



The Great Suppression

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Colin Fenton (with microphone), Managing Partner, Blacklight Research LLC, participating in the J.P. Morgan Center for Commodities' (JPMCC's) inaugural Research Council meeting in the Center's CoBank Lecture Hall on April 18, 2015. Mr. Fenton is also the Co-Chair of the JPMCC's Advisory Council. Professor James Hamilton, Ph.D., University of California, San Diego and member of the JPMCC's Research Council, is on Mr. Fenton's right in the photograph.

The US GDP estimates published on July 29, 2016 confirm the US economy is in a broad and sustained slump. In December 2015, we identified this decline and termed it "The Great Suppression" for reasons we explain below.

But first: the data. The US Department of Commerce says 2Q2016 US real GDP was 1.2% qoq-ann. Consensus opinion had expected 2.6%. In addition to this huge miss, Commerce also substantially lowered its real GDP numbers for the previous two quarters. Estimated growth in 1Q2016 is now 0.8%, revised down from 1.1%. The revision for 4Q2015 is larger: 1.4% has been cut to 0.9%. This means average US real GDP growth over the past three quarters has reportedly been just 1.0%, down from



2.2% in the three previous quarters. Further revisions are scheduled, as per normal practice. We expect the GDP numbers will be lowered again, much as the Federal Reserve lowered 65 of the preceding 80 monthly growth rates for US industrial production in its April 1, 2016 annual revisions.

Five main suppressants drive the Great Suppression

What is the Great Suppression? In December 2015, we wrote:

“The global economy is in a slump. The slump is broad, significant, and sustained. Contractions are visible in select but large channels for investment, trade, rail freight traffic, industrial production, consumption, and corporate profits, though not yet global GDP. Symptoms of distress are rising across all capital markets. They are in credit, commodities, equities, interest rates, and foreign exchange. Several high-yield mutual funds are liquidating. The S&P 500 appears to have made a primary top in May. After years of rigidity in the value of the offshore Saudi riyal, there have been two swoons in the past 12 months, albeit small on a percentage basis. These signals, among others, go beyond mere corrections and idiosyncratic adjustments. Some of them are the strongest changes in 40 to 50 years. Collectively, they suggest a more serious and common challenge for markets and the global economy. To help explain what we think is happening, we give the slump a name: the Great Suppression.” (Blacklight Research, *The Great Suppression: Policy choices spurred the slump, can policy reversals fix it?*, December 21, 2015).¹

To suppress means to withhold. It can also mean stop, curb, reduce, or prevent. On net, a suppressant can be beneficial or harmful. It can be expertly managed or not. It can be suitable for the current condition of the world or an artifact of a time gone by. But suppressants always restrain. This is the core concept.

The Great Suppression is centered in energy and emerging markets (EM). Five main factors have guided its evolution over several years.

The first suppressant can be traced back through Beijing’s efforts to address China’s exceptionally poor air quality and overinvestment in non-residential construction. On May 27, 2013 the government in Beijing ordered that coal-fired boilers within Beijing’s Fourth Ring Road be replaced by clean energy alternatives before the end of 2015. The order applies to all boilers with a generation capacity of at least 20 tons of steam per hour. These units are principally used for residential heating. The Chinese government also began to rein in non-residential construction growth, which had the direct effect of reducing demand for coking coal and iron ore in China’s steel mills. These policy decisions were reinforced by two bilateral climate agreements with the United States, settled in November 2014 and September 2015. The primary purpose of these agreements is to reduce carbon dioxide (CO₂) and other emissions from the world’s two largest emitters.

Cynics have doubted Beijing’s commitment to reduce its hydrocarbon demand on such an abrupt time frame. Yet, China’s coal consumption growth contracted by 0.77% YoY in 2014 and then by another 1.48% YoY in 2015, after posting a compound annual growth rate (CAGR) of 4.1% in the prior 5 years, according to *BP Statistical Review* data published in June 2016. This voluntary halting of coal demand growth was the single largest factor in curbing global primary energy demand growth to 1.1% in 2014



and 1.0% in 2015, or less than half of the normal 2.5%. In the past four decades, such weak growth has happened only during recessions or near-recession years: 1974-75 (0.4%), 1980-82 (-0.5%), 1991-93 (0.6%), 1998 (0.7%), 2001 (1.1%), and 2008-09 (-0.1%).

In response to China's turn away from high-sulfur coal imports, on January 12, 2014 Indonesia announced a ban on export of all unprocessed mineral ores, hoping to spur investment in a domestic nickel refining industry. The rushed announcement at first confused markets on whether it was effective immediately or would be phased in through 2017. In any case, the net effect was depressive for demand. Restricted nickel ore exports helped spur a 59% price increase in LME cash nickel prices in the first 18 weeks of 2014. This temporary price spike helped curb demand for stainless steel products and reinforce the impression of a broad slump in China's demand for metal-based consumer and construction goods.

Australian and Brazilian miners responded differently to China's policy shift. They cut offer prices for their ores in an effort to find demand but still saw their shipments to China plunge. Suppressed commodity trade flows to China have substantially weakened GDP growth in Australia and Brazil—the world's seventh- and twelfth-largest national economies.

