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Market Facts

Revisiting The Federal Reserve And Crude Oil After The Collapse

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We concluded a July Market Facts on the relationship between crude oil prices and monetary policy:

> *If there is a connection between monetary policy and crude oil, it may come on the income elasticity side: Monetary stimulus led to increased consumer demand in the U.S. and elsewhere, which was satisfied by Chinese and other producers who demanded more energy in the process. Otherwise, the argument can be dismissed out of hand.*

This same conclusion was reaffirmed in our most recent Commentary.

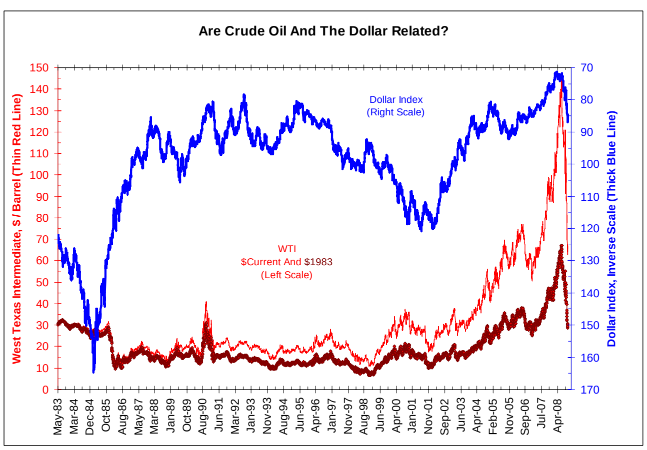
We noted in that same July Market Facts that crude oil prices had risen 50% and the dollar index had fallen 5.2% since a previous observation. As crude oil prices have declined close to 55% since mid-July and the dollar index has risen 17.6% over the same period, we should revisit the question of whether higher crude oil prices are attributable to monetary policy.

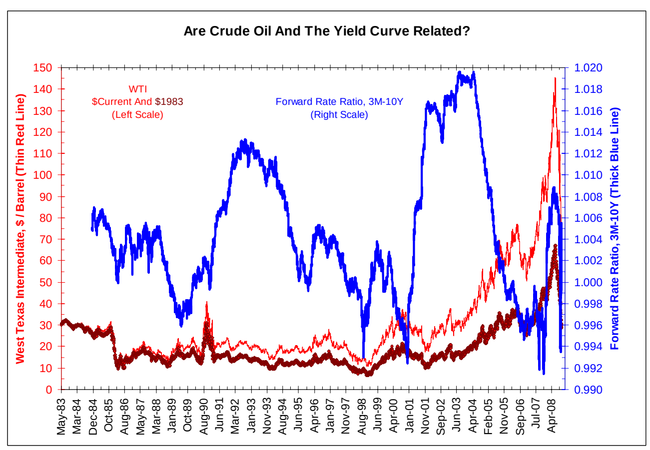
This asymmetric gearing suggests those who had equated crude oil price strength with dollar weakness were guilty of small-sample misinterpretation.

The long-term comparison between crude oil expressed in either current or constant 1983 prices (thin and hatched red lines, respectively, both charts) and the dollar is statistically unstable over time. Of course, traders always have a decision whether to be profitable in their execution or to be correct in their analysis, and there is no doubt trading crude oil and the dollar/euro exchange rate as if they were linked causally was profitable after August 2007.

The same observation applies to a map against the forward rate ratio between three-month LIBOR and ten-year Treasuries (thick blue line, right-hand chart). The action in the yield curve since 2001 has included two violent steepenings, an equally pronounced flattening and now a sudden steepening. A casual observer might conclude monetary policy is being made and re-made on a daily basis, perhaps hourly.

The break in crude oil prices in July occurred six weeks after the June flattening of the yield curve. The yield curve began to re-steepen three weeks ago; if all we need to trade crude oil successfully is this yield curve, we should look for higher crude oil prices by Thanksgiving.





Conclusion

Even though crude oil prices may have exhibited some modest correlation to both the dollar index and to the yield curve since July, the simplest explanation is all three measures were affected by the global financial crisis far more than they affected each other. The crisis led to a drop in industrial demand, to a closure of dollar carry trades and to abrupt changes in monetary policy simultaneously and has led to coincidental correlation.

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