Have We Reached an Inflection Point in Economics History?: "Indeflation" and Energy

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[Ed's note by PG: This is a guest post by Chris Nelder, an energy analyst and journalist; his work can be found at GetRealList and Energy & Capital. Chris is the principal author of Profit from the Peak – The End of Oil and the Greatest Investment Event of the Century, and the co-author of Investing in Renewable Energy: Making Money on Green Chip Stocks.]

A fierce debate now rages among economists, investors, pundits and the puppetmasters of fiscal policy: What's next, inflation or deflation?

Has the most massive money-printing spree in history successfully stimulated the global economy and put it back on an upward course with rising inflation? Or are we still in a global downturn, temporarily masked by the stimulus, with prices, wages and employment still falling?

A comforting 30% gain in the major stock market indexes since the March lows has given renewed confidence to the "green shoots" trumpeters who dominate the airwaves and the press.

But grayer and wiser heads in the investing community—like Dave Rosenberg, John Mauldin, Nouriel Roubini, Gary Shilling, Peter Schiff, and Dave Cohen—have a more bearish view. The financial sector must now deleverage, they argue, which means liquidating assets, repaying debt, saving instead of borrowing, and contracting in general. In their view, the process will take years, not months, and what we have seen since March is a classic bear market rally.

Consider the data Rosenberg offered in a commentary last week in support of his deflationary thesis:

- Residential real estate still sports a 12-month supply of unsold inventory, and housing starts have staged a very weak recovery this spring.
- Every major industry posted a decline in May. Industrial production had its seventh decline in a row in May, to a level last seen 11 years ago. The Institute of Supply Management (ISM) index, a measure of manufacturing activity and a proxy for tech spending, is still falling.
- Employment slid in May to greater depths than were seen in the last two recessions, and "real organic personal income" fell for the second time in the last three months. Ultimately, recessions don't end without rising employment, meaning consumers with money to spend.
- Prices are generally still falling. The Producer Price Index (PPI), used to evaluate wholesale price levels, is down 37% year-over-year "to a 50-year deflation low of -5.0."

There are other signs that this spring's green shoots may be browning. The Consumer Price Index (CPI), the Labor Department's key measure of inflation, has fallen 1.3% over the past year, the largest decline in nearly 60 years, mainly due to the 27.3% crash of the energy index component.

Meanwhile, the consumer remains beaten and bruised. As my colleague Steve Christ pointed out last week, U.S. household net worth fell by $1.3 trillion in the first quarter, and household wealth is down 21.6% from its 2007 peak. Commercial real estate is contracting painfully, with prices plunging and vacancies and defaults soaring. Meanwhile, consumer credit defaults are still rising, even as rising interest rates have snuffed out the resurgence in home-buying.

Liquidity in the credit markets remains a problem as well. Banks simply aren't lending out the Fed's forced injection of fantasy capital. Indeed, they are entirely intent on paying it back as quickly as the Fed will let them, on the heels of secondary stock offerings and other measures they have taken to raise capital and reduce their exposure. (For a personal anecdote, I called Discover two weeks to take advantage of a recent 1.8% promotional offer on balance transfers they had sent me, and was told that they aren't accepting any more balance transfers right now, from anybody, period.)

On the whole, I think the case for deflation and contraction is well made.

Commodity Inflation

At the same time, food and energy prices have been rising rapidly. Oil has rocketed from the low $40s to the low $70s in just four months, a roughly 71% gain. Soybeans rose about 50% over the same period, with most other grains gaining similarly. Normally, this would suggest inflationary fears, and indeed it has apparently drawn hedge fund money off the sidelines, out of bonds, and back into energy and commodities. (Energy analyst Dave Cohen did a great study of speculation in the current commodity cycle last week in "Bad Signs, New Bubbles.")

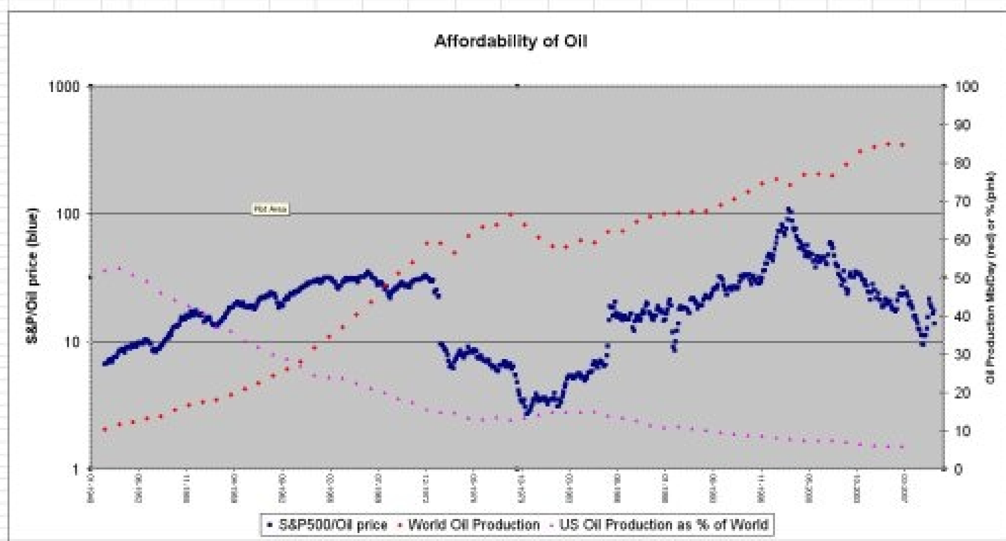
I don't want to make too much of the commodity resurgence, however. The market continues to price oil inversely to the dollar, and the dollar's fall has been echoed almost perfectly by oil prices:

