Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

There Will Not Be Blood

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Donald Luskin

The surge in oil has been somewhat overdone, but at base it's a sign of improving growth prospects.

Update to strategic view
US MACRO: Record crude oil prices are not likely to be sustained, as inflation and dollar collapse expectations unwind. But elevated oil prices are not necessarily a shock to growth. More likely, they are the product of improving growth expectations. **OIL:** The oil price has been driven to all-time highs both by improving growth expectations and by speculation based on misplaced inflation and dollar fears. We expect lower oil prices as those fears dissipate.
[see Investment Strategy Dashboard]

Considering that markets seem prepared to panic over virtually *any*thing these days, it's impressive to us that there has been so little palpable reaction to crude oil hitting seemingly dramatic new all-time highs. Quite the contrary. The price of crude has risen more than 17% over the last month -- yet stocks have rallied, with the energy-sensitive transportation sector making all-time highs. This seemingly improbable juxtaposition of events is likely explained by the exhaustion of negative sentiment since the climax bottom in March in the wake of the collapse of Bear Stearns (see "Bernankruptcy" March 17, 2008). That event represented a turn upward in sentiment itself, but also in the macroeconomic growth prospects that had been depressed by negative sentiment. So since then, incoming macroeconomic data has generally stabilized and in many cases improved (see "The Bear Stearns Bottom: One Month Later" April 17, 2008). The especially large magnitude of the recent oil price move no doubt contains some unique speculative elements which, as we will discuss later in this report, suggests to us that move is overdone. But as a first approximation, recovering growth prospects go a long way toward explaining the paradox of all-time high crude prices *and* all-time highs for transportation stocks. That's because while the oil price might mistakenly be seen as an exogenously determined input cost -- where a sudden rise in the price represents a simple penalty on growth -- it is more properly seen as an endogenously determined equilibrium, in which, all else equal, increasing demand coming from rising growth moves the oil price appropriately higher. In other words, crude oil is not trading at \$119 (yesterday) because of some "supply shock" -- it is trading at \$119 because we can afford it. To put it yet another way, the oil price isn't the driver of growth -- it is driven by growth.

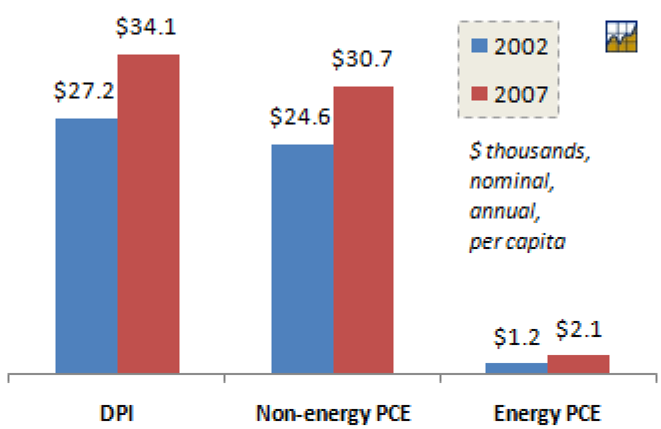
Consider the history of the last five years, from 2002 through 2007. The nominal price of gasoline at the pump almost tripled, yet per capita gasoline consumption didn't fall, it grew by 3.8%. Gasoline went from 7.6% of retail sales to 10.3%, yet that doesn't seem to have hurt other retail sales much -- they grew 25.6%.

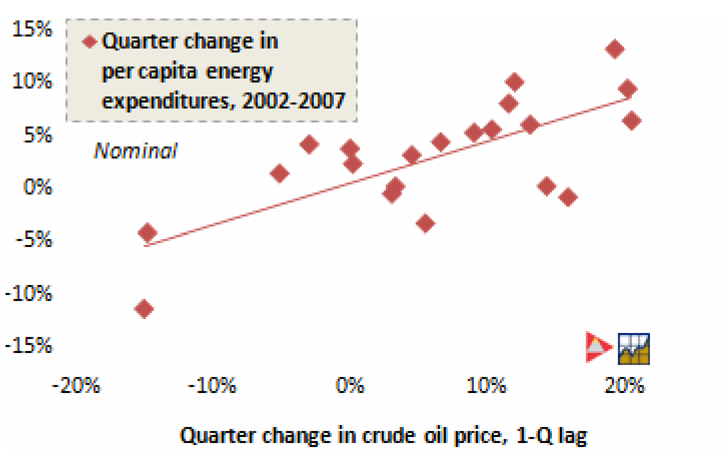
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

