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The Fed's Oil Crisis

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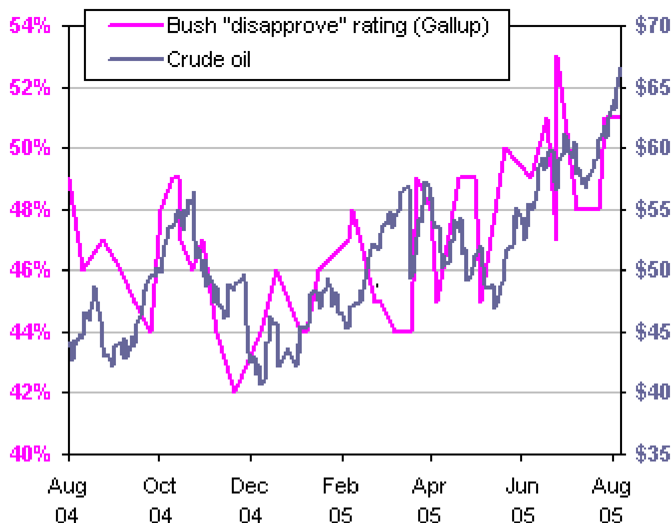
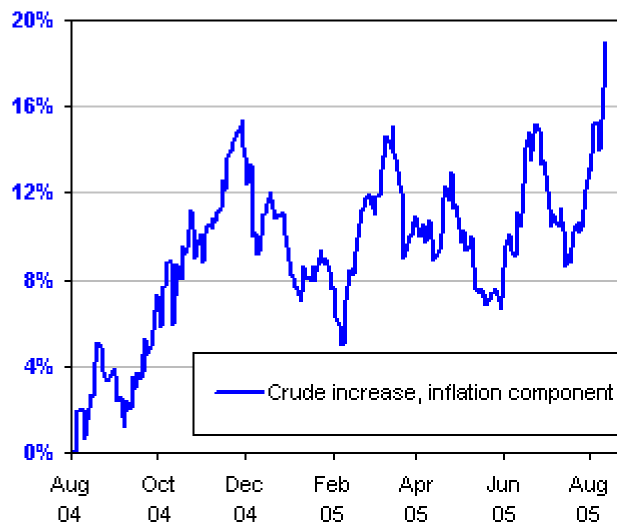
The oil spike has a strong inflationary component -- yet it may make the Fed less vigilant.



There's good news and bad news about **oil**. The good news is that crude oil is at all-time highs and the world hasn't ended. To be sure, high crude prices produce a sense of fear, evoking dark national memories of the **oil crises** of the mid-1970s and early 1980s. That's why every dollar higher in crude prices translates into about 40 basis points in increased **disapproval ratings** for **President Bush**. But what's different about today's high crude prices, as opposed to those of the 1970s and 1980s, is that today they are not the result of **supply shocks**. There is no actual shortage of oil today, at least not in terms of satisfying present consumption demand; **inventories** are at all-time highs. In part today's high crude prices are the happy result of **global growth**. Think of them as a transaction cost involved in doing the **global labor arbitrage** that keeps **retail prices** so low. If it costs $1.00 more to drive to **Wal-Mart** to save $10.00 on **Chinese**-made goods, where's the harm?

The bad news, though, is that -- just as in the 1970s -- there is a significant **inflation** component underlying today's high crude prices. The chart at right estimates the inflation component by comparing the increase in oil priced in ***dollars*** over the last year to the increase in oil priced in ***gold*** over the same period. We assume the *gold* oil price is an inflation-free price, reflecting only **intrinsic supply/demand factors**. Any difference between that and the *dollar* oil price, then, can only be explained by changes in the **purchasing power** of *the dollar itself* -- or, inflation. Of the 52% *dollar* increase in the crude price over the last year, 19% (more than a third of the total increase) is residual to the *gold* oil price increase, and therefore -- by construction -- reflects inflation.



It's particularly alarming that the inflation component of the crude price has broken out to

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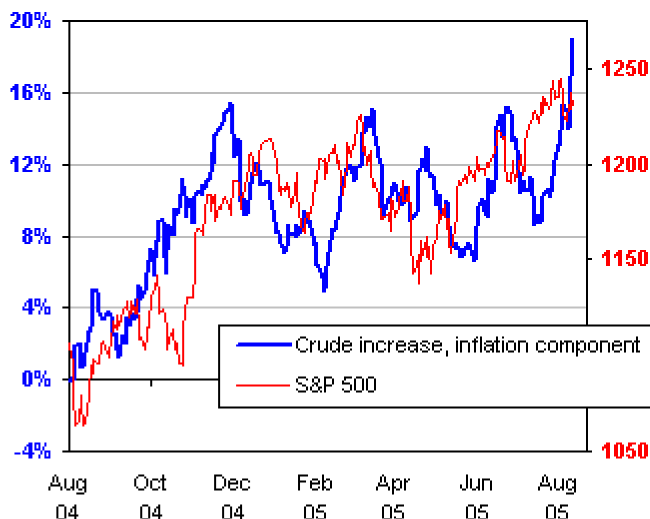
new highs over the last two weeks, at exactly the same time as there has come to be a broad consensus about **the Fed's** continuing vigilance. Six months ago we were voices in the wilderness calling for a **fed funds rate** of 4.25% by year-end, reflecting consistent 25 basis point rate hikes at each **FOMC** meeting. Now that hawkish expectation is reflected in **futures** prices and in polls of **Wall Street economists**, and the latest **FOMC statement** went so far as to use the word *inflation* no less than four times. Yet the oil price is at all-time highs, and its inflation component has broken out to new highs. The gold price is flirting with 17-year highs and the dollar's **foreign exchange** value has weakened. Just when **inflation expectations** ought to be lessening, they are worsening.

