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Commentary

Market Opinions and Topics of Interest

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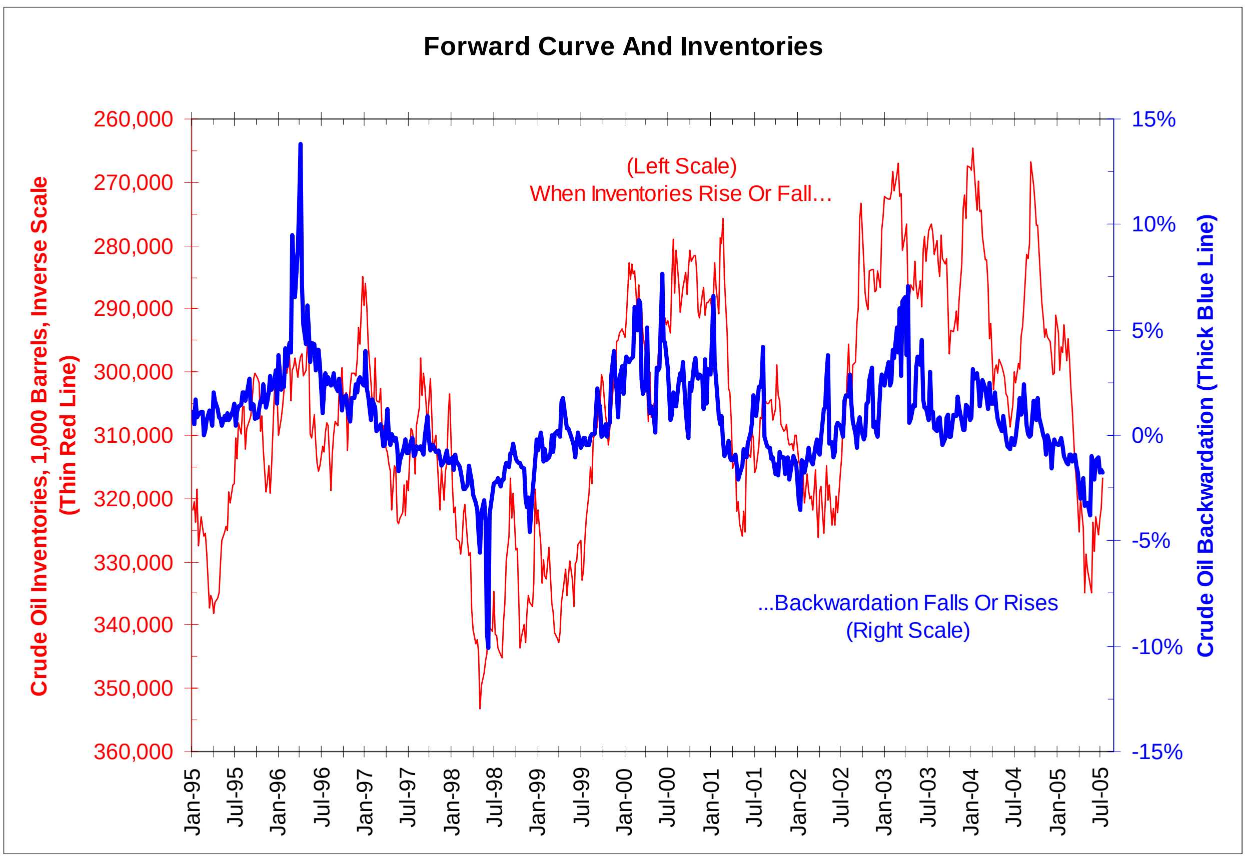
Where Was The Damage From Higher Crude Oil?

Comedians always can get a laugh with a rubber chicken. Economists in need of something to debunk always can point toward the non-relationship between crude oil prices and changes in the weekly inventory numbers. We did this ourselves, most recently in a May Market Facts. But neither futures nor cash commodity markets are inventory scorecards any more than fixed-income markets are spasmodic reactions to the latest economic datum.

Even in the case of inventory levels (thin red line, plotted inversely), the most important impact is not on flat price so much as on the forward curve (thick blue line).

