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INVESTMENT MANAGEMENT

BRIEF MARKET INSIGHTS

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Do Energy Prices Portend Global Growth Headwinds?

The sharp fall in oil prices over the past month leads to several questions about the implications for the global economy. We've written on the subject of slumping gasoline prices as it relates to overall inflation in the recent *Market Perspective* and how central banks might respond. We also concluded that we would maintain our current Energy weight, based on the fact that the major oil producers are now better positioned to weather a fall in prices than they were a few years ago. We recently suggested that OPEC would modestly curtail production, putting a floor on oil prices in the near term. We are still fairly cautious on forecasting a significant upside surprise in oil prices in the first half of 2019.

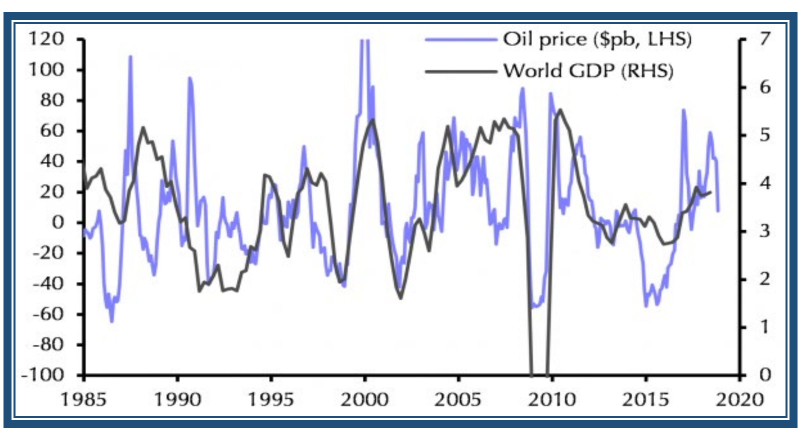
From the perspective of the world economy, a fall in prices should be positive for global growth. This is because it transfers income from oil-producing economies (which have high marginal savings rates) to oil-consuming economies (which have low marginal savings rates). So, on the face of it, the decline in oil over the past few weeks should be a welcome development. However, this conclusion may be clouded by two important considerations.

The first relates to timing. When oil prices fall, the losses are concentrated in a small number of oil-producing economies but the benefits are dispersed over a large number of oil-consuming economies. The drag on activity in the former may be felt relatively quickly, as energy firms curtail investment projects resulting in governments and consumers forced to tighten their belts. In contrast, the boost to activity in the latter can take longer to materialize since consumers may need to be persuaded that lower prices aren't just another aberration before adjusting their behavior.

The second consideration is declining demand. While lower oil prices should ultimately be beneficial for world growth, this may be overwhelmed by another concern. More specifically, a drop in oil prices can often be driven by more fundamental concerns about the health of the global economy. However, a shift in income from savers to spenders, a fall in prices should act as an automatic stabilizer that helps to cushion any slowdown in world growth. But past experience suggests that this may not prevent growth from weakening in the short-term. Exhibit I below suggests that drops in oil prices more typically coincide with slowdowns in the global economy.

EXHIBIT I

World GDP Growth & Change in Brent Oil Price (% y/y)

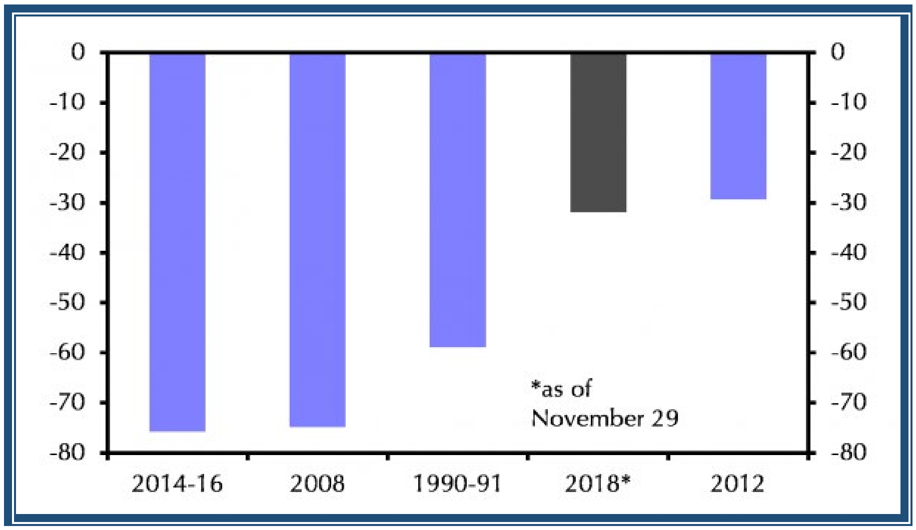


Source: Bloomberg, Morgan Stanley and Capital Economics

It's worth noting that the recent drop in prices is relatively small compared to past drops in market prices (See exhibit II). It's also the case that the oil markets can be very fickle as well – and as recently as three months ago, the debate was centered on whether a combination of a strong U.S. economy and sanctions on Iran would push prices back above $100. Even so, it is still the case that the decline in oil prices adds to a growing list of concerns that point to a slowdown in the global economy over the near term.

EXHIBIT II

Change in Brent Oil in Previous Price Slumps (%-pts)



Source: Bloomberg, Morgan Stanley and Capital Economics

In conclusion, we maintain that falling oil prices have not altered our concurrent view that although real GDP growth most likely will slow, it should not drop below its 2.5% potential rate in the mid-2019 period. We also believe that the slowdown will most probably result in delaying the Fed's tightening cycle, and maintain our overall U.S. GDP forecast of 3.0% for 2019.

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