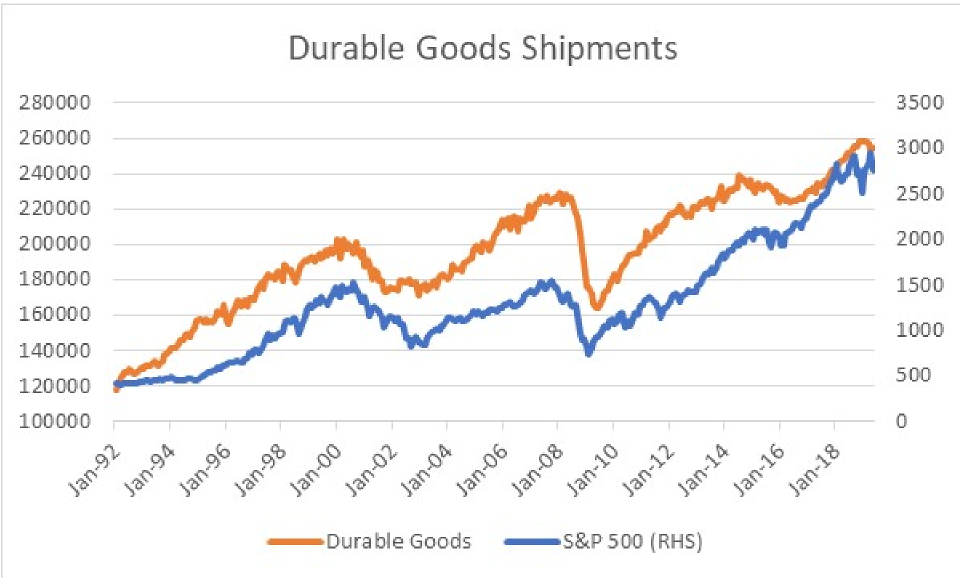
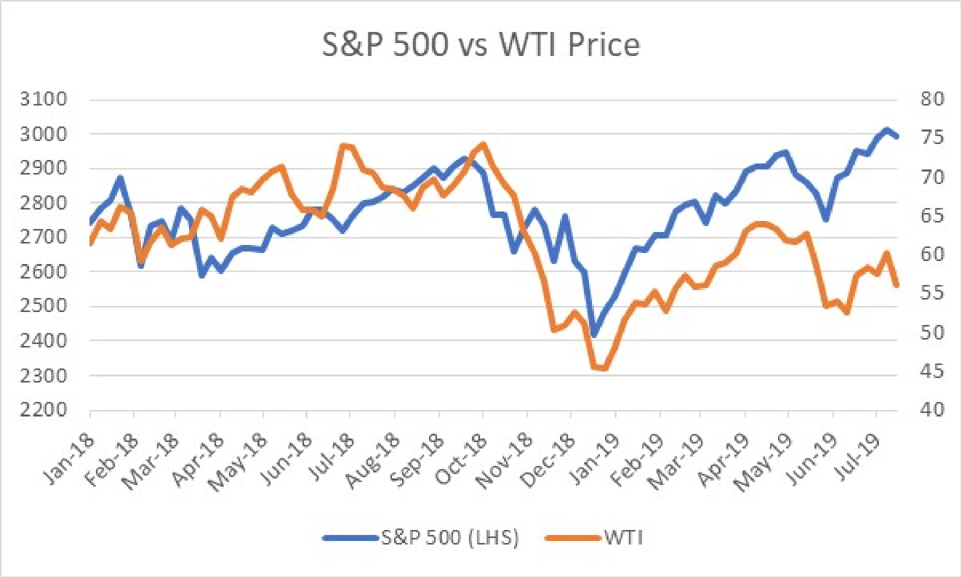
PEAK DRILLING IN THE PERMIAN

