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# *Special Report*

June 2008

## Petroleum and Credit Markets

June 12, 2008 Conference Call
(This transcript has been edited)

James A. Bianco, President, Bianco Research: Good morning, everybody. This is Jim Bianco. Welcome to our monthly Conference Call.

### Summary/Conclusion

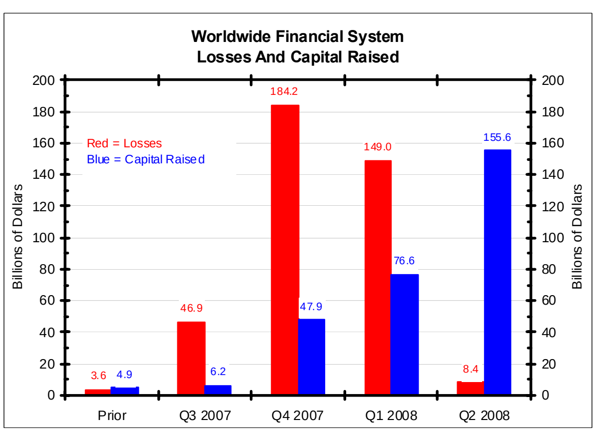
Today's presentation is "Petroleum and the Credit Markets." As is usually our case, we try to find topics that we have been discussing, to try and fill them in a little bit that happen to be topical. And credit markets and what has been happening with gasoline prices have been right at the top of the list. The structure for today's Conference Call is that I will speak for about 10 or 15 minutes about the credit markets. And I have Howard Simons on the line us, too, from our office, and he will talk a little bit about petroleum and the gasoline markets afterwards. So let me get started with this on Page 2 and at least run through what has been happening in the credit markets as of late.

### Banking Losses And Capital Raised

**Worldwide Financial System Losses and Capital Raised**
As of June 10, 2008
In Billions of Dollars

| | Total | | Q2 2008 | | Q1 2008 | | Q4 2007 | | Q3 2007 | | Prior | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Losses | Capital | Losses | Capital | Losses | Capital | Losses | Capital | Losses | Capital | Losses | Capital |
| America | 170.6 | 153.8 | 8.4 | 71.8 | 65.6 | 49.8 | 69.6 | 31.4 | 26.3 | 0.8 | 0.7 | 0.0 |
| Europe | 200.5 | 127.9 | 0.0 | 77.8 | 80.8 | 23.3 | 101.4 | 16.5 | 15.4 | 5.4 | 2.9 | 4.9 |
| Asia | 21.0 | 9.5 | 0.0 | 6.0 | 2.6 | 3.5 | 13.2 | 0.0 | 5.2 | 0.0 | 0.0 | 0.0 |
| Worldwide | 392.1 | 291.2 | 8.4 | 155.6 | 149.0 | 76.6 | 184.2 | 47.9 | 46.9 | 6.2 | 3.6 | 4.9 |

Source: Bloomberg




"Banking losses and capital raised" is what is on Page 2. This is a table that we constantly use. I still maintain that it's one of the more important measures of trying to assess what has been happening in the financial system.

As of June 10, the last update that we have, if you look at the table on the left, or if you look at the chart below it, both of them show the same information, whichever is your fancy. We have \$392 billion that has been written off by the Financial System since the third quarter of last year. They have raised \$291 billion. So their net down is still around \$100 billion. As we have been saying, the typical financial firm – typical – is levered about 14:1, some more and some less, but, on average, about 14:1. That means that, roughly speaking, there is about \$1.4- to \$1.5 trillion less available in lending then there was a year ago. The financial system is shrinking.

Not only is it shrinking in terms of capital, but it's also shrinking in terms of deleveraging. The deleveraging numbers are very difficult to get a handle on. For instance, this week, Lehman Brothers did proudly announce that they have deleveraged from 32 times to 25 times. Yet Merrill Lynch also reported this week that they are not going to tell anybody their leverage ratio. That's their business, not ours. And that is the problem with getting a handle on the deleveraging. There are gross leverage numbers that we can look at. But there are problems with the gross leverage numbers that make them highly suspect to drawing any big meaning from them. But, beyond that, on a firm-by-firm basis, they are not going to tell us what they are doing. So the financial system continues to shrink.

