain stable payments to physicians. The most recent temporary fix was passed in March 2014.

Freezing payments for one year would cost about $15 billion, and extending it for 10 years would entail a bill of $135 billion. However, savings from this avenue could result in reduced participation of physicians in the Medicare program and disruption of care.

It remains to be seen if the current Congress will surprise pessimists and deliver constructive legislation before the term expires in 2017. With the presidential campaign soon to accelerate, the two sides will have to choose between making progress on today's issues and merely accumulating bulletin-board material for the next election. We're hoping for the best…but reality may once again disappoint.

Looking Beneath the Sticker Price of Gasoline

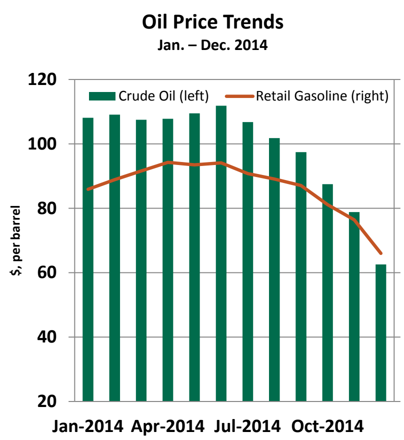
As discussed above, the energy price crash will greatly benefit global consumers, primarily through lower fuel costs. But translating one to the other is not always a straight line.

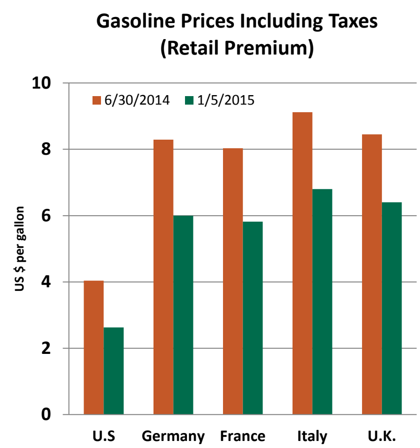
The price of crude oil is the primary driver of retail gasoline prices. Research at the Energy Information Administration (EIA) indicates that roughly two-thirds of the gasoline price at the pump reflects the refinery cost of crude oil.

Effectively, there are four factors that determine gasoline prices in the United States: (1) the price of crude oil; (2) refining costs and profit margins; (3) retail and distribution costs and profit margins; and 4) taxes. Of these four factors, the first two explain a large part of the changes in retail prices. The latter two are the retail elements of the supply chain and are less influenced by day-to-day variations in the price of crude oil.

If you are wondering why the price at the pump takes longer to adjust after crude oil prices have changed, wholesale gasoline prices adjust contemporaneously with changes in input costs at the refinery. But retail prices adjust with a lag. According to the EIA, "about half of the change in crude oil prices is passed through to retail prices within two weeks of the price change, all other market factors equal."

There is more to gasoline costs than crude oil prices.





Sources: Haver Analytics, EIA

U.S. gasoline prices have declined almost 40% since June 2014, as compared to a nearly 54% drop in the price of oil. So there is still some room for further declines.

Senators Robert Corker and Chris Murphy of Tennessee and Connecticut, respectively, see the situation as an opportunity to raise the 18.4-cent-per-gallon federal gas tax (unchanged since 1993) to replenish the underfunded Highway Trust Fund that pays for roads and bridges. Their hope is that they could slip this in without alarming consumers, but the anti-tax sentiment in Washington is strong.

Gasoline prices are down about 30% in Germany, France, Italy and the United Kingdom. Differentials to the United States are largely driven by high fuel taxes in Europe, where the average number of miles driven annually is about 75% of that in the United States. Trains make up much of the difference, but declines in fares to rebate lower energy costs are unlikely. So the consumption boost that Europe will enjoy on the back of the oil price decline will be more modest.

Understanding the transformation of crude oil into useable fuel is helpful to assessing the potential benefit of recent trends. They promise to be substantial but may take some time to realize and may vary from place to place.