THE LONG RUN

"Strange, strange are the dynamics of oil and the ways of oilmen."

-- Thomas Pynchon, *Gravity's Rainbow*

As we sit to compose this letter, the S&P 500 and the NASDAQ Composite have each just experienced their worst price performance week since May of 2012. European bourses have fallen into double-digit negative performance for the year as weak economic reports out of Germany are fueling fears of potential deflation on the continent. Adding to these pressures, weakening productivity reports have cast doubt on the sustainability of growth in China, the newly crowned *largest economy in the world* according to the IMF. With all of this, the S&P 500 is still only 4% below its all-time high, and consumer confidence continues to rise in the United States. While this resilience at home may seem untenable, we see evidence that some of the major current adjustments on the global stage may, in fact, be inuring to the benefit of the United States economy.

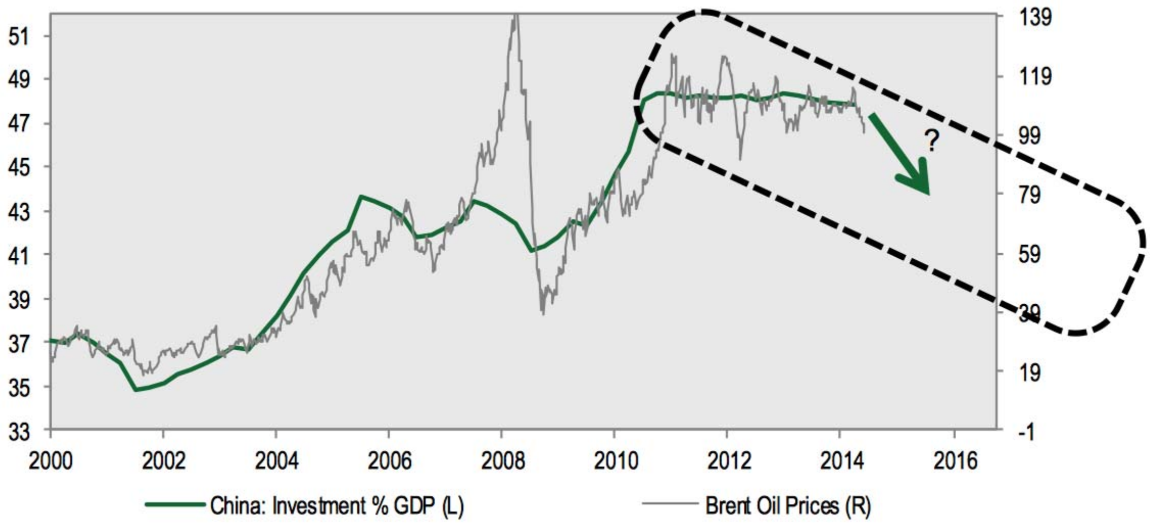
We have discussed many times in these pages that we expect to be living in a less coordinated global economy with slower potential growth rates for some time to come. From deleveraging in developed markets, to rising labor costs in emerging economies, to more nationalist fervor around the world, we have argued that various economies would begin to face a wide range of differentiated threats in the post 2008 world and would need to respond with uncoordinated and diverging economic policies. At the center of this argument has been the belief that the successful "macro" trades of the 2000s – fueled by hyper-industrialization in developing economies and waves of easy credit – would need to give way to more carefully selected thematic investments where investment prospects were less tethered to general growth in global GDP. Specifically, we have advised that investments in emerging markets and industrial commodity-based assets would need to give way to investments in innovation and industry-specific opportunities (like the genomics revolution in healthcare, technology and efficiency advances in manufacturing, and the shift in technology toward mobility – to name a few).

The current storm in equity markets around the world supports this thesis and is centered on a dramatic downturn in the price of oil and other industrial commodities. Crude oil prices have fallen more than 20% since June, and energy stocks have led the market declines. Oil sits as a central lynchpin for global industrial activity – and the current trajectory of oil prices, production, and demand offers insight into where growth opportunities may and may not exist going forward. In our last *Long Run*, we showed how the number of miles driven in the United States have been falling, reducing our demand for oil. We will spend a moment here to take a look the current state of the Chinese economy and the likely impact on oil prices going forward.

China has been one of the central drivers for demand growth in the oil markets over the last 15 years. The Chinese government has funded one of the largest building and construction booms that the world has ever witnessed which**,** in turn**,** drove the largest migration in human history as Chinese workers moved from rural areas to gleaming new cities where jobs promised to be more abundant. The reality behind this boom, however, is disquieting and may go a long way toward explaining why we have seen such a significant drop in commodity prices. China has been investing a higher and higher percentage of its GDP into construction projects to create jobs and further growth, but these investments are no longer able to move the economic needle. In fact, the economic growth rates in China are slowing even with government investment at extraordinary levels rarely seen in major or minor economies.

Paul Krugman earned his Nobel Prize in economics for (among other things) his insights into the causes of Asian Financial Crisis of 1997. Before the crisis, many Asian economies – including Thailand, Malaysia, and Indonesia – had been growing at an extraordinary pace and enjoying their own industrial and construction booms. This attracted foreign investors who wanted to participate in high-growth opportunities in these "Golden Dragon" economies. By 1996, Malaysia had started construction on the tallest building in the world as a testament to its growth. By the end of 1997, however, these economies were in ruin. Foreign investors unceremoniously fled, and currencies collapsed. Krugman's key insight was that these economies had been investing a larger and larger percentage of their GDP to drive growth. When the percentage of GDP expenditure rose above 30%, the investments became less efficient and then finally failed to drive growth. The government investment model, in its design, simply proved itself to be unsustainable.

China's investment percentage of GDP is now just below 50%. The Chinese government has set a new five-year plan to move from being an investment-driven economy toward being a more consumer-based economy, but these changes take time and will sap the current supports that the government is providing for GDP growth. In August, Cornerstone Macro prepared the instructive chart below. It shows just how correlated the price of oil has been to China's investments as a percent of GDP, and it suggests what may happen to the price of oil if China's investments slow. The decline in oil prices over this last month certainly seems to follow this script.



To add to oil's woes, it is clear that pricing pressure is not just an issue of slackening demand. We are in the midst of an historic energy supply boom here in the United States that dwarfs the supply boom that brought global oil prices down in the 1980s and 1990s. In a telling sign, Saudi Arabia simply lowered prices last week on the oil they would sell with no adjustment to production levels. The suggestion is that demand simply doesn't look strong enough to support high prices considering the ample current supply of available oil and that supply cuts may be less effective in this environment.

The silver lining in this story is that lower oil prices provide a significant stimulus to the U.S. consumer. Gas prices in the U.S. are down below $3.00 per gallon in many states – putting more money into shoppers' pockets. Many have wondered why consumer stocks have performed so well over the last 18 months, and part of the answer may well be this energy cost-saving stimulus at work. (Of course another part of it may be the very real improvement in the employment picture.) Falling oil and commodity prices offer another important benefit: Lower inflation risks. Low inflation allows interest rates to stay lower for longer. When put together, a strengthening U.S. consumer, low inflation, and low interest rates create powerful support for stocks. So we look out over a complex and shifting global landscape with caution, and we do have concerns that the current spike in volatility may lead leveraged traders, hedge funds, and tactical investors to chase to the exits and push markets into full-correction territory. However, we also see powerful tailwinds forming in certain industries and geographies and would be meaningful buyers in these areas on further weakness.