One of the big problems – and this gets to the news today – is that only \$291 billion has been raised against \$392 billion in losses. One of the things that we have found is that, as financial firms lose money, their shareholders get mad at them. But they view losses as a temporary thing because you can always talk about, "That's it. It's a loss. We're going to move forward. There won't be any more losses. Maybe there will even be write-ups when things get better." You raise money, and you lose your job. And that seems to be the case over and over again, all the way to today's news with Joe Gregory and Erin Callan losing their jobs at Lehman Brothers, not surprisingly four days after a 30% dilution in the stockholders of Lehman.

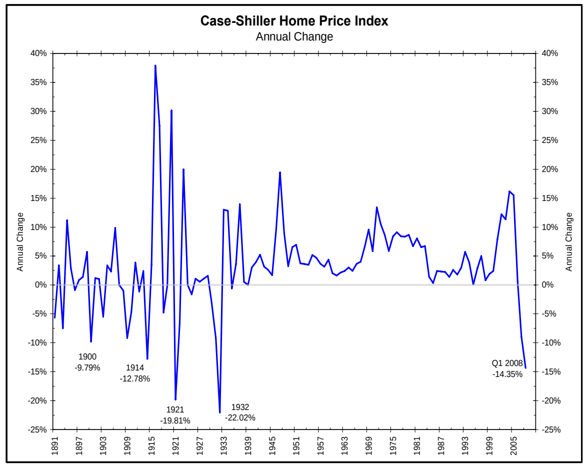
That is one of the problems, I think, that we face here as far as raising capital is concerned, which is that it is a career-ending decision in many cases to raise capital. That is why a lot of firms have been very difficult to do it. It is not a career-ending decision to report losses.

