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Commentary

Market Opinions and Topics of Interest

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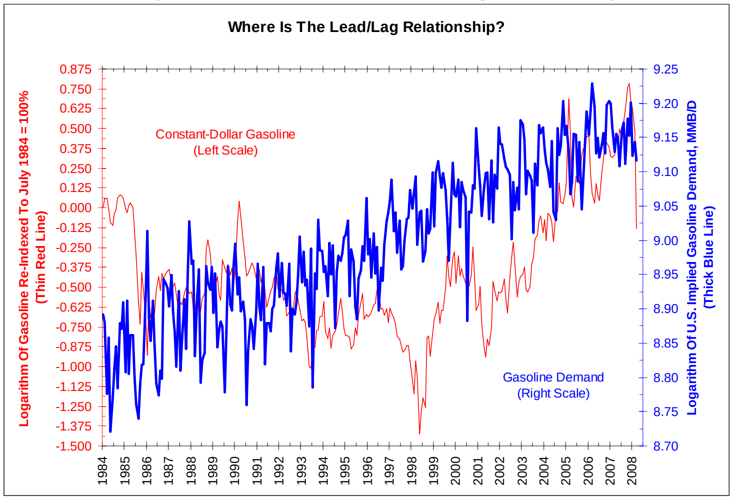
Gasoline, Productivity And Inflation After The Downturn

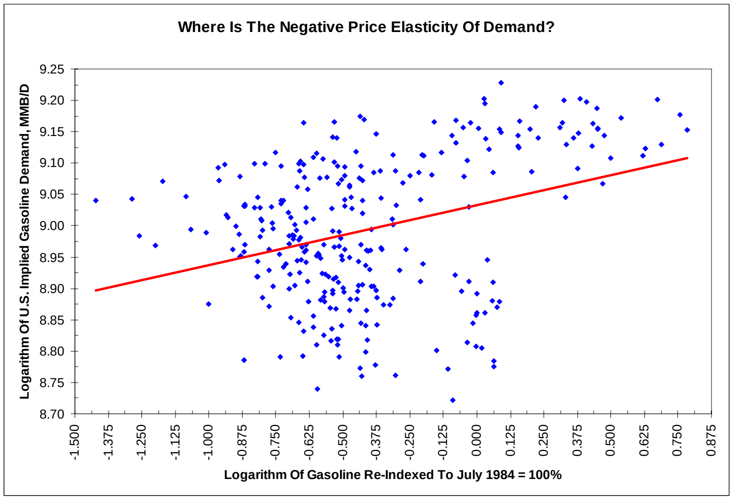
Much has changed since our May Commentary on gasoline expenditures, inflation and productivity. That document was written when crude oil was at $125, roughly twice the recent price level, and one week before global equities reached their post-Bear Stearns high. Global growth was still strong, investment banks were still walking the earth and Benjamin Bernanke was three weeks away from threatening to raise interest rates to combat still-rising inflation.

While vehicle-miles declined 5.6% in August from year-ago levels, a significant level to be sure and one consistent with declines in the 1974-1975 and 1980 recessions, it is important to remember prices are affected not by vehicle-miles but rather by total volumetric demand. We repeat from May (original boldface):

> ***If we index constant-dollar gasoline prices to July 1984 levels and map the logarithm thereof (thin red line, left-hand chart) against the logarithm of implied gasoline demand (thick blue line), we see total gasoline demand has risen higher in an erratic fashion for almost a quarter-century independent of price.***

If price elasticity of demand was operating as designed, we would see a negative trend in the scatter diagram (right-hand chart). **The trend is erratically positive. The partial contribution of price to total demand may be negative, but it is being overwhelmed by income- and engineering-related factors. Both continue to support our original thesis that gasoline demand can rise independently of price so long as the economic value added by its consumption exceeds the total cost paid.**