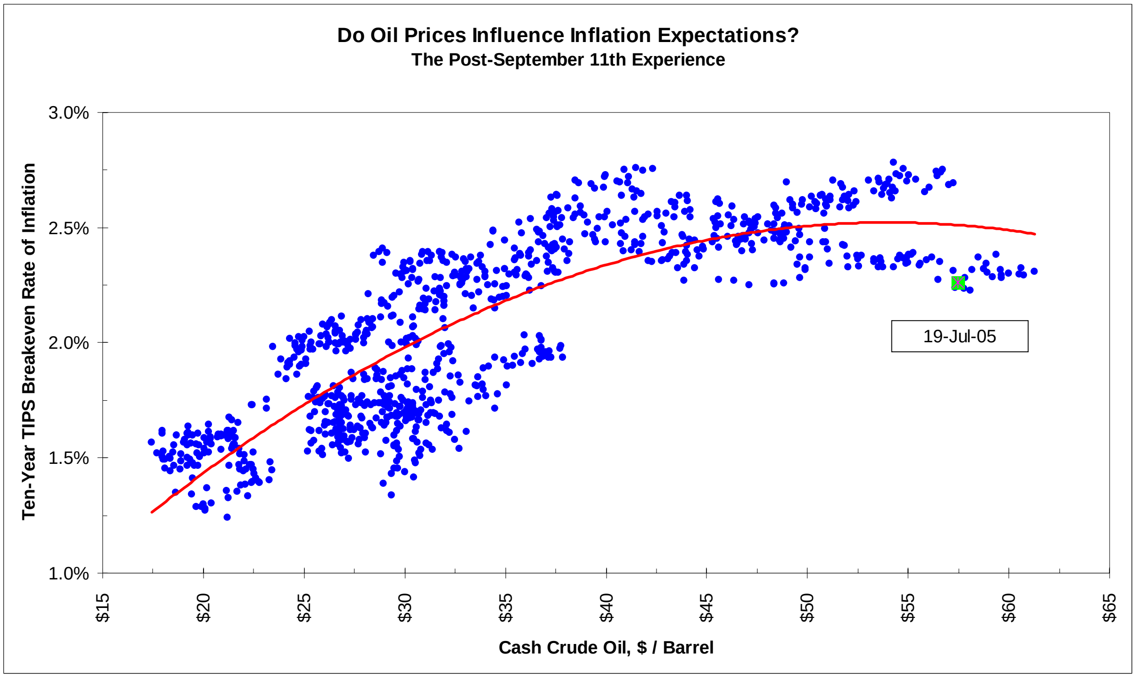
We are approaching a critical juncture in the long-term bull market for crude oil prices. Several internal oil market indicators, last reviewed in a February Commentary, are pointing toward an emerging downturn in price. These will be updated in a successor Commentary to this one. Given the experience of the last two years of this bull market, one which began in February 1999, should we look for unalloyed benefits in financial markets, or will the outcome be non-definitive?

The recitation below, built on a market-by-market basis, drives toward the non-definitive conclusion.



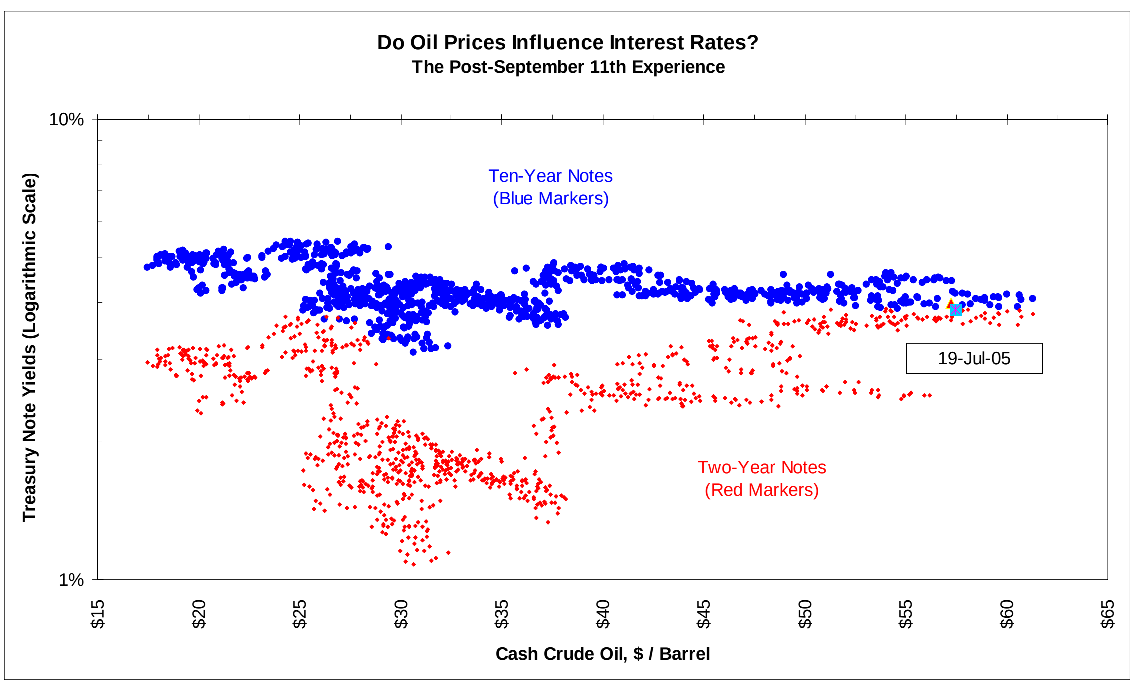
Where Was The Damage?

