

War, Oil, and Recession

In the aftermath of the first Internet stock-market bubble of the late 1990s the economy went into a relatively shallow recession starting in 2001. That recession was precipitated by a tight monetary policy, with the Federal Reserve setting short-term interest rates consistently above the pace of nominal GDP growth (real GDP growth plus inflation). In that sense – as a result of tight money – the 2001 recession was similar to the recessions of 1970, 1973-74, 1980, 1981-82, and 1990-91.

Since that 2001 recession, it's been almost twenty-five years with the US economy only in two more recessions lasting a grand total of twenty months. By historical standards, it's unusual to have spent so little time in recession. Even odder, is that the key factor behind the two recessions we've had since 2001 have not been overly tight money.

The first recession was the so-called Great Recession of 2008-09, when overly stringent mark-to-market accounting standards turned the spark of the bursting of the housing bubble into an inferno in the banking system. Yes, the Fed had been too loose for years before then, but it wasn't particularly tight going into the crisis.

Then came the mini-COVID depression of 2020, when governments and fear of illness led to massive temporary (and often irrational) shutdowns of economic activity.

Once again, the Fed and monetary policy wasn't the culprit. As a result, it's sensible to fear that the next recession might also be for reasons other than monetary policy and the Iran War could fit the bill.

How this conflict ends and how quickly is hard to gauge. Although the US would like to see a popular revolt that transitions to a completely new and stable government, without rule by the mullahs, some sort of military coup is also possible, where more secular-oriented leaders in the Iranian armed forces step forward if they are willing to accommodate some US demands, perhaps in exchange for getting control of local oil revenue.

For now, oil prices that were around \$65 per barrel before the war were approaching \$100 by Friday. And now some fear a temporary closure of the Strait of Hormuz could spike oil prices even higher. About 20 million barrels of crude per day typically pass through that area, which is about 20% of global consumption. In turn, some analysts are considering scenarios with oil getting to \$200 per barrel.

A price spike that high would almost certainly hurt the purchasing power of countries that are dependent on foreign sources of energy and would generate uncertainty and volatility elsewhere. But as a net petroleum exporter, the US economy is more resilient to – and insulated against – oil price spikes than it's been in many decades.

The US consumes about 20 million barrels per day (roughly equal to the amount sent through the Strait, although the US itself only gets a small portion of that particular oil flow). So, if US consumption didn't change, US purchasers would have to pay an extra \$2.7 billion per day for oil compared to before the war started. (20 million times \$135). That's not chump change. Worse, it could lead to a bear market in stocks with a loss of wealth that adds to the cost.

But it's important to recognize that other things would change, as well, including creating a huge income boost for energy producers, incentivizing more domestic production.

In the meantime, it's important for policymakers to recognize that a negative oil supply shock would not create the kind of inflation the Fed is designed to fight. It'd lead to a big shift in *relative* prices while not altering the money supply, which is the ultimate source of inflation or the lack thereof.

We think the Fed would probably react by temporarily standing still on monetary policy as what would make an oil price spike inflationary is if the Fed reacts by easing policy to try to ease the blow to some consumers. Then higher general price inflation would be likely.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-16 / 7:30 am	Empire State Mfg Survey – Mar	3.9	4.2	-0.2	7.1
8:15 am	Industrial Production – Feb	+0.1%	+0.0%	+0.2%	+0.8%
8:15 am	Capacity Utilization – Feb	76.2%	76.1%	76.3%	76.3%
3-18 / 7:30 am	PPI – Feb	+0.3%	+0.3%		+0.5%
7:30 am	“Core” PPI – Feb	+0.3%	+0.3%		+0.8%
9:00 am	Factory Orders – Jan	+0.1%	+0.2%		-0.7%
3-19 / 7:30 am	Initial Claims – Mar 14	215K	213K		213K
7:30 am	Philly Fed Survey – Mar	10.0	5.0		16.3
9:00 am	New Home Sales – Jan	0.720 Mil	0.724 Mil		0.745 Mil