Tea Leaf

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Your guide to understanding today's economy and financial markets

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Three Peas in a Pod

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Economic pain in the U.S. is shared by major economic players around the globe. Much of the developed world is also in recession, while many developing nations are reeling from soft commodity prices, declining exports, rising unemployment, and extremely volatile stock markets.

Two principal players—Europe and Japan—are in worse shape than is the U.S. As noted frequently, the U.S., Europe, and Japan are in recession simultaneously for the first time in the post-WWII period.

Europe

I have no doubt that European politicians and business leaders were laughing at America 6-12 months ago for the enormous housing and financial mess we got ourselves into. They stopped laughing last fall when the reality set in that European challenges exceeded those in the U.S.

The 16 nations sharing the euro currency saw the economy contract 1.5% (after inflation, or real) during 2008's final quarter, when compared to the prior quarter. The U.S. decline in the same quarter was reported at a 3.8% real annual rate.

However, apples and oranges are being compared. The 1.5% decline in Europe results in a 6.0% real *annual* rate of decline, exceeding that of the U.S.

Besides severe weakness within the financial system, a major problem is exports. Export-dependent Germany, which comprises nearly half of European economic output, actually fell at a faster rate, with shrinkage of 2.1% during the October to December period.

Japan

As recently as three months ago, the International Monetary Fund (IMF) forecast that Japan's economy would outpace that of the U.S. and Europe in 2009. After all—so the story went—Japan had largely avoided the U.S. housing and credit bust that precipitated the global recession…whoops.

More recent IMF projections now suggest that Japan's economy is now the weakest in the developed world, with a deeper recession underway than in the U.S. or Europe. The IMF now suggests that Japan's economy will shrink 2.6% this year, versus contractions of 1.6% and 2.0%, respectively, in the U.S. and Europe *(bloomberg.com)*.

The problems are primarily two… weak exports and a strong currency

Japan's dependence on exports to the U.S. and around the world is a major problem in a world where economic growth and exports are in decline. A good example is Toyota, viewed by many as the world's premiere automaker. Toyota management in recent weeks forecast its first loss in 70 years during 2009…and slashed production in Japan by half in the current quarter.

A stronger yen has also hurt export opportunities for the Japanese. A roughly 20% rise in the yen's value versus other major currencies during the past year simply makes Japanese-produced cars, electronic equipment, and most everything else more expensive around the globe.

Oil Down…Gas Up

No shortage of discussion during the past six weeks has focused on the fact that even as reported oil prices have continued to decline, gasoline prices have continued to rise.

According to AAA, U.S. gasoline prices averaged $1.96 per gallon for the regular unleaded product on February 17, 2009. Some "experts" suggest a move toward $2.25, or higher, is likely in coming months. Wholesale gasoline prices have jumped more than 20% this year, while oil prices have fallen roughly 25%, closing near $35.00 per barrel yesterday.

Is there a logical explanation for this?

Two Reasons

The first reason is that U.S. oil refiners have cut back on gasoline production since December. As of February 6, the

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latest data available, U.S. refinery capacity was used at an 81.5% rate, the lowest level in 17 years. By comparison, refineries were running at 87.4% of capacity in early December *(USA TODAY)*…

…the underlying premise of economics—supply and demand—does work sometimes. Less supply of any commodity typically means a higher price.

Why have refineries been cutting production? Most industry experts suggest that, given the sharp plunge in oil prices during 2008's second half, refiners lost money on every gallon sold during the October to December period.

Note, however, that refineries are now profitable again. Should gasoline prices move slightly higher in coming weeks as many suggest, even as oil prices possibly stabilize, more gasoline production will likely push prices modestly lower again.

WTI vs. Brent

The second reason is the "disconnect" between the primarily reported oil prices. Most references to oil prices in the U.S. media are for the West Texas Intermediate (WTI) contract, a highly sought after light sweet crude oil that trades on the New York Mercantile Exchange. This oil, highly preferred versus many other oils in the world that require more costly refining, typically trades at the top of global oil prices.

However, a major glut has developed in the Southwest, with U.S. crude storage at an 82-week high. For the record, an excess supply of any commodity, especially when in one primary location, depresses the price.

By comparison, the current contract for Brent crude oil, the primary European and U.K. measure of oil prices, closed yesterday at $41.03 on the ICE Futures Exchange *(cnbc.com)*. This measure of oil is typically $5-$10 *below* the WTI contract price.

The point here is that much of the oil we use in this country—most of it imported from around the globe—is higher in price than the simple U.S. measure reported by the media would suggest…

…it's pure economics…boring stuff at best

Jeff

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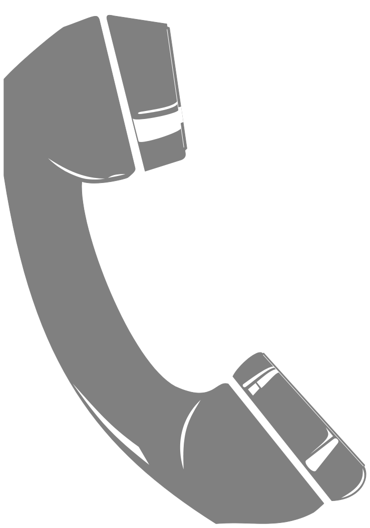

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Husqvarna Professional Products, Inc.
(the world's largest producer of lawn mowers, chain saws and portable gas-powered garden equipment)

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How is it that one careless match can start a forest fire, but it takes a whole box to start a campfire?

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