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MARKET CALLS

The bin Laden Commodities Crash

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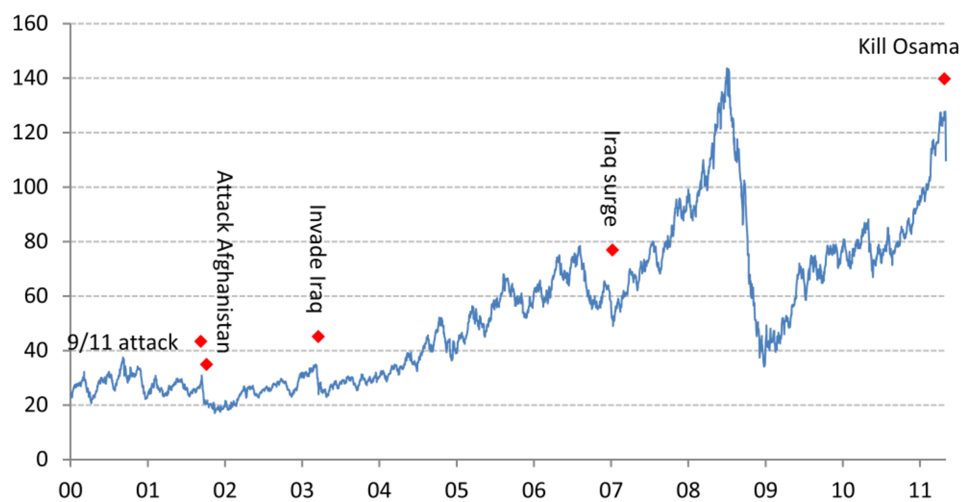
A speculative reaction -- and a downpayment on the peace dividend in the War on Terror.

Two weeks ago we said our trader's gut was sensing speculative over-reach in commodities -- marked by a reasonless run for the roses in silver, and the Glencore IPO that has "sell the top" written all over it (see "Gold Hits Our $1500 Price Target" April 20, 2011). And we've maintained for some time -- too long, perhaps -- that the oil price was impounding a more than sufficient risk premium to account for the recent bout of regime instability in the Middle East and North Africa (see "An Oil Shock Tipping Point?" March 3, 2011). It's all come home to roost with a vengeance this week, especially yesterday. Because something like this was so clearly in the cards, we don't feel compelled to look for deeper explanations or implications. But here are a few thoughts that go beyond just relegating this to a mere speculative reaction.

- The death of Osama bin Laden may mark a secular turning point in the oil price, just as the terror attacks of September 11, 2001 marked a turning point (see the chart below). Seen in this broad context, the recent geopolitical risk premium in the oil price is only the latest small increment in the premium that has been accruing

Crude oil (Brent)



Source: Reuters

Update to strategic view

OIL, COMMODITIES, GOLD, US RESOURCE STOCKS: The anticipated speculative reaction in commodities and energy is upon us. The death of Osama bin Laden may have been the catalyst, signaling the possible end to the secular geopolitical risk premium in oil that has obtained since the War on Terror began in 2001. For other commodities, global growth and reflation continue to underpin a durable bull case.

US STOCKS: The equity risk premium has been elevated since Congress gave Bush Iraq war powers. If Osama bin Laden's death means the end of the War on Terror, reduction in the equity risk premium would mean significantly higher stock prices.

US MACRO: If Osama bin Laden's death ends the War on Terror, there could be a significant peace dividend, a substantial aid in US deficit reduction. Just rolling defense spending back to its level at the peak of the Reagan build-up would save $144 billion annually.

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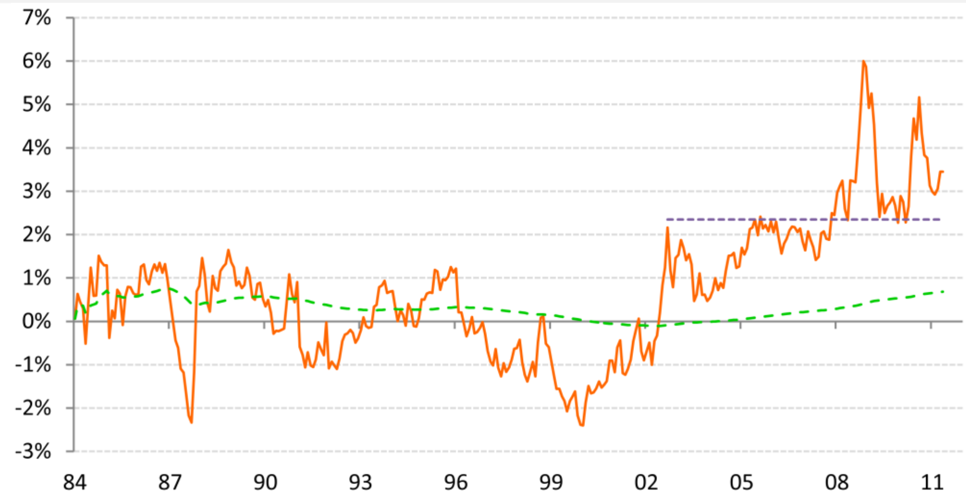
since the War on Terror began and the US responded with destabilizing (though arguably necessary) large-scale combat interventions in Afghanistan and Iraq. If bin Laden's demise means the War on Terror is effectively over, then the risk premium can come out of the oil price.

