TrendMacrolytics

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# Oil In Perspective

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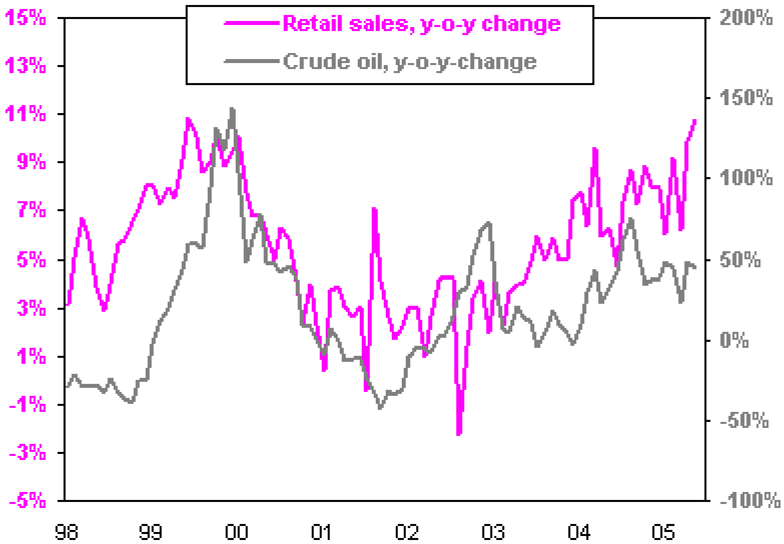
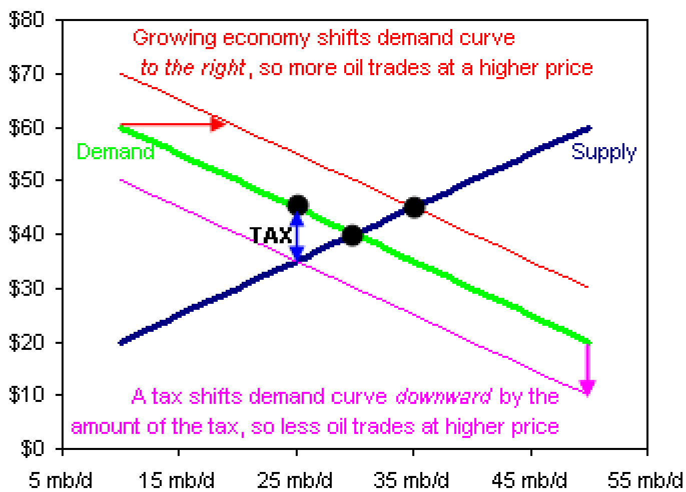
**The risk from record oil prices is less than meets the eye -- or, at least, different.**




With **crude oil** making all-time highs, the conventional wisdom is that the **economy** should have already collapsed. Yet it hasn't -- not even the **consumer** economy, **Wal-Mart's** dark visions last week notwithstanding. It may seem strange at first, but the reality is that changes in the crude oil price are *positively* correlated with changes in **consumer spending** -- that is, as the chart at left shows, they rise and fall roughly in tandem. So the conventional wisdom is wrong about the cause-and-effect relationship between oil and the consumer economy -- high oil prices don't necessarily depress spending. Of course that doesn't mean the opposite is true, that high oil prices somehow stimulate spending. We think the truth is that *both* oil prices *and* consumer spending are determined *together* by a common causal factor -- **economic growth**.




To the extent that today's high oil prices are the result of natural **demand** growth born of overall economic growth, then there is nothing especially dangerous about them. It's just a plain vanilla case of the **demand curve** for a good shifting to the right, resulting in a greater quantity transacted at a higher market-clearing price. This is in distinction to the case of a **supply shock** or a **tax**, which from the perspective of consumers is a deadweight loss resulting in *both* higher prices *and* lower quantities. And it doesn't even begin to consider second-order effects such as the impact of **economies of scale** and **technological innovation** on the **supply side** of the oil equation. While world **GDP** and oil demand have risen spectacularly over the last century and a third, roughly speaking the **real price** of oil has remained within a fairly narrow