A second major suppressant in the Great Suppression is the Federal Reserve's zero interest rate policy (ZIRP) and the engineering of negative interest rates by the BoJ and ECB. The FOMC kept interest rates too low for too long. ZIRP overstimulated debt-driven investment in energy supply. Excessive ZIRP financed marginal projects in US light tight oil (LTO) production capacity that are uncompetitive at lower prices and now need to be unwound. US crude oil production (including lease condensates) increased to 9.6 million b/d as of June 2015 from 4.9 million b/d in January 2009. That is an 11% CAGR over six years in a domestic industry that had experienced a 17% cumulative decline in output across the previous seven years. After backing out comparable light sweet crude imports and optimizing refinery input slates, this burgeoning LTO supply became increasingly stranded within the United States due to federal trade restrictions on the free export of crude oils.

This is the third major suppressant: an antiquated ban on crude exports from the United States—the world's largest and fastest-growing liquids producer—that was finally removed in December 2015. Policymakers belatedly began to address this bottleneck in June 2014, when Washington creaked open a narrow bypass by allowing free export of processed condensates. Though these volumes were small, they helped redraw the global cost curve because LTO full-cycle marginal costs in the US Midcontinent are meaningfully lower than marginal costs in the rest of the world (though \$25 per bbl above current WTI cash prices). Simultaneously, there was a large increase in legally-compliant outflows of crude oil to Canada and of natural gas liquids (NGLs) and other "unfinished oils" to a rising number of international buyers (n=16 in June 2015 versus n=6 in August 2013). This trade competition surprised complacent supply chains and forced significant downward pressure on both bids and asks in many crude and product markets. Following Congress' outright removal of the US crude export ban in December 2015 and the sharp uptick in US crude exports that has followed, these deflationary pressures have intensified.



Slower oil demand growth and rising supply availability incents the fourth major suppressant: OPEC production policy. In November 2014, OPEC's members, led by Saudi Arabia, chose to abandon price stability as a policy objective in favor of promoting their market shares. This expansion of output is a repeat of a competitive tactic deployed with great success in 1986-91. OPEC's oil ministers voted to maintain the policy at their next two meetings in June and December 2015. Media reports have repeatedly interpreted OPEC's actions as directed toward suppressing competition from the LTO producers in the US Midcontinent. This assumption is only modestly correct and overlooks a far more important reason. There is intense competition within OPEC—specifically among Saudi Arabia, Iraq, and Iran—for primacy in supplying the Chinese import market. There are also religious and geopolitical considerations at work.

Riyadh's actions also stem from a fifth and final major suppressant: the world's repressed response to the Syrian crisis. Washington drew a "red line" in Syria and then failed to enforce it in August 2013. That month, the UK Parliament also voted against air strikes in Syria. Suppression of military force by these two great powers led to a diplomatic agreement brokered by Russia, which then annexed Crimea within six months. Russia subsequently inserted troops into Syria and began its own airstrikes in September 2015.

These steps backward and forward did not go unnoticed by the regional (and would-be) powers in the Middle East. One purpose of OPEC's Saudi-led production policy is to curb production from Russia—a rival for the Chinese market and an indirect military adversary on the battlefields of Syria and Yemen—and of Mexico, which has reversed course on its own half century of suppressant measures in investment. But the use of oil as a policy tool to increase treasure and project power (and suppress a rival's earnings and influence) comes at the price of diminished spare capacity, notwithstanding the present overhang in inventory. The world's spare oil production capacity is now only 1.20 million b/d rather than the 2.12 million b/d expected a year ago. Projections for spare capacity rise only to 1.35 million b/d by the end of 2017. This production buffer is very small.

These five major suppressants—climate policy, FOMC monetary policy, US crude export policy, OPEC production policy, and international policy toward the Syrian crisis—are the largest drivers of the Great Suppression. Each derives from intentional decisions. Management of these factors will determine whether the Great Suppression becomes a global recession or merely threatens one in a long expansion.

Given the enormous public and private debt burden in the US, we are acutely concerned about the risk of a double-dip recession. We see a potential parallel for 2014-18 from the example of 1980-82. We ask whether 2014-2016 is comparable to the shallow recession of 1980, whether 2Q2016 to 1Q2017 will prove comparable to the "Oasis" year of 1981, and whether late 2016 through mid-2018 will bring a debt crisis reminiscent of 1982. One main difference between these cycles is 2014-18 is resulting from highly accommodative monetary policy and working first through EM, commodities, and investment channels before it fully hits developed markets possibly in a US debt crisis. In contrast, the 1980-82 double-dip recession resulted from highly restrictive monetary policy that targeted US consumption and consumer price inflation, before slamming into EM in the debt crises of 1982. We peg the odds of a formal US recession starting before January 2017 at two-in-three.



Endnote

1 This research paper is available upon written request to colin.fenton@blacklightresearch.com.

Author Biography

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In addition to Mr. Fenton's responsibilities at Blacklight Research LLC, he is also a non-resident Fellow at Columbia University's Center on Global Energy Policy. From 2010 through 2015, Fenton supervised commodities research at J.P. Morgan Chase & Co., where he was also the firm's chief commodities strategist. Earlier in his career, Fenton was a managing partner at Curium Capital Advisors, a managing director at Duquesne Capital Management, the Chief Intelligence Officer of Ospraie Management, and a member of the Commodities Research Group at Goldman, Sachs & Co. Fenton holds a Master's of Science in Foreign Service from Georgetown University's Edmund A. Walsh School of Foreign Service. He also is a graduate of Princeton University, where he studied history.

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