- This era of heightened geopolitical risk has been reflected in stocks, too. Ever since Congress granted George W. Bush Iraq war powers in October 2002, the equity risk premium has upshifted to a new high secular plateau. It has persisted in both good times and bad, no matter what various other risk measures such as VIX indicated along the way (please see the chart below). As the risk premium comes out of oil -- leading to *lower* oil prices -- we would expect the risk premium to come out of equities, too -- leading to *higher* stock prices. With forward earnings now back to within 20 bp all-time highs (and being upgraded at a 30% annual rate), and with Treasury yields still low, this sets up for the strong year in US stocks we've been forecasting (see "Stock Outlook: Differences Make a Difference" November 10, 2010).

— US Equity risk premium --- Post 84 average --- Post Iraq average
Forward S&P 500 earnings yield minus 30-yr Treasury yield, monthly data



Source: Zacks, Federal Reserve, S&P, TrendMacro calculations

- Another positive is that there could be a peace dividend here. At a run-rate of more than $700 billion/year, defense spending has almost doubled in real terms since the terrorist attacks of September 2001, rising to a level 25% above the highest level of the Reagan defense build-up (please see the chart on the following page). There are significant savings to be had if the death of bin Laden gives the US the excuse to withdraw promptly from Afghanistan (and with General David Petraeus having been kicked upstairs to CIA last week, there is no one of any particular credibility on the ground there to object). Even maintaining defense spending at the high level of the peak of the Reagan build-up would save $144 billion/year. Just rolling defense spending back to where it was at the end of 2007, before the onset of the Great Recession, would save $130 billion/year.

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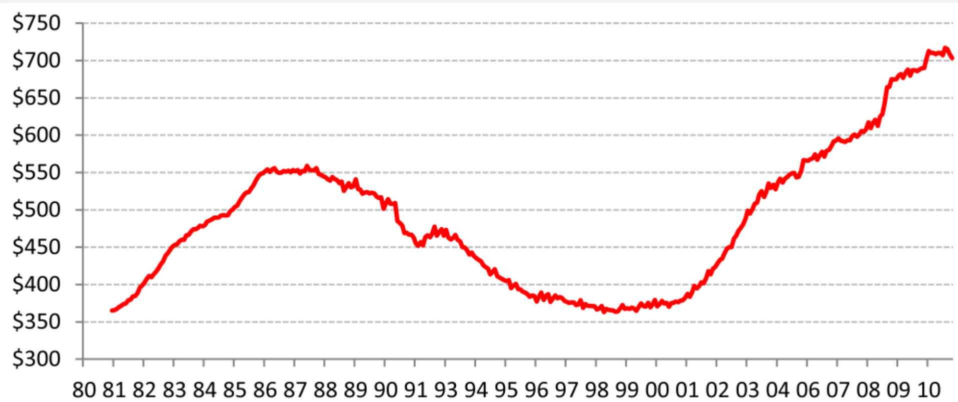
Department of Numerology

The all-time high for spot gold was reached on Monday at 1575.79. This is just 27¢ off the all-time high for the S&P 500 at 1576.06 on October 11, 2007.

- What about gold? There's a case to be made that gold's secular bull market -- which has roughly coincided with oil's -- has been motivated by the same geopolitical risk premium. We can't rule that out at least as a contributing factor, but we really don't think it's the dominant driver for gold as it is for oil. We continue to see gold as predominantly a reflection of reflation and reliquefication. With that in mind, we've been saying for quite a while that the main bull case for gold is gone (see "Gold is a Hold" December 20, 2010), with our forecast that the Fed is unlikely to have to execute further quantitative easing after QE2 is complete in June. At his press conference last week, Ben Bernanke made it official (see "On the April FOMC" April 27, 2011). So we're now on the second-best bull case for gold -- simply that the Fed fails to promptly withdraw QE2's liquidity and raise rates as the economy continues to recover, embedding for real above-trend inflation that is now only a fearful possibility. Gold is going to have to go through the anticipated speculative correction now -- but once that plays out, we still ultimately expect high prices.

US defense spending
USD billions, 2011 dollars, trailing 12-months cumulative



Source: US Treasury, TrendMacro calculations

Bottom line

The anticipated speculative reaction in commodities and energy is upon us. The death of Osama bin Laden may have been the catalyst, signaling the possible end to the secular geopolitical risk premium in oil that has obtained since the War on Terror began in 2001. For other commodities, global growth and reflation continue to underpin a durable bull case. The equity risk premium has been elevated since Congress gave Bush Iraq war powers. If Osama bin Laden's death means the end of the War on Terror, reduction in the equity risk premium would mean significantly higher stock prices. There could be a significant peace dividend, a substantial aid in US deficit reduction. Just rolling defense spending back to its level at the peak of the Reagan build-up would save $144 billion annually.