Northern Trust

WEEKLY ECONOMIC COMMENTARY

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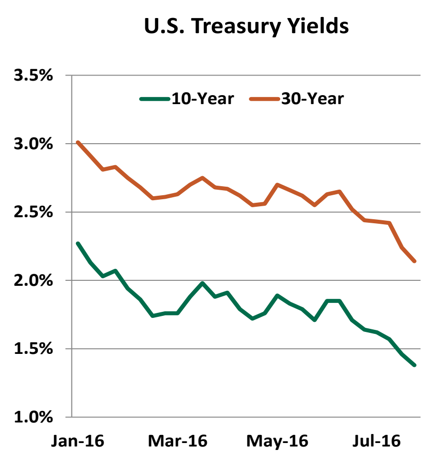
- **Brexit Has Created a Run on U.S. Treasuries**
- **No Matter Which Way Oil Goes, the U.S. Seems to Lose**

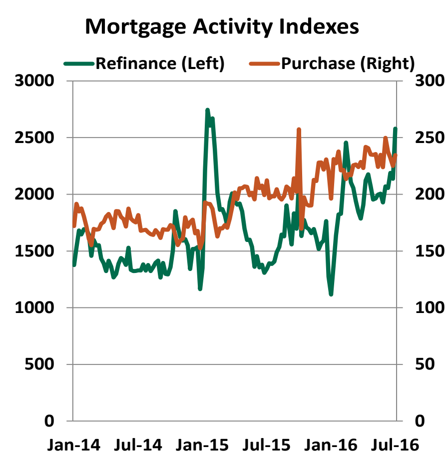
I'd never been to Japan until this past week. I took a course in Japanese history in college and was fascinated by how a formerly feudal country transformed itself into one of the world's great industrial powers. The customs, the art and the food always intrigued me, and so it was a special treat to see it at close range this week.

The reason for my visit was to attend a gathering of economists from around the world. When the site was selected, I thought it would be a great opportunity to immerse myself in the demographic and commercial dynamic of the Far East. There was certainly plenty of that, which I'll cover in coming weeks. But even though events in Europe are geographically and economically remote from Japan, they dominated the group's discussions.

You are probably somewhat weary of hearing about the after-effects of "Brexit," but it remains foremost in the minds of markets. This week, we'll focus on how prospects for European dis-integration might affect the U.S. economy. At the moment, it seems that the cross-Atlantic influences will be limited, but a couple of situations bear watching.

Credit is due to Northern Trust's fixed-income team, which anticipated that U.S. interest rates would fall sharply in the weeks after the United Kingdom voted to separate from the European Union (EU). I wonder if even the team knew how correct it would be: yields on the 10- and 30-year U.S. Treasury bonds reached record lows this week.





Sources: FRED, Mortgage Bankers Association, Bloomberg

The U.K. situation remains highly uncertain. Investors continue seeking the safety of government securities, but an increasing number of sovereign bonds around the world carry negative interest rates. The United States is a rare exception; therefore, our securities have become a target for global portfolios. Yields have fallen below current and expected inflation, so the real interest rates on bonds are now less than zero.

Very low interest rates favor borrowers at the expense of savers. U.S. mortgage rates are at their lowest level in more than 50 years; a 30-year mortgage is available at a rate of just 3.5%. Yet indexes of home lending have increased only modestly.

Tighter underwriting standards, which require stronger evidence of ability to repay, mute the benefit of low borrowing costs to the housing sector. Given the excesses of the pre-crisis interval, these steps make sense. But they do dampen credit extension.

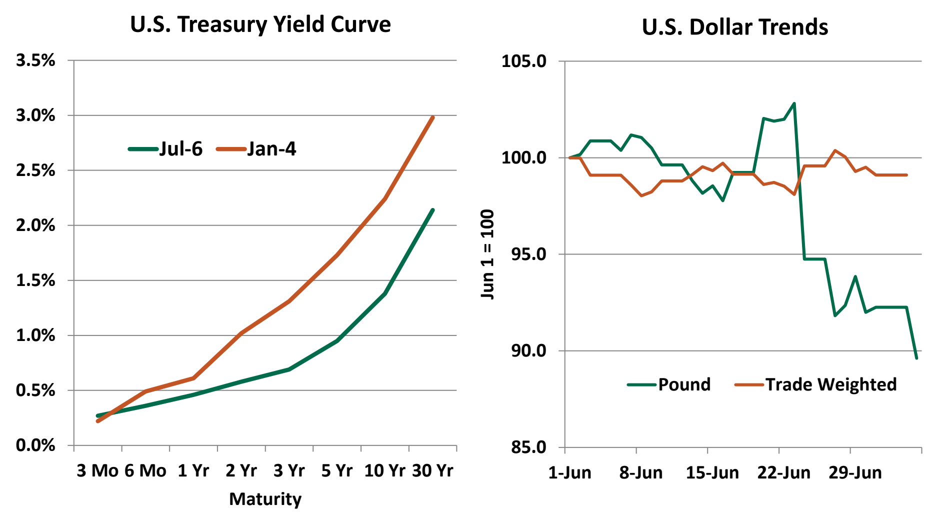
Roughly 3 million American households are "underwater" on their loans, and millions of others have very little equity in their homes. That makes it difficult for them to refinance or move. Conditions for prospective new home buyers are improving, but slow wage growth and the overhang of student debt serve to defer purchases.