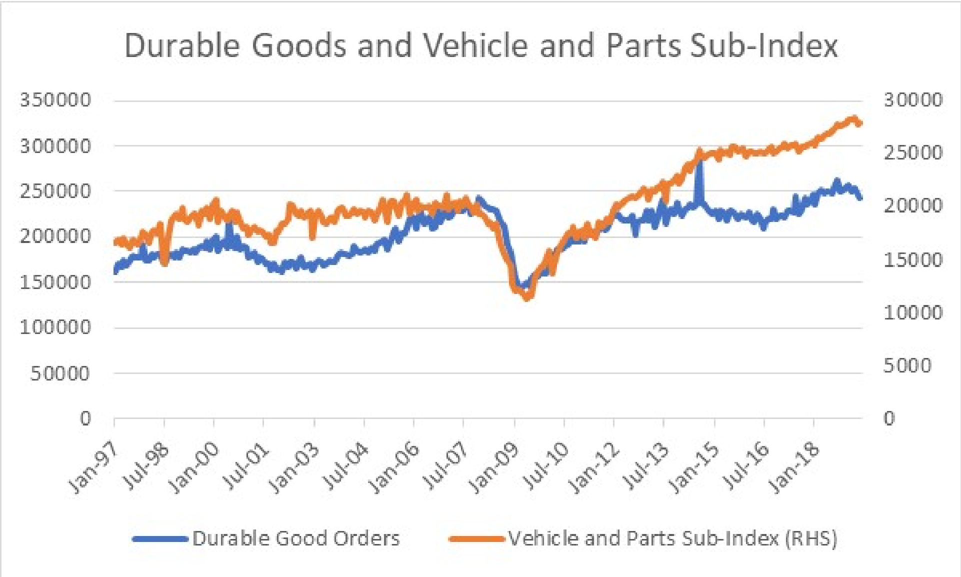
US durable goods orders have been a reliable indicator for the S&P 500 Index over the last 20 years or so. In the late 90s, it was the dotcom boom that drove durable goods, in the mid-2000s, it was the housing boom, and in my view, the recent growth in durable goods has been caused by the industrial demand associated with the shale boom in the US. The oil price crash in 2015 did cause durable goods to weaken temporarily, but growth in the shale region soon returned, and durable goods, and the S&P 500 Index, have moved higher with it.



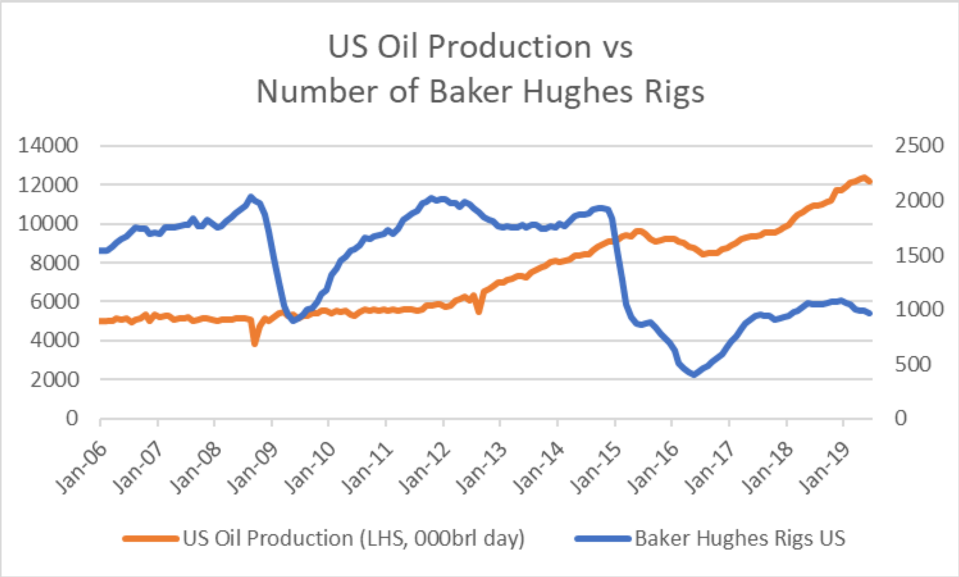
Some evidence for this comes from the markets, where, over the last year or so, the correlation between oil and the S&P 500 has been very high. The precipitous decline in the oil price in Q4 2018 and in May 2019 was matched with falls in the S&P 500.



