TrendMacrolytics

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Is It "All About Oil"?

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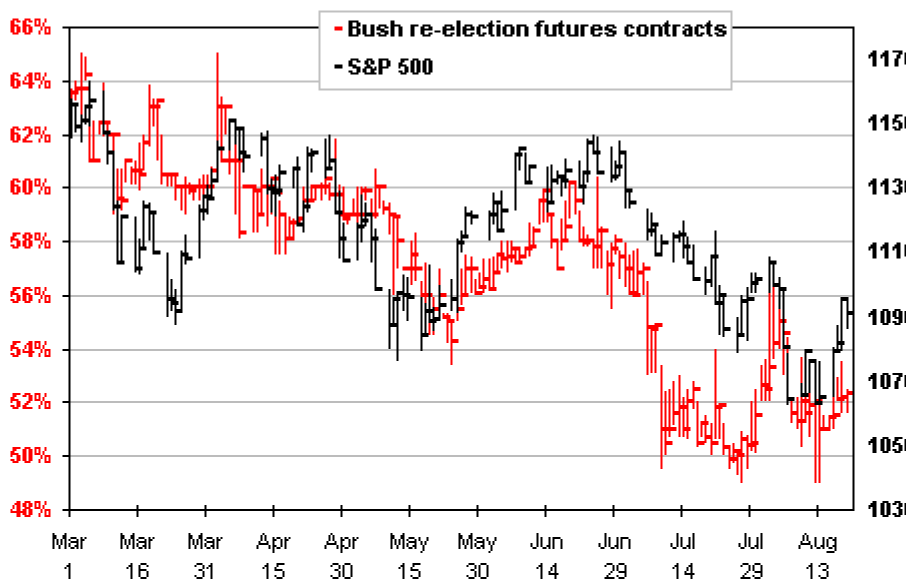
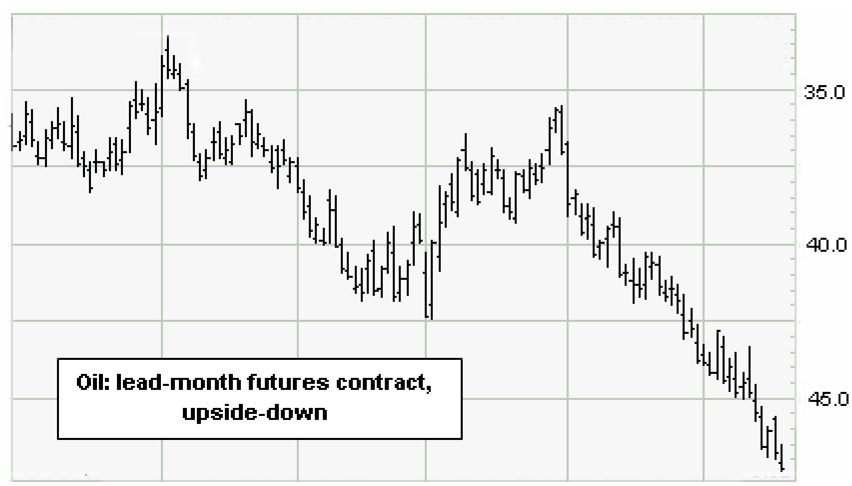
Donald Luskin

Or is oil all about President George W. Bush?

We've talked all year about the strong correlation between the stock market and **President Bush's** re-election probabilities. Surely the lines of causation in this relationship run both ways. On the one hand, the equity market wants the continuation of Bush's pro-growth policies. At the same time, Bush wants a strong market and a strong economy in order to get re-elected. The analysis of causation gets considerably more complicated when we factor in the price of oil.





As the charts at right show, the price of oil has moved inversely to the stock market and Bush's re-election probabilities with great consistency since March. Under the conventional analysis that treats oil as an independent economic variable and a source of exogenous "price shocks," it's easy just to say that high oil prices slow the economy, and are therefore bad both for the stock market and for Bush. But that's too simple by half.