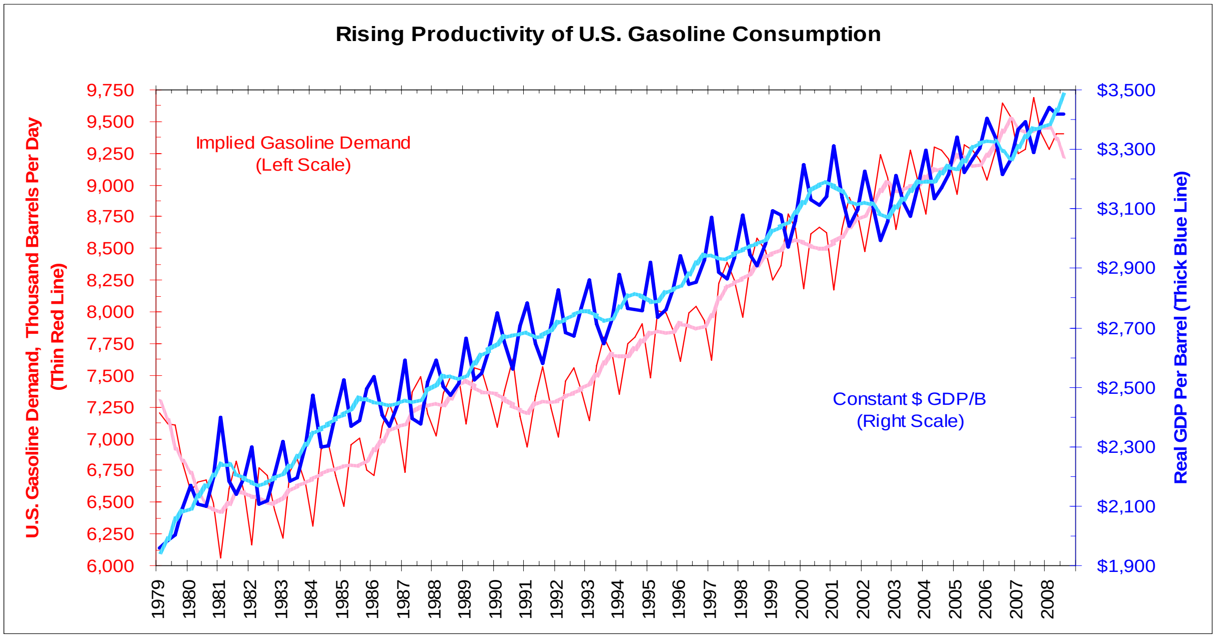




Productivity

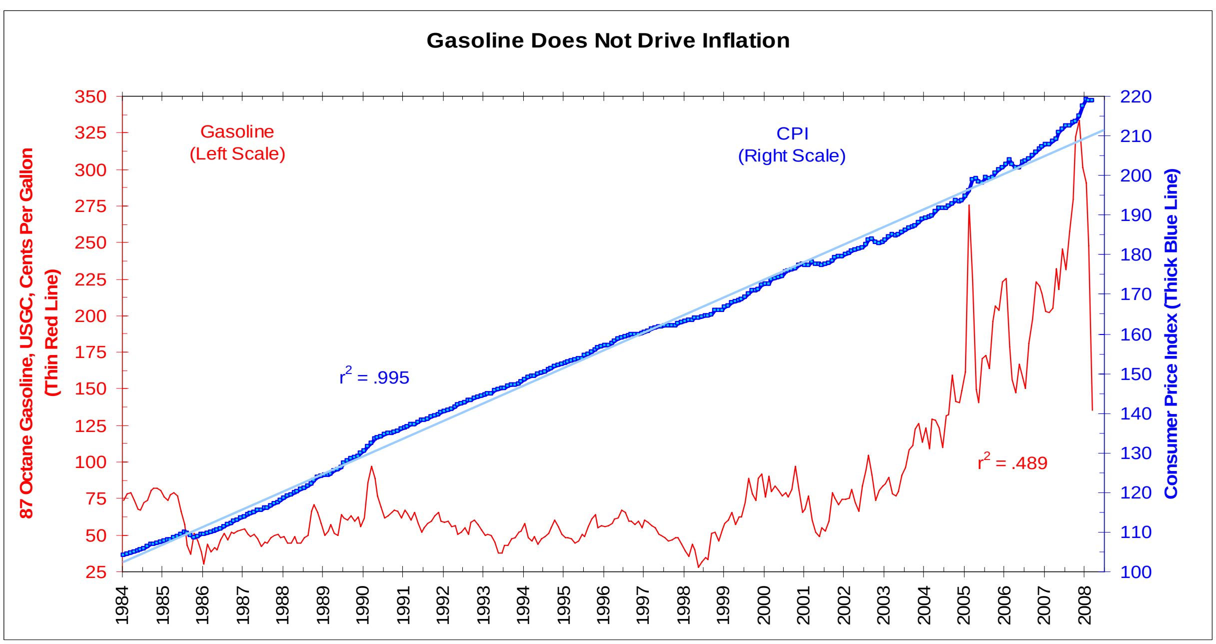
Implied gasoline demand (thin red line, following page) fell 3.0% from year-ago levels in the third quarter; on a seasonally adjusted basis (light red line), it fell 2.2%. Constant-dollar GDP per barrel of gasoline consumed (thick blue line) has declined 0.64% before seasonal adjustment and is at a record high after seasonal adjustment (light blue line).

This much seems clear: The U.S. and indeed the global economy were able to absorb higher petroleum prices without crisis; they have been unable to absorb the credit crunch with similar equanimity. Any decline in petroleum demand produced by the credit crunch and its income effects will exceed that of higher prices.