The notion that higher oil prices would not be dangerously inflationary would have been heretical only a few years ago. Yet inflationary expectations as measured by the ten-year TIPS breakeven rate of inflation began to level off once crude oil prices began their ascent over $40 per barrel, as seen in the scatter diagram below. **The most rapid climb in inflationary expectations occurred before, not after, the biggest jump in crude oil prices.**

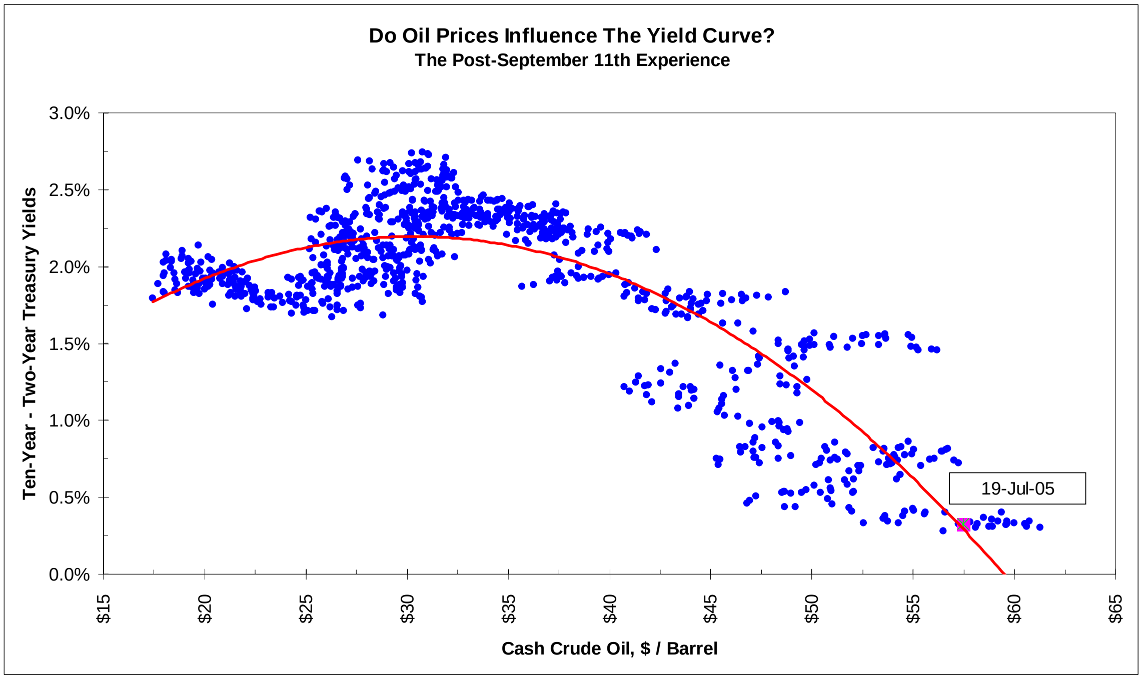


Interest Rates, Yield Curves And Spreads

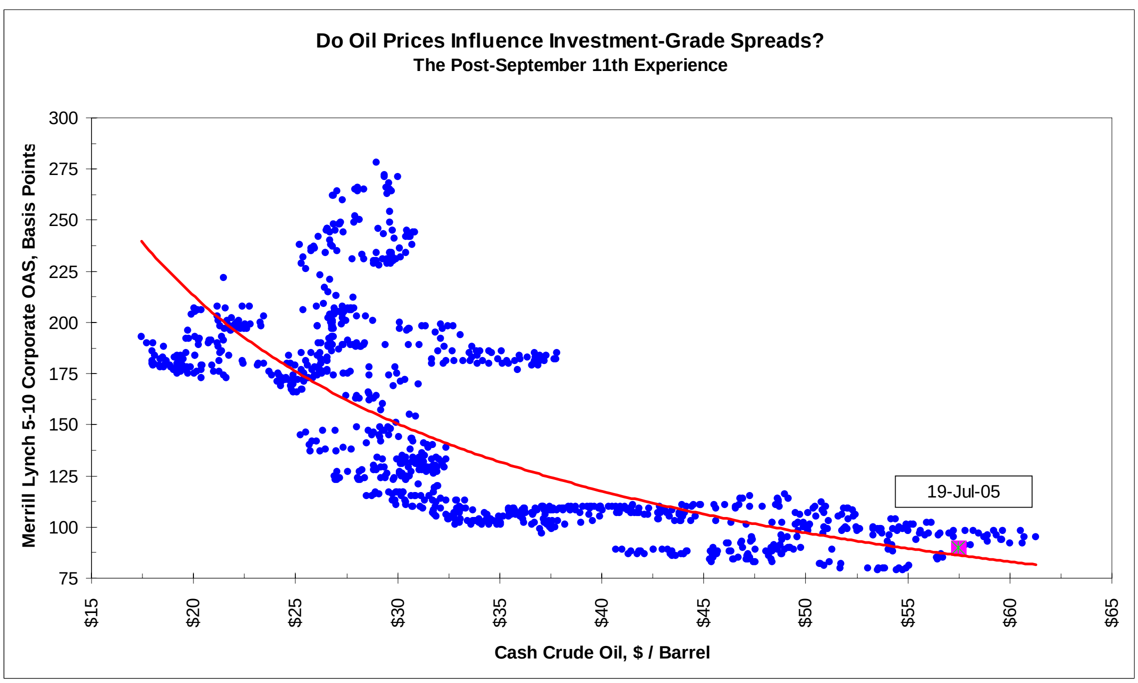
As inflationary expectations are an important part of nominal interest rates, it should stand to reason that crude oil prices have had little effect thereon. This is demonstrable, especially at the long