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MACROCOSM

Oil Melts Up, Too

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Just like last year, stocks march higher despite fears of a geopolitical oil shock.

The Brent crude oil spot price has risen almost all the way back to last April's high at $128.04 (though in real terms, it would have to rise to $130.01). Yet the slow-motion melt-up in stocks seems unperturbed. It's the same as last year, when stocks rose right along with crude oil. When stocks finally began last May what would turn out to be a deep correction, it *wasn't* triggered by the oil price -- crude prices had already begun to correct three weeks *before* stocks finally did. Stocks are probably due for a rest here anyway, but apparently an oil price shock of the magnitude, duration and cause of last year's -- and this year's so far -- is not really all that shocking.

- As last year, the oil price now is driven by geopolitical risk. Brent crude is now highly correlated to the market-implied probability -- today at 40% -- that the US or Israel will strike Iran to interdict its nuclear weapons capability (please see the chart below).

Update to strategic view

US STOCKS, OIL, US MACRO: Exactly as a year ago, the oil price is rising on geopolitical fears, and stocks are melting up despite it. Stocks deserve a rest in any case. But without a destabilizing military event in Iran, we don't see this move in oil as enough to constitute a "shock" deserving a serious correction, or driving deep economic consequences.

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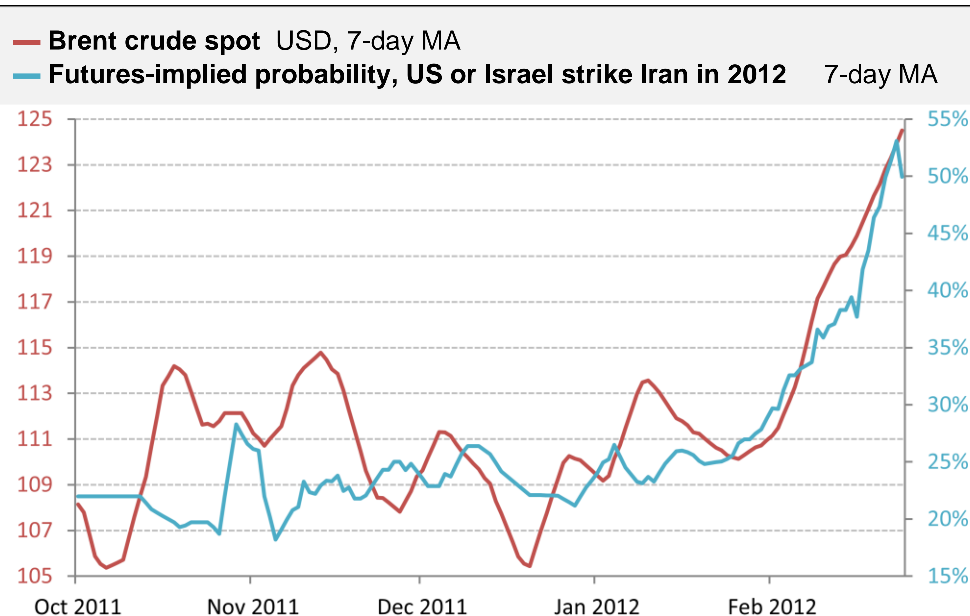

Source: Bloomberg, Intrade

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From first principles we can argue that if we must flirt with an oil shock, this is the kind of flirtation we want to have.

- It's only a geopolitical risk, not yet a military reality. There are no actual shortages, only precautionary hoarding. So if the risk passes without eventuating, that hoarding will be quickly unwound and prices will just as quickly fall.
- It's just political. That is, it's not because we've run out of oil, nor because end-user demand has suddenly become disproportionate.
- So far the *domestic* political reaction has not been unconstructive. In a speech this week, President Obama called for an "all of the above" energy policy, including expanded exploration and production -- shamelessly, or perhaps just unconsciously, borrowing the slogan used for many years by Republicans to embrace more drilling.
- It's unhelpful that the global economy is struggling to emerge from the Great Recession with the highest real crude oil prices in history (on an annual average basis; please see the chart below). No matter how energy-efficient the world becomes, it would always be better at the margin if oil were cheaper and we could use more of it.
- We've argued that high oil prices contributed to the US growth disappointment in the first half of last year (see "Footprints of the Black Swans" June 30, 2011). Yet it's devilishly difficult to find strong statistical correlation between growth and energy prices, period-to-period. What stands out clearly from the data is that the effect of the oil price is *non-linear* -- that is small, orderly changes don't seem to matter, but *shocks* can definitely cause recessions (see "An Oil Shock Tipping Point?" March 3, 2011).
- For a recession-causing shock, the oil price move must be some combination of large, unprecedented, sudden and long-lasting. For example, in mid-1990 in the run-up to the first Iraq war, the oil price

Real crude oil price January 2012 dollars
1861-2011: annual average; 2012: current price

Source: BP, TrendMacro calculations

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almost tripled over just four months, going to a new all-time high (in nominal terms). The present move in oil doesn't qualify.

- The economic backdrop probably matters, too. An economy running at full capacity is very vulnerable to *any* shock. But an economy like ours, with an historically large output gap, should be resilient to supply shocks because demand is so weak (see "Testing 1, 2, 3" September 7, 2011).
- With growth so sluggish (yes, we've seen the drop in new claims, but forward earnings remain stalled since late August and earnings reports continue to disappoint -- see "Can Stocks Keep Melting Up?" February 10, 2012), we already see risk that the US economy could gently degenerate into something that could qualify technically as a recession. Higher oil prices might make it so, if it wasn't baked in the cake already. But without a true oil *shock*, a recession of this type would be gentle and brief.

The present slow-motion melt-up in stocks has been driven by the generationally extreme undervaluation from which the move started, back when we called the bottom last October (see "Europe Fails, US Stocks Flail" October 4, 2011). As fears of a global systemic credit hard-stop emanating from Europe have gradually receded, that deep undervaluation has begun to heal (see "Risk Reappraisal" January 20, 2012). Now, after a 24% gain in the S&P 500, stocks remain cheap relative to crisis-era standards, which are themselves cheap in a broader historical context. So the question here is simple, yet indeterminate:

- The slow-motion melt-up can continue -- with the usual pauses and small corrections -- If oil prices remain as high as they are now while tensions with Iran remain. They are not a *major* penalty on an already sluggish economy. Stocks haven't been betting on growth anyway, in our view -- rather, merely recognizing the withdrawal of systemic risk arising from Europe.
- Obviously, if tensions with Iran escalate into a military event, then all bets are off. We have no inside information on whether or when that might happen, or how it would play out. We can easily imagine horrific versions of it, but also versions that would be quite beneficial to the long-term stability of the region.
- That said, we note that fears about Iran have arisen just as fears about Europe have receded. As we survey market chatter, and as we talk to clients, we get the impression that the investment community is now so accustomed to being afraid, that when one threat is taken off the table another is all too easily adopted to replace it.

Bottom line

Exactly as a year ago, the oil price is rising on geopolitical fears, and stocks are melting up despite it. Stocks deserve a rest in any case. But without a destabilizing military event in Iran, we don't see this move in oil as enough to constitute a "shock" deserving a serious correction, or driving deep economic consequences.