The dollar's decline can be viewed as the proper result of printing trillions of dollars out of thin air, without new assets to back it—the inflationary thesis.

Indeflation

On the whole this year is looking a great deal like last year across the energy and commodities sector, with the same sort of inflation. But there is an important difference this year: The economy and the consumer are sick, very sick. Gasoline at $3 was a nuisance last year, but this year it really hurts.

Perhaps we should be zooming out on this picture, and considering the *affordability* of oil. Consider this 60-year chart from the blog of "Mr. Excessive," which tells quite a different story:



The affordability of oil, as measured by the S&P500, peaked in 1999, and has been in decline ever since. Oil prices began rising sharply at that time, as the early effects of peak oil began to be seen. Global conventional oil production has been flat since 2005, despite a tripling of prices.

So is it inflation or deflation?

My pal Gregor Macdonald argued this question elegantly on his blog in April, and in a recent conversation asserted, I think rightly, that it's not an either-or question. In fact, we're seeing inflation (of prices) and deflation (of assets) simultaneously. Investor guru Doug Fabian has termed this "indeflation" and Izabella Kaminska of *FT Alphaville* has called it "compartflation."

Instead of just looking at the dollar and inflation, we should consider that, as former International Petroleum Exchange head Chris Cook argued on The Oil Drum, *energy is the only real currency*. Our fiat money is but a distorted representation of it, and that energy is declining in real terms as oil, natural gas, and coal all become progressively harder to extract and of lower energy content.

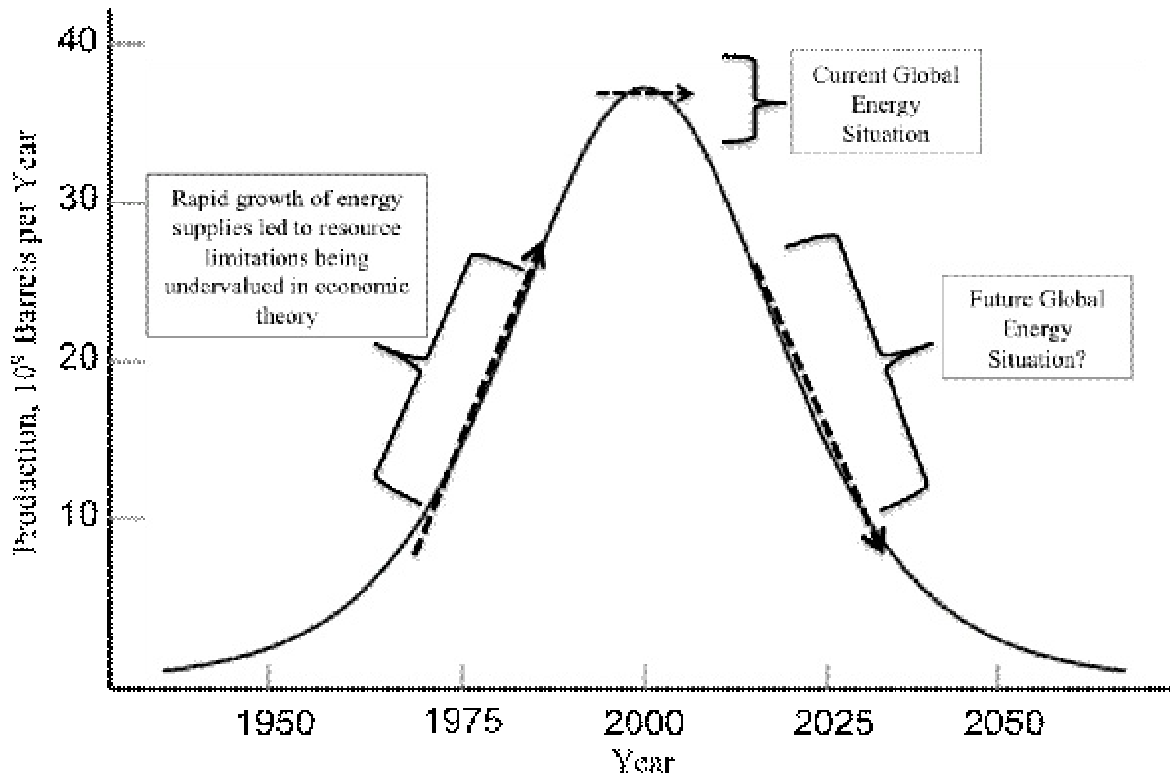
Are We At An Inflection Point?