**Total Banking System Losses & Capital Raised**
As of June 10, 2008
Billions of U.S. Dollars

| Firm | Loss | Capital Raised | Difference |
|---|---|---|---|
| Citigroup | 42.9 | 44.1 | 1.20 |
| UBS | 38.2 | 29.0 | (9.20) |
| Merrill Lynch | 37.1 | 17.9 | (19.20) |
| HSBC | 19.5 | 3.5 | (16.00) |
| IKB Deutsche | 15.9 | 13.1 | (2.80) |
| Royal Bank of Scotland | 15.2 | 24.0 | 8.80 |
| Bank of America | 15.1 | 20.0 | 4.90 |
| Morgan Stanley | 12.6 | 5.6 | (7.00) |
| JPMorgan Chase | 9.8 | 7.8 | (2.00) |
| Credit Suisse | 9.6 | 1.5 | (8.10) |
| Washington Mutual | 9.1 | 12.1 | 3.00 |
| Credit Agricole | 8.2 | 9.1 | 0.90 |
| Lehman Brothers | 8.2 | 13.9 | 5.70 |
| Deutsche Bank | 7.6 | 3.2 | (4.40) |
| Wachovia | 7.0 | 10.5 | 3.50 |
| HBOS PLC | 7.0 | 7.8 | 0.80 |
| Bayerische Landesbank | 6.7 | 0.0 | (6.70) |
| Fortis | 6.6 | 1.0 | (5.60) |
| Canadian Imperial (CIBC) | 6.5 | 2.9 | (3.60) |
| Barclays | 6.3 | 9.7 | 3.40 |
| Societe Generale | 6.2 | 10.1 | 3.90 |
| European Banks Not listed | 6.1 | 2.1 | (4.00) |
| Mizuho Financial Group | 6.0 | 0.0 | (6.00) |
| ING Groep | 6.0 | 3.1 | (2.90) |
| West LB | 4.9 | 7.7 | 2.80 |
| LB Baden Wuerttemberg | 4.0 | 0.0 | (4.00) |
| Dresdner | 3.4 | 0.0 | (3.40) |
| Natixis | 3.4 | 0.8 | (2.60) |
| Etrade | 3.3 | 1.8 | (1.50) |
| Wells Fargo | 3.3 | 4.1 | 0.80 |
| Bear Stearns | 3.2 | 0.0 | (3.20) |
| National City | 3.1 | 8.9 | 5.80 |
| Goldman | 3.0 | 0.0 | (3.00) |
| Other Asian banks (excluding Mizuho, Nomura) | 2.8 | 0.6 | (2.20) |
| Lloyds TSB | 2.7 | 0.0 | (2.70) |
| BNP Paribas | 2.7 | 0.0 | (2.70) |
| Landesbank Sachsen | 2.7 | 0.0 | (2.70) |
| HSH Nordbank | 2.5 | 0.0 | (2.50) |
| DZ Bank | 2.5 | 0.0 | (2.50) |
| Nomura Holdings | 2.4 | 1.2 | (1.20) |
| ABN Amro | 2.4 | 0.0 | (2.40) |
| Other Canadian banks (excluding CIBC) | 2.4 | 0.0 | (2.40) |
| Bank of China | 2.0 | 0.0 | (2.00) |
| Commerzbank | 1.9 | 0.0 | (1.90) |
| Bank Hapoalim | 1.7 | 2.6 | 0.90 |
| Royal Bank of Canada | 1.6 | 0.0 | (1.60) |
| Mitsubishi UFJ | 1.6 | 0.0 | (1.60) |
| Unicredit | 1.6 | 0.0 | (1.60) |
| Alliance & Leicester | 1.4 | 0.0 | (1.40) |
| Other US Frims | 1.3 | 1.7 | 0.40 |
| Dexia | 1.3 | 0.0 | (1.30) |
| Caisse d'Epargne | 1.2 | 0.0 | (1.20) |
| Hypo Real Estate | 1.0 | 0.0 | (1.00) |
| Gulf International | 1.0 | 1.0 | 0.00 |
| Sumitomo | 0.9 | 3.1 | 2.20 |
| 21 Taiwanese banks | 0.9 | 0.0 | (0.90) |
| Rabobank | 1.7 | 0.0 | (1.70) |
| Sovereign Bancorp | 0.9 | 1.9 | 1.00 |
| Sumitomo Trust | 0.8 | 0.0 | (0.80) |
| Aozora Bank | 0.6 | 0.0 | (0.60) |
| DBS Group | 0.2 | 1.1 | 0.90 |
| Shinsei | 0.2 | 0.0 | (0.20) |
| **Total*** | **391.9** | **288.5** | (103.40) |

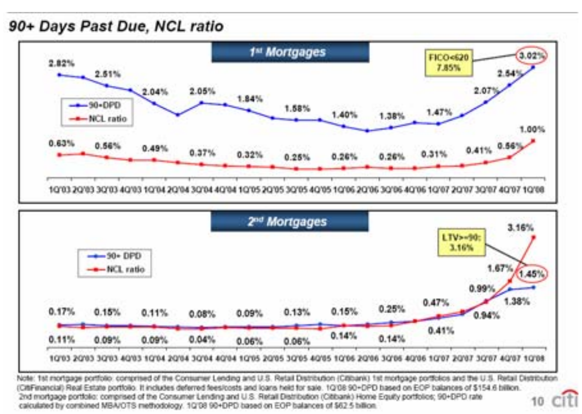
Source: Bloomberg L.P.

**Worst Home Market Since The Depression** Page 3 – the home price market continues to slump. This chart shows Case-Shiller on an annualized basis, and we spliced in the latest monthly data. It shows that, right now, by this measure, this is the worst home price market since 1932.




This is a market unlike any other market that we have seen. And there has been an argument that has been out there that I think that it's largely correct, and that is that the losses – the $392 billion-worth of losses – have largely been in the subprime area. A lot of that stuff has largely been written down. There is nothing left there to lose. So those losses should, then, try and moderate themselves, and we shouldn't see those losses continue. That I would agree with.

**2nd Mortgage Losses Skyrocket** But if you look at Page 4, this is data that comes directly from Citibank, their first-quarter investor presentation. Second mortgages, which also cover home equity loans, you could see that the losses there – at least the NCLs – the non-conformings – and the 90 days past due have been skyrocketing. From two years ago at 14 or 15 basis, we're up to 145 basis points or 316 basis points.