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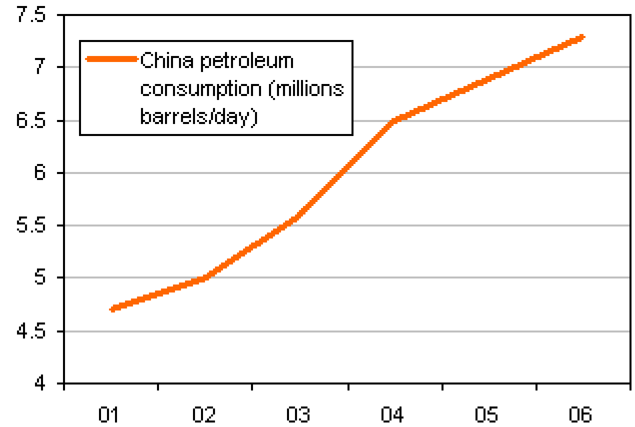
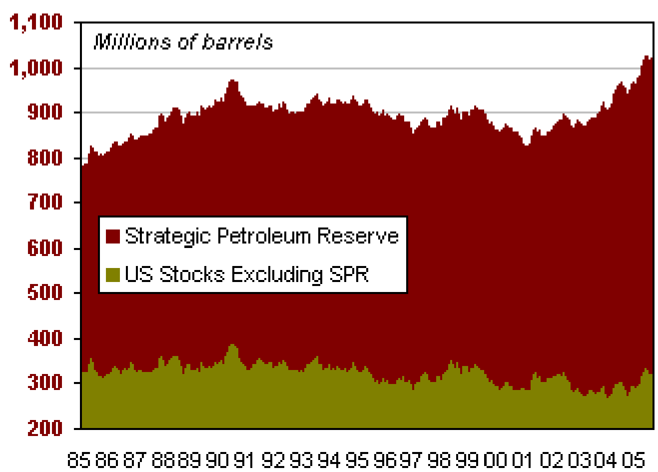
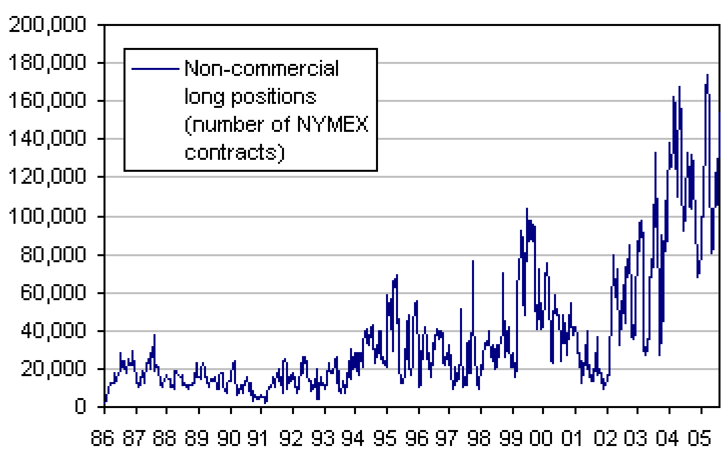
range over the entire period. In fact, it's lower today than it was a decade after **Colonel Drake** first extracted it in **Pennsylvania** in 1859.

This growth-driven view is no less valid when we include the rapid economic development of **China** as part of the equation. China's oil consumption is indeed growing rapidly, at least in percentage terms -- 55% estimated growth by 2006, compared to a 2001 baseline, according to **OPEC**. Even at that, though, in 2006 China's total consumption will be less than a third of **North America's**. But be that as it may, so long as the avenues of **trade** remain open between the **US** and China, then our two economies will be beneficiaries of each other's growth, with rising incomes on both sides compensating for a higher oil price. An **American** should no more worry about growth-driven demand from China than an **Oregonian** should worry about growth-driven demand from **Minnesota**.



