The Daily Dish

Financial Turbulence

DOUGLAS HOLTZ-EAKIN | OCTOBER 11, 2018

Eakinomics: Financial Turbulence

Yesterday was a choppy day for financial markets. The S&P dropped 3.3 percent (95 points), the Dow fell 3.2 percent (832 points), and the Nasdaq was down 4.1 percent (316 points). The obvious questions is: Why?

I have no idea.

But there are two observations that I think are relevant. Lots of observers pointed to fears of higher interest rates and higher inflation. That explanation is a bit hard to swallow as the Fed has indicated that it would normalize interest rates for a long time; thus, higher rates should come as no surprise. And there was no real news on an uptick in inflation. But if there was evidence of inflation rising more rapidly and sooner than expected, then everyone should be rooting for higher interest rates to contain the rise and, thus, extend the expansion.

The second observation is that financial markets are not the real economy. The real economy looks quite solid: Jobs and income are growing, and business fixed investment continues to support the expansion. The outlook for 2018 and 2019 did not not change significantly yesterday. To the extent there have been negative developments in the fundamentals, they come in three forms. The first is ongoing events in the tech sector — in this case, a Google data breach — portend intrusive, hasty, and counterproductive regulatory intervention. The second is the growing evidence that the China tariffs are *not* a temporary feature of the economic landscape, but rather a more permanent anti-growth fixture.

The third is higher oil prices. Yesterday, Brent oil contracts closed at $82.60 per barrel and West Texas Intermediate ended at $72.63. These prices are more than 30 percent above what the federal Energy Information Administration (EIA) anticipated in January, and likely are having a modest negative impact on growth. As laid out by AAF's Phil Rossetti, you cannot explain this increase only by more rapid global economic growth; indeed the International Monetary Fund recently downgraded the outlook for global growth. Instead, the problem lies on the supply side of the oil market. Naturally, one is tempted to blame the OPEC cartel, but that is not the whole story. Instead, pipeline congestion in Canada (caused by political challenges) is likely a significant underlying cause of constrained supply and higher oil prices.

Even more important, the U.S. market is responding. EIA's highlights from this month's Short Term Energy Outlook states, "U.S. crude oil production averaged 11.1 million barrels per day (b/d) in September, up slightly from August levels. EIA forecasts that U.S. crude oil production will average 10.7 million b/d in 2018, up from 9.4 million b/d in 2017, and will average 11.8 million b/d in 2019."

In short, the only near-term threats in the real economy are the potential for anti-growth policy. Financial market turbulence will come and go, but focus should remain on policies that support the fundamentals of real economic growth.