How can this be? One explanation is that even a vigilant Fed that moves the funds rate to 4.25% by year-end won't have been vigilant enough -- it will take more than that to put the inflationary genie back in the bottle. But that doesn't explain last week's rally in **long-term Treasuries**, with **10-year yields** falling below the 4.25% mark where a vigilant Fed would ostensibly have the overnight rate less than four months from now. The **bond** rally suggests another explanation: that the apparent consensus for the Fed's continued vigilance is illusory, or is in the process of unwinding. Perhaps the bond market is foreseeing a Fed that keeps policy **easier** for even longer than it already has in order to combat potential **economic weakness** arising from high oil prices -- although we are hard-pressed to understand what evidence the market is relying on for such a forecast. One economist whom we respect has highlighted a phrase from the latest FOMC statement -- "Aggregate spending, despite high energy prices, appears to have strengthened since late winter" -- as signaling that the Fed is already knowingly **accommodating** the rise in oil prices with easy money. We are tempted to argue that this phrase actually should be understood just the other way -- that the Fed sees *no need* to accommodate the oil price. Furthermore, this is precisely the error that the Fed made in the 1970s, and we would expect that today's Fed would be smart enough to not make the same error again. Indeed, in March, when the Fed first went visibly on inflation alert, it appeared to be very much the appropriate response to a surge in oil prices. Yet since the latest FOMC meeting, the fact is that the oil price has surged -- and gold, the best single indicator of inflationary expectations, followed the oil price higher much as it did after oil's May surge (see "Greenspan's Conundrum" June 27, 2005). If the Fed has indeed changed its mind and is now prepared to accommodate the oil price increase, then bond markets will end up bitterly disappointed. Yes, short run, an accommodative Fed will keep rates low, and that's good for bonds. But before long the inevitable inflationary consequences of the Fed's error will end up driving yields far higher than they would have had to be if the Fed has simply remained vigilant in the first place.



And therein lies the real risk for the economy, and for **stocks** -- and the explanation for last week's stock market weakness. Throughout the Fed's rate-hiking regime that began last June, we have dismissed the conventional wisdom that higher rates were necessarily deleterious to growth and bad for **equities**. We have characterized that regime as a **normalization**, not a **tightening**, and said that by dealing with inflation before it gets out of hand, the economic **expansion** and the **bull market** in stocks can be made more durable. So far so good on that call -- the economy and the stock market have both performed very well since the rate hikes began last year. The evidence seems to even suggest that stocks have been unconcerned with

the inflationary costs of the Fed's **"measured"** pace of normalization. The chart above shows that the fluctuations in the S&P 500 over the last year have corresponded closely to changes in the inflation component of the oil price. Does this mean that inflation is good for stocks? Well, as a first approximation, it *is* -- stocks are nominal instruments. And after the savage **bear market** triggered by the Fed's **deflationary** error in 2000, perhaps stocks are comforted by a bit of the inflationary devil they know. But in the end inflation will lead to the same catastrophe for stocks as it will for bonds. When the evidence of strong inflation eventually breaks out into the **headline statistics** that the Fed and **the media** can't ignore, we'll quickly move from normalization to tightening, and from tightening to **shock treatment**. And we'll learn that while demand-driven high oil prices don't induce recessions, as always, policy errors *do*.

Bottom Line: Through all the fashionable doom and gloom about twin deficits, through last year's **election** and the initiation of a Fed rate-hiking cycle, and through this year's real and imagined threats of economic slowdown, **protectionism**, new **taxes**, **terrorism**, and a **housing bubble**, our position by and large has been that everything would turn out okay and that stocks were **undervalued**. Everything *has* turned out okay, and just two weeks ago stocks had moved to four-year highs. We are inclined to think that the Fed will not repeat its error of the 1970s here, and that much of last week's market action seemingly anticipating such a repeat will unwind sooner rather than later. But if the latest move in oil prices and other forward-looking inflation indicators does mean that the Fed intends to back off its vigilance and fall even further behind the inflationary curve, then all bets are off. This is a time of risk, but stocks come into it very undervalued based on **consensus forward earnings** (which, at the moment, are still accelerating) and on long-term Treasury yields (which, at the moment, are falling). It's difficult for us to see much downside in stocks when so much has already been discounted in **valuations**, or much upside while the prospect of a major Fed error is in the forefront. While we wait to see what happens, though, earnings continue to accrete and stocks continue to be the king of **carry trades** (see "The King of Carry Trades" June 14, 2005). If that error fully eventuates, though, we'd have to throw valuation out the window -- we won't want to be in stocks. TM