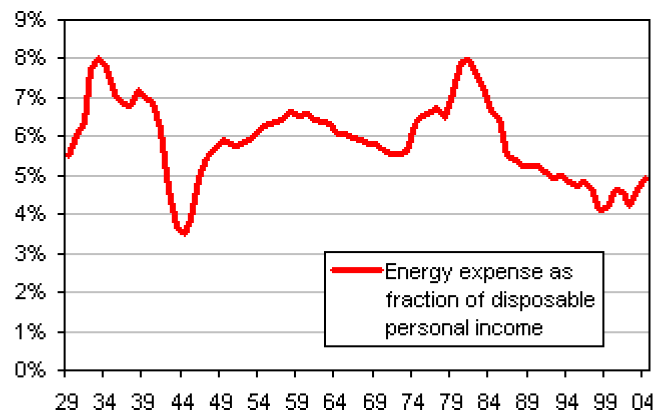



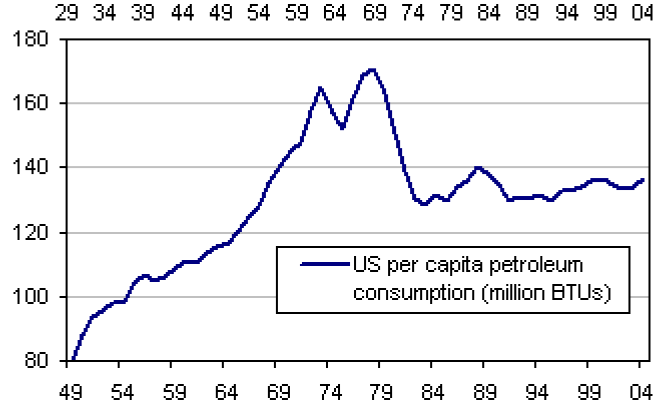

That's good enough for a first approximation, but there are other more negative factors at work, too. We've already discussed the troubling extent to which high oil prices are, in part, the result of accelerating inflation -- and the small but alarming risk that less than full **Fed** vigilance here could lead to even more inflation and even higher oil prices (see, most recently, "The Fed's Oil Crisis" August 15, 2005). It's also worth considering the possibility that today's high oil prices are also the result of **risk aversion**, probably driven by heightened concern with supply interruptions arising from **terrorism** and **geopolitical risk**. Since the **September 11, 2001 attacks**, 160 million barrels of oil that would otherwise have been on the market have been diverted in the **US Strategic Petroleum Reserve**. After the invasion of **Iraq** in 2003, commercial **US inventories** have grown from all-time lows to six-year highs, paradoxically in the face of rising demand and rising prices. Such hedging behavior may be valuable or it may be ill-advised, but either way it is expensive. To the extent that it has contributed to higher oil prices, *that* is a tax -- a deadweight loss to economic growth.




There is surely a speculative element to today's high oil prices, too. One sign of it is the high level of participation in the **oil futures market** by **hedge funds**, **individual investors**, and others outside the **energy industry**. The chart at left shows the surge in the number of long contracts held on the **NYMEX** by **non-commercial traders**, according to the **Commitments of Traders reports** of the **Commodities Futures Trading Commission**.


Further evidence of speculative excess is the tone of panic with which high oil prices are being portrayed in the **mainstream media**. The image at left appeared on the cover of last Sunday's ***New York Times Magazine***, to dramatize a feature article by **Peter Maass** claiming, in essence, that the world is running out of oil. We find that claim to be utterly without merit, ignoring as it does the steady progress in the **cost-effectiveness** of the technologies required to discover, extract, deliver and utilize the planet's vast untapped **petroleum resources**. But this kind of end-of-the-world panic about oil in the mainstream media is very encouraging. Hopefully it is the oil market's version of that classic **contrary indicator**, a **bear** on the cover of ***Business Week***. Further, some behavior that appears on the surface to be hedging could be, in fact, more evidence of panic and speculation. The US Strategic Petroleum Reserve is now full to the brim. Is that so different than when, in 2001, the **State of California** locked in all-time highs in electricity prices with long-term contracts -- which, in the fullness of time, have come to seem absurd?




So some forces less salutary than just growing demand -- inflation, risk aversion, and speculation -- have their role to play in today's oil prices, too. Those forces are threats to growth at the margin, but it would be a mistake to think they have the power to throw the economy into the kind of **recession-*cum*-depression** experienced in the oil crises of the 1970s -- an image evoked all too often in today's discussions about energy. Today the US economy is far more insulated from oil shocks than the conventional wisdom appears to believe. **Direct energy expenditures** (**gasoline**, **natural gas**, **home heating oil** and **electricity**) take up a tiny fraction of **disposable personal income** -- for the average American, it is less than 5% (and only a portion of *that* is directly linked to *oil* prices). And contrary to popular mythology, the average American is not an ever-fattening oil glutton. In contrast to the vertiginously climbing pace of ***per capita* petroleum consumption** from which the US fell so hard in the 1970s, **trend growth** in consumption has been flat now for a quarter century. So worry prudently, if you must worry. But don't panic.

**Bottom Line:** By offering these perspectives, we're not trying to be obtuse -- we're not saying there aren't real risks, costs and dislocations associated with today's high oil prices. Our purpose is to remove the stench of panic from our clients' deliberations about exactly how high oil prices will impact the economy and the markets. High oil prices are not, *ipso facto*, a one-way ticket to recession. And no, we're not running out. Short term, we're probably in the midst of a **speculative blow-off**. But one big wildcard in oil now is that the Fed will succumb to the **inflationary** temptation of **accommodating** high energy prices by slowing down its **rate-hiking campaign**. We don't expect that will actually happen, but as we wrote last week, recent action in **commodity** and **fixed income** markets suggest that it's by no means an impossibility (again, see "The Fed's Oil Crisis" August 15, 2005). If you want to bet against the end of the world and get paid while you wait for the world not to end, the best play is still the king of carry trades -- long the deeply **undervalued stock market** in a durably strong economy, and short the **overvalued bond market** in a world in which rates are almost surely going higher (see "The King of Carry Trades" June 14, 2005).

**Late breaking news:** The **State of Hawaii** has failed to take our advice to not panic, and has announced plans to impose **price caps** on gasoline. If this compulsion to repeat the **regulatory** mistakes of the 1970s spreads to other states, all bets are off. TM