What this is suggesting is that as long as we are in the worst home price market since 1932, yes, the losses will continue. No, they won't continue in subprime. But they can continue in things like alt-A. They can continue in things like home equity loans. They can continue in other areas of the housing market. So we may not be past the losses.

Another good example of that happens to be, again, the story of the week. Lehman Brothers raised money in April. Their offering was oversubscribed in April. They had the opportunity to raise a lot more money in April but elected not to. When they were asked in their conference call earlier this week, "Why didn't you take the opportunity in April," their answer was, "We didn't think that we were going to have the losses, and it's only the middle of June." So they had no visibility beyond the next 60 days as far as the losses that they saw were concerned. So it's still more likely that those losses will continue, and the stigma with raising capital will continue as far as we go from there.

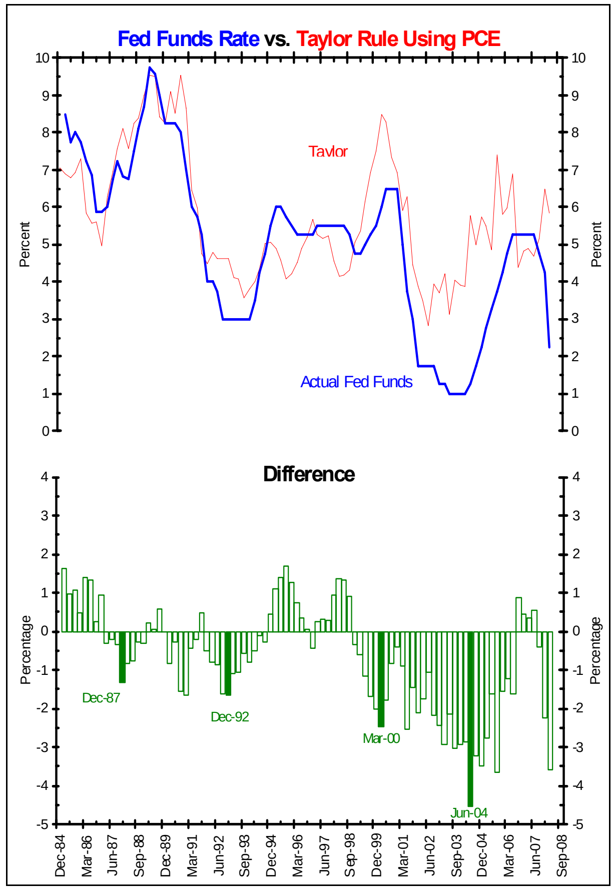
**The Federal Reserve Is Too Easy** Now, on Page 5, what I am trying to argue here in the first couple of pages is that the credit crisis is still with us. It never went away. It's changing its form, but the financial system is still under stress. Starting in August, the Federal Reserve started to respond to the credit crisis. The way that the Federal Reserve responded to the Credit Crisis – let's go back and remember what happened in August – is that they held a meeting on August 7 when the funds rate was at 5.25%. They decided that they didn't need to do anything. They held the Funds Rate steady at 5.25%. Jim Cramer yelled at them. Everybody said, "You have to do something about the credit crisis." And 10 days later, we had an intermeeting ease.

The market demanded that the Fed act. And the Fed listened to the market and followed its demands. That was largely what we saw throughout the fall. They eased 50 basis points in September. The FOMC Statement led us to believe that was it. "We gave you two 25 basis point cuts in September so we are going to hold." The market demanded that they do more, and they did more.

The market that they do more in December and they invented the TAF auction. The market demanded that they address the Monday of Martin Luther King holiday, when we thought that the Market was going to crash, and they cut 75 basis points. Then they cut another 50 basis points 8 days later. The market demanded of the Fed. And the Fed listened to the market and moved forward.