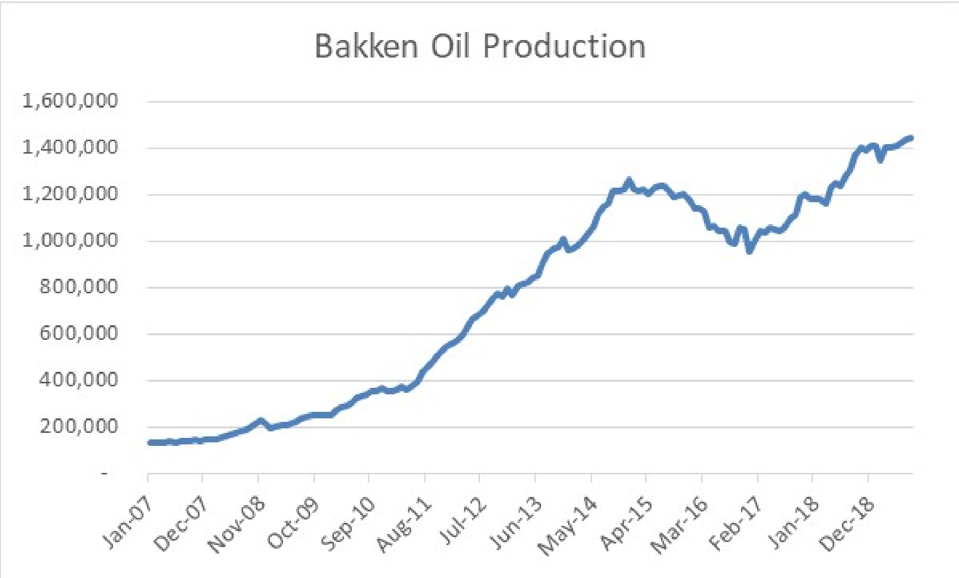
The biggest component of durable goods is the transportation sector, with the vehicles and parts the biggest component of transportation. Shale drilling makes substantial use of trucks and other vehicles. While it slowed in 2016 with the weakness in oil, it moved higher in 2017 and 2018.



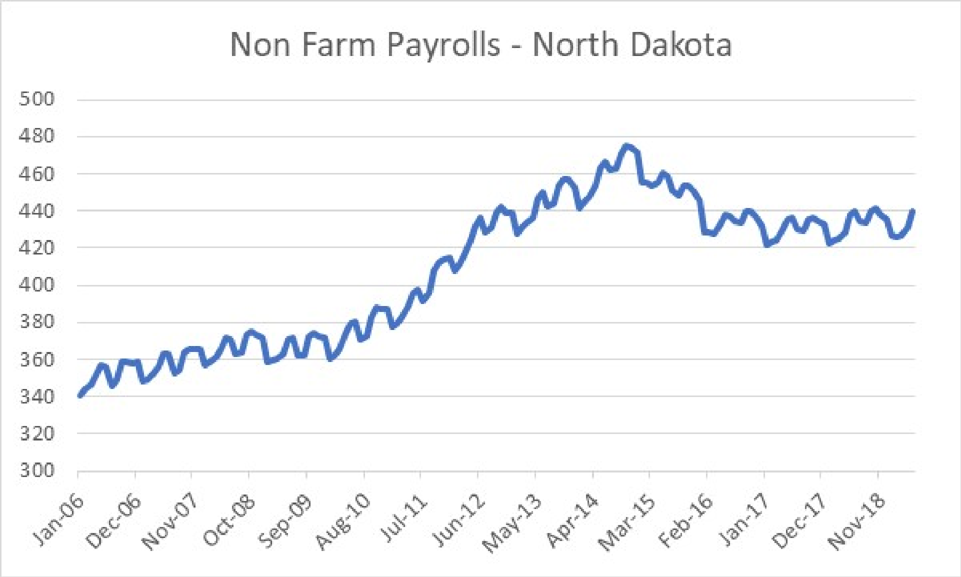
If the US shale oil industry is a key driver of US activity, then investors are sensible to keep an eye on the price of oil. Recent data shows some potential peak in oil production and in number of rigs being used in the US.