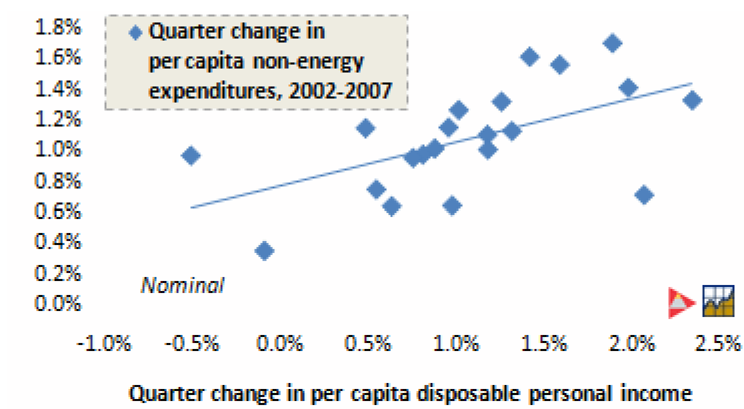
Over the same period, nominal per capita expenditures on energy goods and services (which are dominated by gasoline) have risen by $900 per year, from $1,200 to $2,100. But at the same time, per capita disposable personal income has risen far more -- by $6,900, from $27,240 to $34,130. Yes, energy expenditures grew from 4.7% of personal consumption expenditures to 6.5%, and from 4.4% of disposable income to 6.1%. But at the end of the day, the average American was nevertheless net ahead by $6,000 per year. So despite the seeming drag from energy, per capita personal consumption expenditures other than energy were able to grow a healthy 24.9%.





As one would expect, the crude oil price is an excellent predictor of per capita consumer energy expenditures -- so as the oil price rises, we must expect those expenditures to rise, too. But because raw fuel is only a minority component in the total cost function of energy goods and services, the percentage rise in expenditures is only a fraction of the percentage change in the oil price. Historically, only a bit more than 40% of the oil price change makes its way into nominal energy expenditures (the regression has an r-squared of 52).

But at the same time, historically, the oil price shows no correlation at all with *non*-energy expenditures. That is to say, the conventional wisdom is not true: a rising oil price has not led to a decline in nominal non-energy expenditures. What explains non-energy personal consumption expenditures is changes in disposable income. Historically, a bit less than 30% of changes in nominal disposable income makes its way into nominal non-energy expenditures (the regression has an r-squared of 32).



All that demonstrates that, to the extent that a rise in oil prices is an endogenous growth-driven phenomenon, it is not to be feared. But that said, to what extent is the recent sharp rise in oil prices actually some kind of exogenous shock? We don't rule out some element of that, in this case rising from speculation based on misplaced inflation fears. In our view, while there are still significant inflationary forces at work arising from the Fed's excessive rate cutting during the credit crisis (see "Fed vs ECB -- the ECB Wins" April 23, 2008), with the Fed's introduction of new non-inflationary credit facilities, we've thankfully turned aside from the worst-case inflation risks we were facing several weeks ago (see "Inflation Inflection" March 25, 2008). Much of the current marketplace chatter about inflation seems to us not a rational appraisal of where Fed policy is really moving now, but rather just an extension of the same old "collapsing dollar" narrative that has prevailed since the credit crisis began last summer. How can the dollar be said to be collapsing when, on a trade-weighted basis, it's been in a narrow trading range for the last two months? Inflation is being blamed for everything from food riots in the third world to rice-hoarding at Costco -- but how, then, to explain that the gold price has fallen more than 10% since its highs a month ago, as we cautioned it could as the Fed changed course (see "Three Quarter Profile In Courage" March 19, 2008)?

The "collapsing dollar" narrative seems itself to be collapsing today, with foreign exchange -- including the seemingly impregnable euro -- dropping dramatically, along with oil, gold and commodities of all types, while stocks rally. If that persists for a bit longer, then we'll be especially confident that the oil price had indeed found a sustainable growth-driven -- and not growth-crushing -- equilibrium. In the parlance of the recent movie about the early days of the oil industry, we don't think oil is going to drink the economy's milkshake.

BOTTOM LINE: Record crude oil prices are not likely to be sustained, as inflation and dollar collapse expectations unwind. But elevated oil prices are not necessarily a shock to growth. More likely, they are the product of improving growth expectations. The oil price has been driven to all-time highs both by improving growth expectations and by speculation based on misplaced inflation and dollar fears. We expect lower oil prices as those fears dissipate.