end of the curve (blue markers), the maturity we should expect to be most sensitive to inflation. The relationship here is non-existent. The yield on two-year notes has increased with higher crude oil prices, but this is attributable to monetary policy, not to anything related to oil prices.

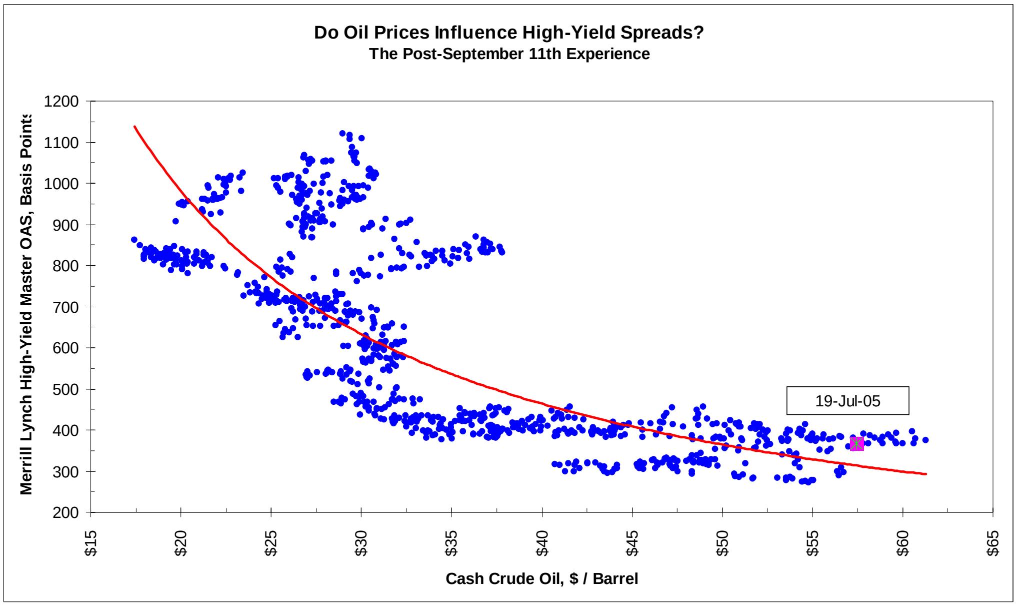


The notable flattening of the yield curve alluded to above has accelerated in the higher crude oil price environment. If, as is widely supposed, a flatter yield curve reflects expectations for some combination of lower interest rates and lower inflation – naïve conceptions often honored in the breach, we might add – **the flattening of the yield curve in a rising crude oil price environment should be interpreted as disinflationary.**