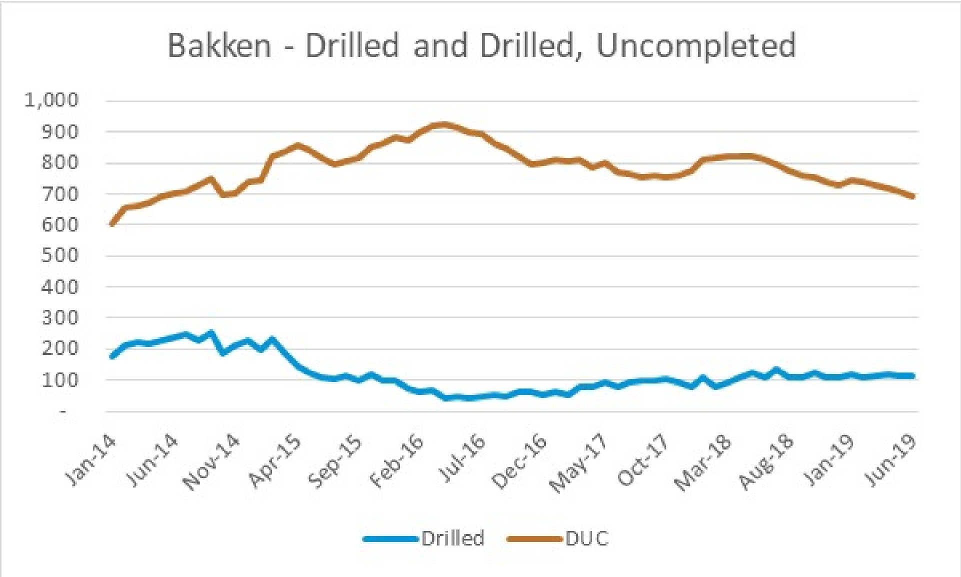
However, there is a big problem with both of these measures. When we take a closer look at one of the first US regions to develop shale we can see that both oil production and rig count are not that highly correlated to actual employment. Bakken was one of the first US regions to develop shale oil. Bakken is currently at all-time peak in oil production.



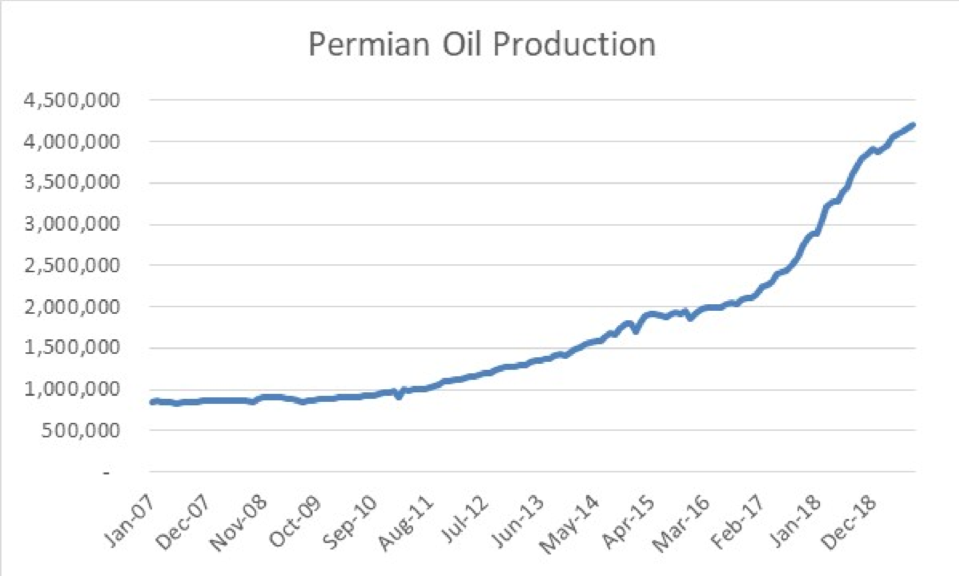
The surge in Bakken oil production has not been matched by an increase in employment in North Dakota, where Bakken is located. Jobs lost in the 2015 oil bust never returned.