We now appear to be bumping our heads against an invisible ceiling, where the decline in real energy meets our pain tolerance for high prices. When gasoline hit $4 last year, it created real demand destruction because people simply couldn't afford it with their evaporating dollars. Likewise, the spike in natural gas and coal prices ultimately translated into such high prices for basic building materials like cement and steel that demand was curtailed.

It now seems possible that we have reached an inflection point in economic

history, where the price at which energy is high enough to sustain new production is the same price at which things become too expensive, leaving us no option but to downsize.

Academics including Charles Hall, Cutler Cleveland, and Howard Odum have explored the relationship between primary energy and economic growth exhaustively. Hall and his graduate student David Murphy graphically depict where we are now as follows:



Until we understand this key point, we are going to continue to go through wrenching cycles like we experienced over the last year. Spiking energy and commodity prices lead to destruction of the economy, which then gathers itself at a lower overall level until prices spike again, and back around the wheel we go. As energy declines, the ceiling will get lower and lower, and it will take more and more money to buy the same things.

No amount of tinkering with monetary policy can change that. Unlike money, Btus can't be printed out of thin air.

Unfortunately, neither the Fed nor Congress seems to have learned this lesson.

The Fed still thinks that tweaking interest rates, buying bonds, forcing banks to keep the fantasy money, hiding the stress test results and the like can somehow ease us into a manageable recovery.

A few bright bulbs in Congress suggested last week that we exchange 70 million barrels of light sweet crude oil from the Strategic Petroleum Reserve (SPR) for an equivalent amount of lesser quality heavy sour crude, in an effort to dampen oil prices. Aside from being a fundamentally bad idea, I continue to believe such a move would be utterly ineffectual. The maximum official rate at which the SPR can be drawn down is four million barrels per day, but I suspect the actual rate would be far lower. In any case, the price difference between the two grades of oil is fairly small, and the value of the swap would virtually disappear within a flow of 84 million barrels a day of

globally priced oil.

The other bit of new legislation, a "Cash for Clunkers" bill that passed last week, also appears to be completely toothless. I supported the idea until I learned the anemic requirements of this bill, which would offer $3,500 vouchers for a mere 2 mpg gain in fuel economy for light trucks and SUVs, and $4,500 for a 5 mpg improvement. Cars would only need to gain 4 to 10 mpg to qualify.

Suffice to say that I still have very low expectations that our national leadership will offer any tangible, effective methods to significantly reduce our consumption of petroleum. I certainly do not see them coming to grips with the near-certainty that by 2012, the world's oil supply will go into terminal and relentless decline.

Looking internationally, finance ministers for the Group of Eight (G8) expressed concern over the influx of capital into the commodity sector after their meeting last weekend. In a communiqué, the group stated, "Excess volatility of commodity prices poses risks to growth. We will consider ways to improve the functioning and transparency of global commodity markets, including considering IOSCO [the International Organisation of Securities Commissions] work on commodity derivative markets." Ministers have asked the International Monetary Fund (IMF) and the International Energy Agency (IEA) to suggest new ways to monitor and regulate the oil markets, in an effort to limit speculation and dampen future volatility.

If done very carefully, such an effort could moderate the boom-bust cycles ahead, and give the world a crucial measure of slack in which we can sustain the long term investment horizon needed to transition to a renewable energy infrastructure. If done hastily or badly, it could starve the energy markets of capital, or cause unintended and probably worse effects.

I think that as it is now constituted, the market is inadequately equipped to face this inflection point of indeflation, and history is no longer a useful guide. We're entering uncharted territory while the risk of peak oil is still priced at approximately zero.

So what does all this mean for investors?

First, it means long-term investing in a diversified portfolio of stocks is probably not going to be a good strategy for a long time to come (if ever); it's time to play defense and look for low-risk yield. Second, it means that investing in oil and commodities will continue to be the name of the game for many years, but investors must watch the signs I have identified here carefully to know when it's time to dive in and time to jump out as we churn through these cycles under a dropping ceiling. And third, it means that we all need to learn to live at a lower level, eliminate debt, build savings, and buckle up for a long and bumpy ride.

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