If higher crude oil prices act as a tax – and this ignores last year's sophistry of whether they are a true tax or not, something to contemplate the next time you fill up the family chariot – we should expect them to damage corporate balance sheets. And if balance sheets deteriorate, credit quality and corporate spreads should follow. However, this is not observable at either the investment-grade level as measured by the Merrill Lynch 5-10 years corporate bond OAS (immediately below) or at the high-yield level as measured by the Merrill Lynch High-Yield Master OAS (following page). In fact, the trend toward lower spreads accelerated when prices moved out of the upper $20 range. **Our instincts tell us this is spurious correlation, not causality, but if the observations above are confirmed by equity prices, we may have to trust our numbers more than our judgments.**



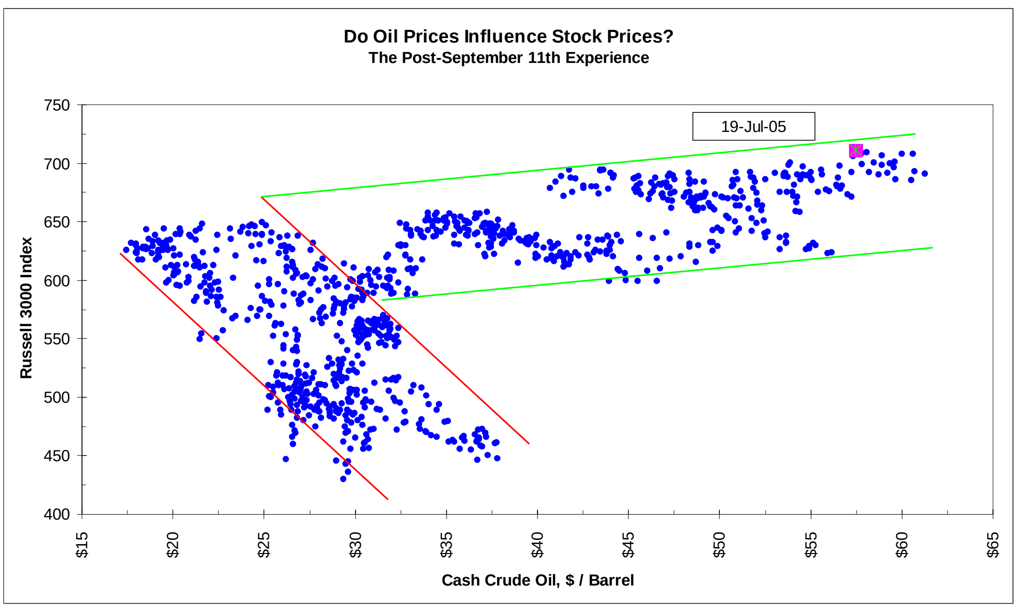


The Equity Connection

We observed in an April Commentary how higher corporate bond OAS levels and CDS costs spill over into the equity market. This is intuitive; barring an event favoring shareholders over creditors such as a leveraged buyout, no one should be willing to take a greater risk on a stock when the associated bonds' credit quality is declining. And as noted later in a May Commentary, we often can define lower CDS costs as a condition precedent to a stock rally.

If all of the negative effects posited for higher crude oil prices are true, then they should dampen profit growth and raise the discount rate at which these diminished profits are valued. This is not observable, which leads us to conclude that either higher crude oil prices either improve stock valuations or that better business conditions are associated with both higher stock prices and higher crude oil prices. Given the resilience of the global economy in general and the American economy in particular in recent years, we prefer the latter explanation.

