TrendMacrolytics

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# High Anxiety

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**High energy prices are unlikely to derail an expansion based on wealth creation and capital formation.**

Certainly, no list of factors that can be considered constructive for sustaining vigorous **economic growth** includes $60-plus **crude oil**, $3-plus **gasoline** and $13-plus **natural gas**. To be sure, the escalation of **energy prices** is inflicting considerable pain on certain sectors most sensitive to the rising costs, including **transportation** and **trucking**. But while higher energy prices are in no way growth-positive, the high anxiety generated by fear that prices at these levels stand to do major economic damage is seriously overdone (see "Played Out" October 5, 2005). The pessimistic case, moreover, largely overlooks the acceleration in **wealth creation** and **capital formation** now underway, which is offsetting the growth drag posed by expensive energy.

To maintain some perspective, it's worth noting that the economy has grown far less **oil dependent** over the last generation or so, while the real price of crude is still below its levels of the early 1980s. Due to **efficiency** improvements spurred in large measure by the oil shocks of the '70s and early '80s, oil consumed per unit of **output** today is about half the levels of that time. Allowing for the economy's reduced oil dependence and the effects of **inflation** over time would require a price approaching $190 to have the same impact as the near-$40 per barrel crude of the early '80s.

But there's also another way of looking at it when one considers that the economy performed quite well during the **Reagan** recovery of the early- to mid-'80s with oil prices that in adjusted terms were sharply higher than today's. Not unlike those times, today's high energy prices come against the backdrop of rapid **income growth** attributable to considerable extent to the enhanced supply-side incentives brought about by the **Bush tax cuts**. Since the first quarter of 2002, **energy consumption** has grown by more than $180 billion. **Disposable personal income**, however, has risen by some $1.25 trillion over the same period. Subtracting the higher energy burden, in other words, still leaves more than $1 trillion in personal income gains over the past four years. This level of aggregate income growth, by the way, is comparable to that experienced during the "boom" years of 1996 to 1999. In any case, the mismatch of rising incomes relative to energy costs goes a considerable way toward explaining the resilience of "the consumer" during the oil price spikes, and suggests it is not likely to falter.

That is also the message coming from data tracking **investment** and **wealth**. In our model, **consumption** is simply the reward for **production**, it being impossible to consume that which has not been produced. Therefore, we look to indicators of **risk-taking** and capital formation which ultimately determine the economy's productive capacity. In what can be considered the economy's growth engines, there is little to suggest energy prices are posing any obstacle. **New orders for nondefense capital goods** continue to grow at double digit rates, and the **GDP tables** show **fixed investment in equipment and software** doing the same (see chart on the

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previous page). In addition to representing a sustained expansion of the economy's income-producing capability, such vibrant real investment activity also reflects a considerable degree of **confidence** in the economy's future growth prospects. That is borne out as well in **credit spreads** showing that the market's capacity to absorb risk remains quite robust. At around 350 basis points, for example, the **Merrill Lynch high-yield spread** remains at levels consistent with strong growth.

**Fed** data confirms, meanwhile, that this environment so favorable to expansion of the **capital stock** is also showing through in strong growth of the **capitalized value** of the economy's **expected future income streams**, *i.e.* wealth. In the latest **Flow of Funds report** published last month, **household net worth** was pegged at a record $49.8 trillion, up some $5 trillion in the past year. Moreover, despite the common perception that any wealth gains have been attributable primarily to a **housing "bubble,"** the gains in net worth were split almost equally between **residential real estate** and **financial assets**. To an important extent, levels of current consumption are dependent on expectations of future income, a phenomenon known as the **"wealth effect."** The vigorous pace of recent wealth creation provides further confidence that a **consumer-led downturn** is likely not in the cards.

Of course, a major contributor to the growth story of the past few years has been the **2003 tax cuts on dividends and capital gains**, which significantly reduced the **after-tax cost of capital** and spurred a revival of risk-taking spirits. Failure to extend those cuts beyond their scheduled 2008 sunset would put the **expansion** at considerable risk (see "What's Spooked Stocks?" October 7, 2005). The other potential dark cloud on an otherwise bright landscape is the risk of the Fed staying too long behind the curve, allowing a significant inflation breakout. In addition to the certainty that this would yield a harsh Fed response, inflation is itself corrosive to productive economic endeavor, raising the risks to capital and lifting **real effective tax burdens on capital** (capital gains is an **unindexed** tax). Here, high energy prices are not wholly irrelevant to the potential risk, since the longer the Fed stays too **easy**, the greater the chance policy will **accommodate** the price spike, significantly compounding the inflationary dynamic.

**Bottom Line:** The fear of economic damage arising from higher energy prices has been significantly exaggerated. This is most likely due in no small measure to a general lack of appreciation for the robust environment of capital formation and wealth creation currently driving the expansion. In these areas, indicators continue to suggest that the ingredients for sustained economic vitality remain in place. TM