CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

April 1, 2012

Energy and Manufacturing…
...Revitalization in America

Long-term trends in US energy production give reason to expect that America is moving toward 'energy independence', in which the country would produce more energy than it consumes. The low cost of US natural gas may attract manufacturing from Europe and Asia, to the further benefit of the US trade balance. The US is also likely to increase its exports of foods.

These factors may presage a stronger and richer period for the United States in the coming years. Will these dispel the gloom that has enshrouded the country during the last decade of wars, recessions and political bickering?

May it be so.

By

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After a long and disheartening period of a declining manufacturing base and ever-greater dependence upon oil imported from unfriendly countries, the tide seems to be turning for both. Manufacturing in the United States will probably grow in coming years and America appears to be moving toward energy independence. Energy first.

Energy. A range of factors is at play, including new drilling techniques that dramatically increase the productivity of old oil fields, development of enormous natural gas fields through hydraulic fracturing, and declining gasoline consumption arising from fewer miles driven and greater fuel economy in the nation's automobile fleet. The recent recession played a role in declining consumption of gasoline and other fuels, but increased domestic production and fuel economy are long-term, not economic-cycle phenomena. At its peak in 2005, the United States imported 60 percent of its liquid fuels; in 2011, imports had fallen to 45 percent. Increased production of oil and of natural gas both arise mostly from techniques involving hydraulic fracturing ('fracking') and horizontal drilling; expansion of drilling on federal lands since 2005 legislation is another factor.

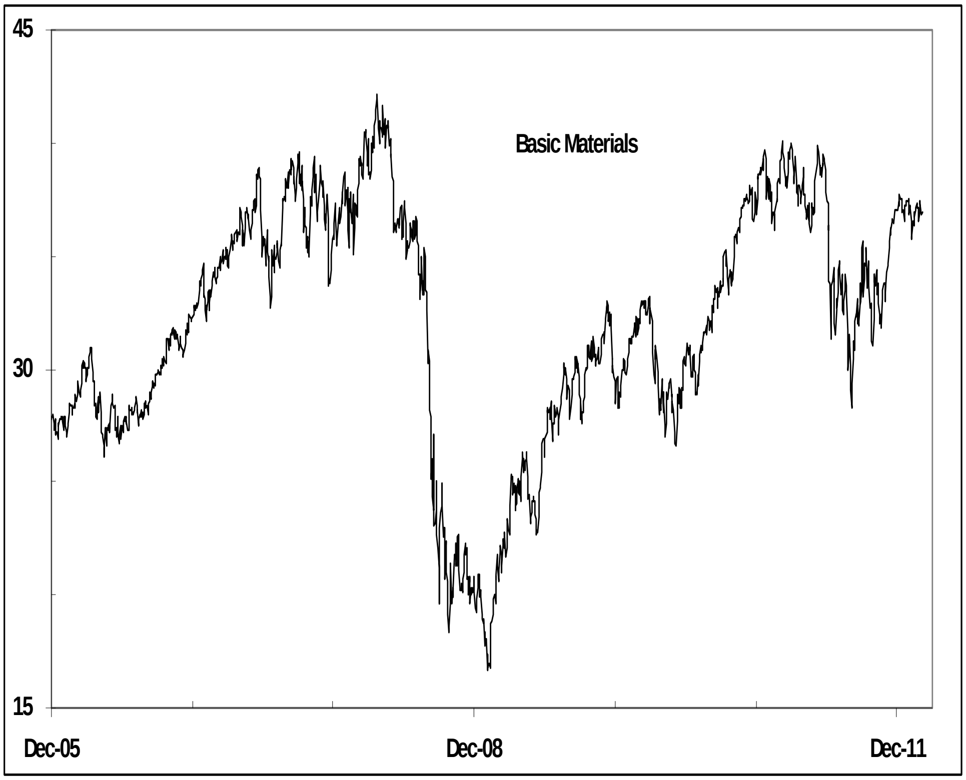
Environmental problems associated with increased production generally and with fracking in particular are serious and contentious; they will not go away. For now, however, the oil and gas industry largely prevails and production is growing. Increased domestic production and decreasing imports of oil have a very beneficial effect on the trade balance in America. Cutting oil imports increases America's security by decreasing the flow of American treasure to the unfriendly oil-exporting countries of the Middle East.

Energy prices and manufacturing. The price of crude oil and, hence, of gasoline is set in global markets, but US-produced natural gas is a commodity the price for which is essentially a local, US price. The US price, having fallen sharply in recent years, is about $5 per million BTUs. By contrast, the cost of natural gas in Europe today is more than $12 per million BTUs. This remarkable price advantage for energy in the US is likely to have real effects on the locus of manufacturing activity. To the extent that energy is a significant cost in a manufacturing process, the United States is the attractive place to conduct that manufacturing. Given its other advantages, including the size of the American market and a generally well-educated work force, the US will probably see more of a shift of manufacturing activity to this country from Europe and Asia, reversing trends that have prevailed over recent decades.

It is entirely possible that, as Chinese labor costs continue to grow and US energy costs decrease, certain types of manufacturing will shift even from China to America. Another favorable trend for the United States generally is the growing wealth of people in the Asian developing economies, a process that increases the demand for meat and grains. America's vast and productive farm lands supply grain and other agricultural products to Asia and elsewhere, another factor that benefits the US trade balance and adds to this country's wealth.

The chart below shows a sub-group of the S&P 500 that includes some of the types of companies that stand to do well in the era of cheap American natural gas and growing agricultural exports. These include chemical and fertilizer companies.

Investment implications. These are long-term trends with important implications for investors. The years-long weakness in the value of the US dollar may be coming to an end. Stocks of energy-intensive manufacturers, e.g., chemicals, aluminum and other basic materials, may flourish. Domestic energy producers may also do well. And, as manufacturing and agricultural activity grows, the country's employment and general level of wealth grows, with positive investment effects across many companies and markets.



In short, and despite serious environmental problems associated with increased production of oil and gas, these big trends are favorable and they bode well for America, her economy and her financial markets for some years to come. Surely the partisan political squabbles in the country present problems; the long process of deleveraging after the credit boom and the financial crisis will continue to restrain economic activity here; Europe's unresolved sovereign debt crisis continues to pose risk to the banking system and financial markets. Against these real problems, however, is the favorable path toward American energy independence and the likely increase in US manufacturing. With patience and an eye to the risks, investment gains lie before us.

The Eurozone crisis. A few comments: Greece did default on its government bonds, the first default by a developed country in many decades. However, the event was so long negotiated and so fully understood, that it went off without a whimper in the markets. The calming effects of the ECB's massive (€1 trillion) bank loan program (the LTRO) continue to obscure the reality that more European trouble lies ahead. Portugal has unsustainably high government bond yields and looks certain to require another bailout. Spain is a very large economy in very great distress and is now feuding with European Union ministers about the required fiscal austerity measures that are sending it into deep recession. Greece itself is likely to require another round of financing or another default to survive in the Eurozone. In short, the ECB's LTRO and Greece's 'successful' default have solved nothing, but have only created calm conditions as Europe marches inexorably toward the next phase of the crisis.

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