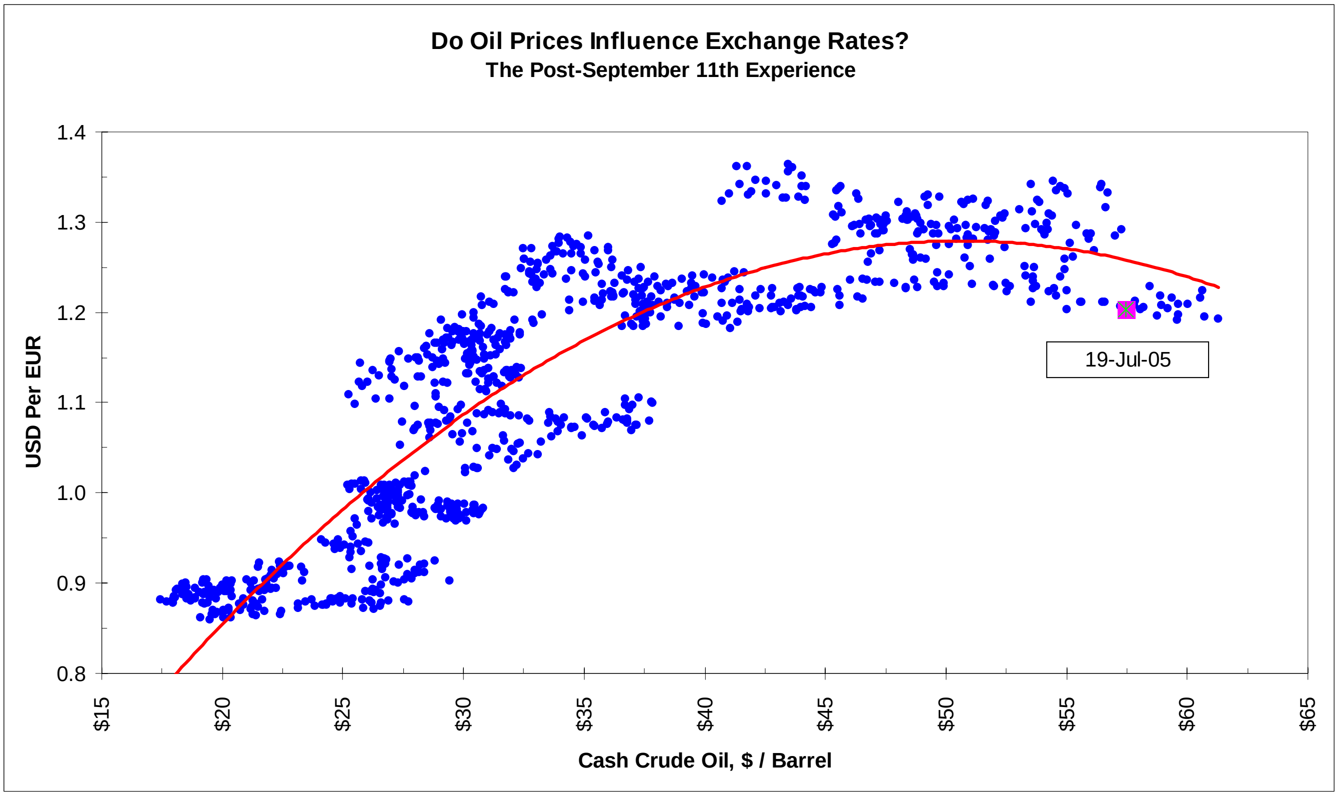
A scatter diagram of the broad American equity market as represented by the Russell 3000 shows two distinct phases in its relationship to crude oil prices. The first, bounded by downward-sloping red channel lines, occurs between September 2001 and March 2003. The second, bounded by upward-sloping green channel lines, occurs after April 2003. This latter relationship, enduring for more than two years, presumably is why bullish television reports highlight crude oil prices for concerned investors.



Oil And The Dollar

The parallel bull markets between the euro and crude oil convinced many of a causal connection to go along with the correlation. In fact, as we noted all the way back in a November 2004 Commentary written while both bulls were in full rut, their link came at the causal level: Monetary stimulus in the U.S. maintained world economic growth and increased the supply of cheap-to-borrow dollars.

As a result of this causal link, the relationship of the dollar/euro rate to crude oil prices is strikingly similar to the relationship between TIPS breakeven rates of inflation and the dollar. Both are the products of monetary policy, and nothing more. The last surge higher in crude oil prices coincided with the downturn in the euro.



Conclusion

The fear of higher oil prices is deep-seated in our culture. Attempts to explain it rationally are pointless; it just is. For this reason, a little tour around the major financial markets can be instructive. The climb to previously unthinkable price levels in crude oil prices has been accompanied by stable inflationary expectations, stable long-term interest rates, declining credit spreads, a flattening yield curve that has yet to choke off economic growth or produce a catastrophic de-leveraging in the credit markets, stock prices at a four-year high and an American economy that is still the world's most important.

Sometimes a question posed in the negative drives best to the heart of the matter. Are markets better off now than they were four years ago? Yes. Would you trade present markets for those of 2002 if it meant crude oil in the $20s again? No. Then should we obsess over present levels and automatically associate any downturn with a better state of affairs? No.

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