In our view the oil price now is largely being determined by the market's confidence in President Bush and his prosecution of the war on terrorism. It's a reverse referendum -- as confidence in Bush falls, the terror premium in the oil price rises. Other than that, we see little of substance to explain $50/barrel. Yes, there is an important inflation component in today's high oil prices (see "Inflation: That

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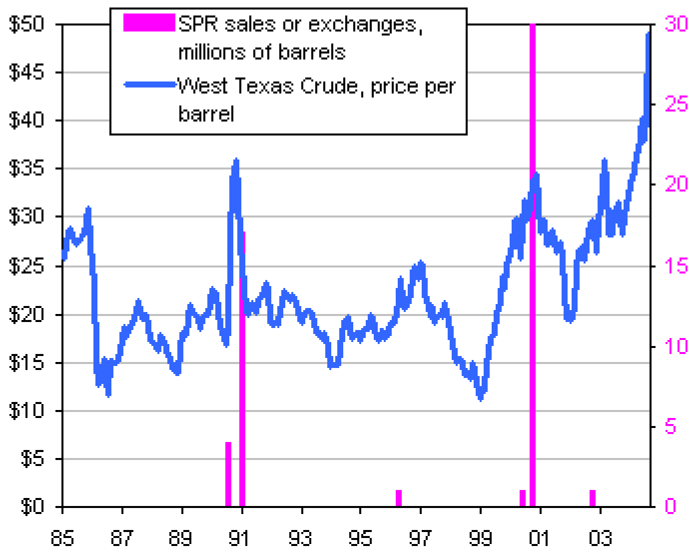
'70s Show?" August 2, 2004). But that alone doesn't explain an oil price otherwise utterly unjustified by the realities of today's supply, demand and inventory situations. Bush's war in **Iraq** was criticized as being "all about oil." Now, oil is "all about Bush."

Markets always have a difficult time when they have to price the costs and risks of emotionally charged, low-probability high-impact events like terrorist attacks. At such times markets can be subject to so-called "bubbles," in which rising prices themselves are given too much credence by market participants as predictors of future risks -- so the higher prices go, the more risk is assumed to be forecasted, which drives prices higher still, and so on. The oil markets may be having an especially hard time of it now because of today's intensely bitter political environment, which is itself rapidly becoming a bubble -- a bubble of Bush-bashing. These two bubbles intersect, to the extent that fears of a terrorist attack are being deliberately stimulated for partisan purposes -- by the left, in order to discredit Bush's success in the war on terror; or by the right, in order to play to Bush's presumed brand-strength as incumbent commander in chief.

The **Bush administration** itself is doing one thing that is undoubtedly contributing to the rising price of oil. Shortly after the terrorist attack of September 11, 2001, the president ordered the nation's **Strategic Petroleum Reserve** to be filled to near capacity at 700 million barrels. Against the backdrop of commercial inventory builds now at a level that virtually constitutes hoarding, the administration's steadfast refusal to draw down the SPR, or at the very least suspend adding to it, is a mystery -- one that raises questions about what the administration knows that the rest of us don't know.



There are two precedents for using sales and exchanges from the SPR in times of unusually high oil prices. In August 1990 and January 1991 -- preceding and Operation Desert Storm -- **President George H. W. Bush** ordered sale of 21 million barrels from the SPR. In September and October 2000, **President Bill Clinton** ordered the exchange of 30 million barrels (that is, a sale with the promise of future repayment in kind from the buyer) in response to the spike in heating oil prices in the Northeast. In both those cases oil prices fell sharply in response.

We predicted that Clinton's move in 2000 would alter speculative market dynamics (see "Oil Reversal" September 27, 2000), and we think a similar move by Bush could do the same thing now. Considering the tangled causal lines that interconnect oil, the election, the stock market and the economy, such a move could have very far-reaching and very positive impact. Indeed, considering the extreme risk premium built up now in stocks (with the technology sector virtually at the same level of undervaluation we saw in the panic bottom of October 2002), it seems that stocks are near discount-the-worst levels and are primed for such a catalyst. Will it happen? The Bush administration has repeatedly said it would not order a drawdown -- hewing to the principle that the SPR is only for "emergencies." Yet the law contemplates economic emergencies, and there is ample precedent from the **Clinton administration** for that. And at some oil price, an SPR drawdown will become a political emergency -- indeed, a necessity. Could $50/barrel be that price? TM