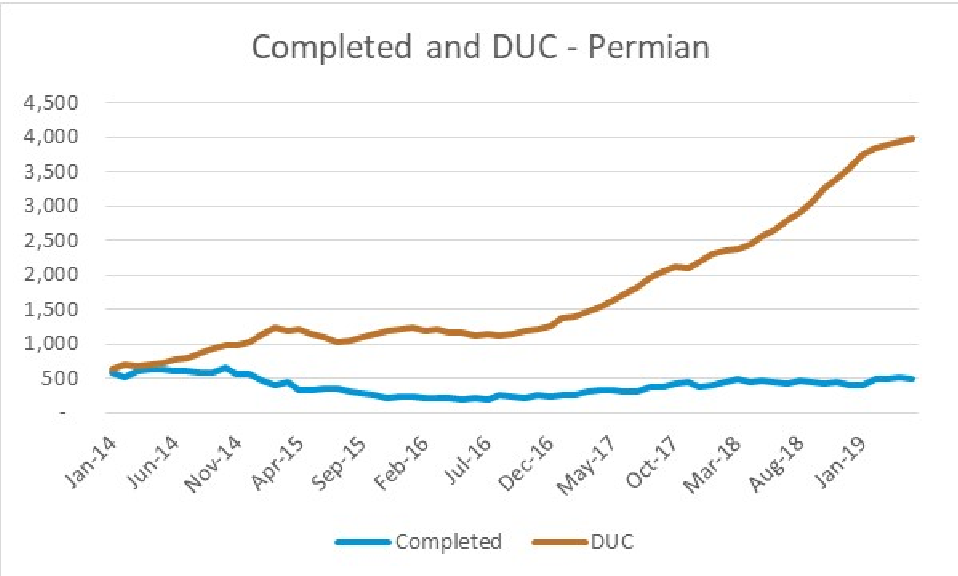
One reason for this is that prior to the oil crash in 2014/2015, Bakken drilled far more wells than it completed. That is, drillers built up an inventory of wells that could be brought online when the oil price recovered, but with no need to increase drilling.



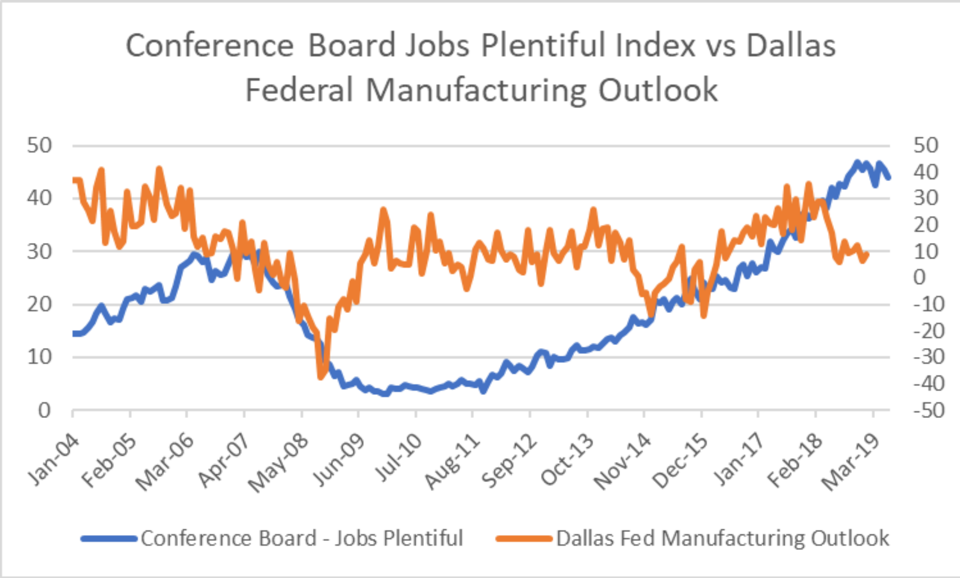
Post the 2014/2015 oil price crash, US oil production has been powered by growth in the Permian basin.



The huge inventory of wells that is now built up in the Permian means that US well drilling activity can fall, even as oil production increases. We are already seeing signs of this in the Permian where completions are slowing but drilled, uncompleted ("DUC") wells are still increasing.



If growth in US oil activity has been a key driver of durable goods and activity, the change in US oil drillers from accumulating DUCs to running them down, should lead to a slowdown in employment growth. There are already signs of that with the Conference Board Jobs Plentiful Indicator rolling over, with the Dallas Federal Manufacturing Outlook already falling.



While the US oil production growth looks likely to continue, there seems to be have been substantial over drilling in the Permian, creating a sizeable overhang of wells. Working through these wells is likely to slow US growth, and in an environment of slowing growth globally, could cause recession.

INFORMATION

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