Gasoline And Inflation

We note, as before, how a simple timeline is more than twice as robust as an explanatory variable for the Consumer Price index (thick blue line) as are wholesale gasoline prices (thin red line); the comparative r^2 values are .995 and .489. **As gasoline prices have been rising for nine years and the CPI only recently has moved over trend, we still find gasoline prices a poor metric for the CPI.** Of course, this may say more about the CPI's construction than about the impact of gasoline prices on household budgets.

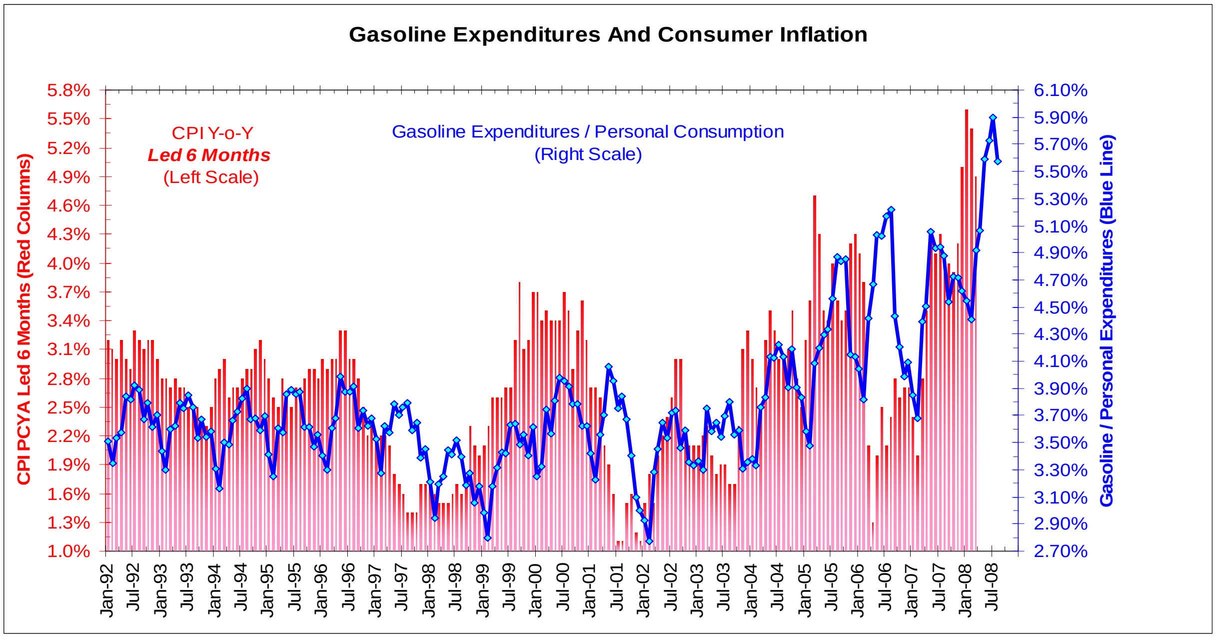


The Consumption Link

If we blend the rising consumption noted above with the rising price, we must get rising total consumer expenditures for gasoline. We can proxy this effect by taking retail sales at service stations as a percentage of total personal consumption (thick blue line, following page). It leads year-over-year changes in the CPI (red columns) by six months on average.

The last datum is for September. We noted in May that if gasoline continued to claim a larger share of consumer budgets in April and May, which occurred, upward pressure on the CPI would result, which also occurred.

The recent drop in gasoline prices is still too short-lived to have produced any material changes in consumer budgets yet; once again, consumer spending is going to be affected much more by the incipient recession and destruction of household wealth than it is by gasoline prices. **If all trends currently observed persist, we should see downward pressure on the CPI through the first quarter of 2009.**



Conclusion

One of the precepts of behavioral finance is pain and pleasure produce highly asymmetric effects; the pain of loss is roughly three times as great as the pleasure of gain. Investors also have a hypertrophic sense of entitlement; gains are supposed to happen while losses are not. Journalists, we can attest, are far less curious about 900-point gains in the Dow Jones Industrial Average than they are about 500-point losses.

The treatment of petroleum prices in general and gasoline prices in particular is consistent with these observations. We have written a series of Market Facts noting the positive partial contribution of crude oil prices to the S&P 500, and others noting the weak and unstable contribution of energy prices to inflation expectations, and it is safe to say neither statistical demonstration has been embraced wholeheartedly.

We were asked many times during the September 2007 – July 2008 doubling of crude oil prices what it would take to bring them back down and we answered consistently, “A global recession.” Lower gasoline prices are of small solace in this context, ranking just above a 2% dividend yield on a stock whose price has fallen by 50%.

When the economy recovers, the long-term bull market in energy prices will return and will not derail that recovery so long as the economic value added by energy purchases exceed their total cost.

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