In an age of de-leveraging, low rates are less helpful.

In the corporate sector, many companies have more cash than they need and their plans for investment are very modest. Some have taken advantage of falling long-term rates to refinance existing debt, but the accumulated savings will have little impact on economic growth. Low rates also offer opportunities for governments to borrow cheaply to finance public investment, but the current atmosphere of austerity makes that unlikely.

So the benefits of record low long-term rates are expected to be quite minor. The costs are difficult to tally, but they could potentially be more significant. Savers are receiving a pittance on their investments, requiring them to set aside more principal to achieve the same financial goal. A rising saving rate means less consumption, which could hinder economic growth.

Low long-term interest rates are extremely challenging for pension systems, which rely on fixed-income investments to match off against the benefits they promised to beneficiaries. Low yields tend to increase the funding deficits in these plans, which require the sponsor to provide replenishment. In the private sector, this increment is a charge against profits. In the public sector, this is a charge against taxpayers.



Sources: U.S. Treasury, FRED

The distance between long- and short-term interest rates in the United States has narrowed significantly. This will hinder the profitability of banks, which typically take advantage of the term spread to enhance their earnings. In addition, flat yield curves are typically thought to reflect a tepid economic outlook. (If growth were stronger, the logic goes, markets would be pricing in restraint from the central bank.) This sort of signaling might become a self-fulfilling prophecy.

The declining value of the British pound, which has hit its lowest level against the U.S. dollar in more than 30 years, is the other significant post-Brexit market adjustment. When the dollar strengthens, it tends to increase our trade deficit, which drags on economic growth. But exports to the United Kingdom represent less than 4% of total U.S. exports. And the trade-weighted value of the U.S. dollar has not changed much in the past two weeks. So this impact is likely to be minor.

U.S. terms of trade have not changed that much.

We will be updating our U.S. forecast next week. We'll certainly need to update our outlook for interest rates, but it seems unlikely that we will make major alterations to our expectations for growth. Unless market conditions deteriorate significantly from here, we expect the worst of the fallout will be confined to the Old World.

There are few countries older than Japan. While Japanese society has become very modern, ancient Shinto principals are still very important. Followers seek to promote harmony in all areas of life. Europe could use a little of that spirit at the moment.

Oil Is Still Not Well

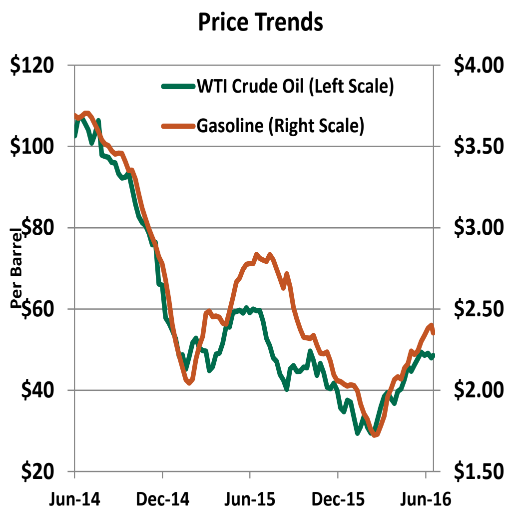
My father thought that allowing his children to prevail at games was poor preparation for the tough competition we'd face as adults. He'd block our shots on the basketball court, leveraging a significant height advantage. At chess, he'd capture our kings within a handful of moves. And his advanced vocabulary turned scrabble matches into real beat-downs. It was a no-win situation for us.

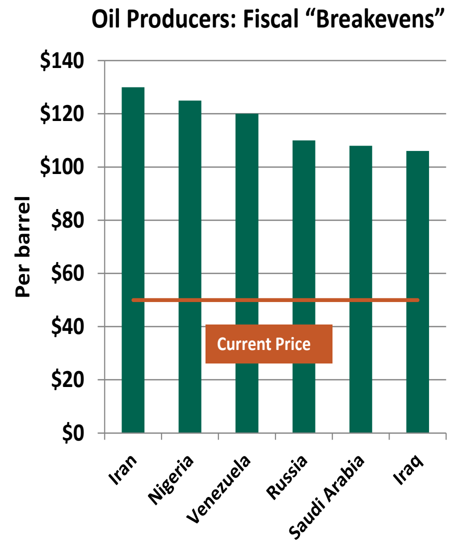
He could be playful about things, though. He always had the same routine when we began: He'd take out a coin to flip to see who would go first. "Heads, I win…tails, you lose," he'd say. My brother and I were almost teenagers when we finally understood that why dad always led off.

It's frustrating when outcomes always go against you in situations where you expect to come out on top half the time. That may be the case currently with the outcome of the energy markets. Oil price declines were supposed to boost the U.S. economy but ended up as more of a hindrance. And now that crude oil is somewhat more expensive, we may feel additional pain with little additional gain.

Since hitting a low in mid-February, crude oil prices have risen 70%. While they are nowhere near the levels of two years ago, this still represents a significant increase. Supply disruptions, which now account for 3.5 million barrels per day, sparked part of the recent price rise. (Global oil production is about 97 million barrels daily.) Canada, where the Alberta wildfires have raged since the beginning of May, is the leading contributor to the outages. Attacks on pipelines in

Nigeria and internal dissention in Libya have limited the output from those countries. These constraints are expected to ease during the balance of the year.





Sources: Bloomberg, IMF

Periodic speculation that energy producers will agree on supply restrictions also contributed to the price rise. Low oil prices caused significant fiscal distress for nations heavily reliant on oil revenues. Venezuela plunged into chaos, experiencing electricity interruptions and food outages. The Russian economy has contracted for more than a year, and the ruble's value has fallen by more than half against the dollar since mid-2014.

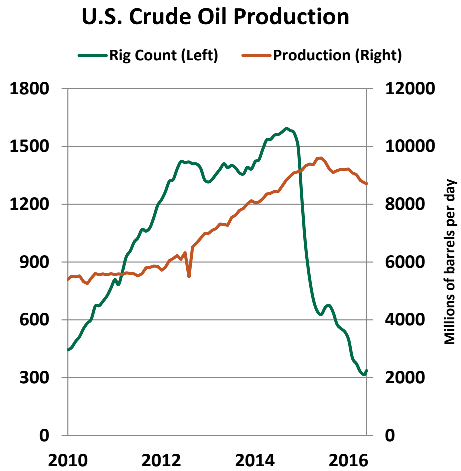
Saudi Arabia, the world's largest producer, was not affected as seriously, but the nation's sovereign reserves have declined by almost 20% since oil prices peaked two years ago. The country is now thinking carefully about diversifying its economy to reduce its reliance on petroleum.

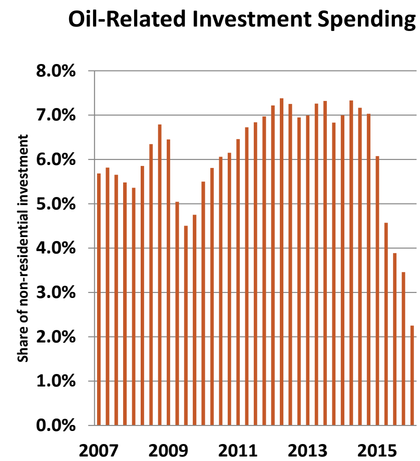
Oil suppliers are pressed but cannot agree on production quotas.

Despite the accumulating stress, a return to production quotas seems a long way off. Iran, recently freed from sanctions, is anxious to ramp up output to its full capacity. Saudi Arabia, its bitter regional rival, wants to limit the profitability of that output. And so the spigots remain open in the Middle East.

A more lasting reason for the oil price rise is the incipient decline in American energy production. U.S. crude output held up remarkably well last year, even as the number of rigs actively producing petroleum fell by more than two-thirds. There has been a significant shake-out in the industry as producers focused on those areas which are most efficient.

American output is down only about 10% over the past year, but analysts expect the decline to continue for some time. Oil reserves remain at near-record levels, reducing the need to produce fresh supplies. Sensing this, producers cut back significantly on their investment plans amid profit pressures.





Sources: Bloomberg, Haver Analytics

The dramatic decline in oilfield investing has been a significant drag on American economic growth in the past five quarters. As we discussed earlier this year, low fuel costs provided a modest assist to U.S. household consumption. But the benefits failed to live up to expectations, leaving the impression that falling oil prices were detrimental to growth in gross domestic product (GDP). Heads, they win.

Well, if that were the case, then the recent rise in oil prices should be beneficial. Not so fast. So far, the supply response to higher prices has been muted. The decline in the rig count has ended, but few facilities have come back online. Several things may hinder producers:

Restarting production is not as simple as opening a spigot.

- Significant uncertainty remains about the direction of oil prices, and operators may want to wait until they are more confident that another downward movement will not occur.
- In some cases, it will require capital to return wells to production. According to industry sources, that capital is difficult to come by. Having charged off important amounts of energy credit, banks are very wary about increasing exposure to the sector. High-yield debt markets, which provided significant amounts of capital to drillers, also turned cautious.
- Employment in mining and logging (which encompasses oil production) fell by more than 200,000 jobs in the past 18 months. Many roughnecks scattered to find other work and may be difficult to recall.

For the moment, then, higher energy prices do not seem to be aiding the domestic U.S. oil industry. And while second-quarter readings on American consumer spending have improved, it would be a stretch to say that higher gasoline prices will help sales of other products. Tails, we lose.

All of this could change if petroleum breaks out of its recent range. But for now, energy consumers and producers seem to be in a no-win situation.