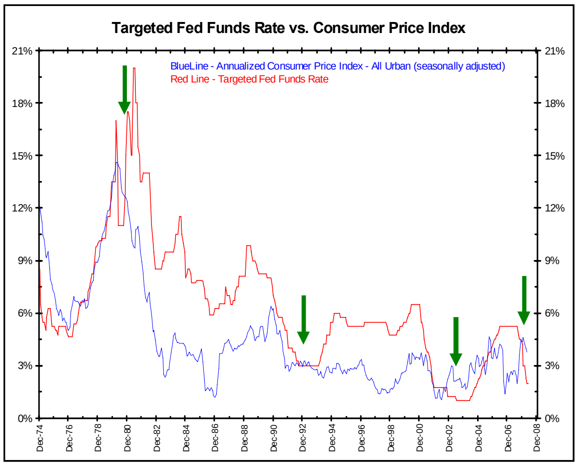
Throughout that entire period, there was – and I want to use the phrase – "no consequence" to what the Fed was doing. In other words, the Fed eased, the Fed invented a TAF auction, or a lending facility, and the market said, "This is good. You're dealing with the credit crisis." And that was the extent of it. But as we moved forward and starting in the last month or two, there has been a bit of a sea change.

First of all, looking at the charts on Page 5 – let me take the chart on the left, "The Taylor Rule" – John Taylor developed a rule for trying to determine what is the proper level for monetary policy.



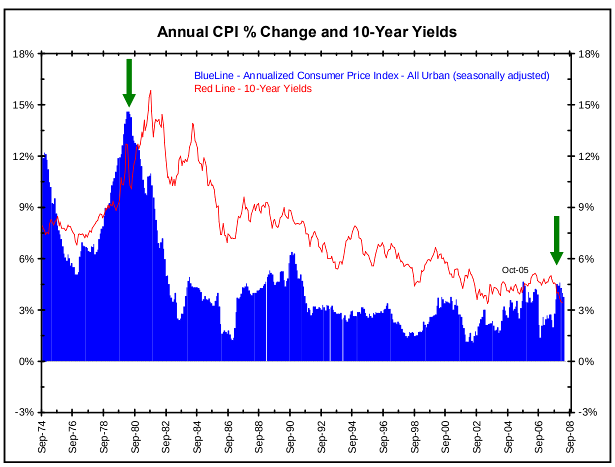

The actual funds rate is in blue. The Taylor Rule's suggested policy level is in red. It shows that, right now, the actual funds rate is 350 basis points below what the Taylor Rule would suggest. The divergence is shown as the bars on green below. That is one of the largest divergences that we have seen in the 20-plus years of data shown here.

The chart on the upper right shows the targeted funds rate in red. It shows the Consumer Price Index in blue, or the CPI in blue. And the green arrows point to every time that we have had a negative real funds rate, every time that the funds rate has been below the inflation rate: 1980, 1993, 2003, and now.




In the prior three periods – 1980, 1993, and 2003 – it has always ended badly. It has always ended with some kind of a crisis. Of course, in 1980, we had runaway inflation, and Volker had to eventually raise the funds rate to near 21%, which you can see on the chart. And 1993 was followed by 1994, which was the worst bond market in history. The year 2003 led to the housing bubble and then the bust that we have now. And, again, we have a negative real funds rate.

The chart below that, in the blue bars, shows CPI – the same thing as the blue line above. And the red shows the 10-year note. This is only the second time since 1979 that the 10-year note has been trading under the inflation rate.




The point of all of these charts is that monetary policy is easy. Monetary policy is too easy by most measures. I would argue to you that it really became too easy with that 75-basis point cut on January 22, and the 50 on January 30. From that moment forward, Fed policy became too easy.

**The Market Wants The Federal Reserve To Hike**

But from August to about, say, six weeks ago, somewhere in there – eight weeks ago, four weeks ago – the market was looking past easy Fed policy. Now, all of the sudden, monetary policy has a consequence.

If you go to Page 6, you see that, in the last several days, what we have seen in the marketplace is that we have gone from last Friday – virtually no chance that the Fed was going to tighten rates this summer – to putting in odds of around 70% or even higher that the Fed is going to hike in August and possibly hike again in September. Now, this would be out of their mode because they don't normally move in August or September, or initiate a new sequence in Fed policy in an election year; they would want to wait until December.

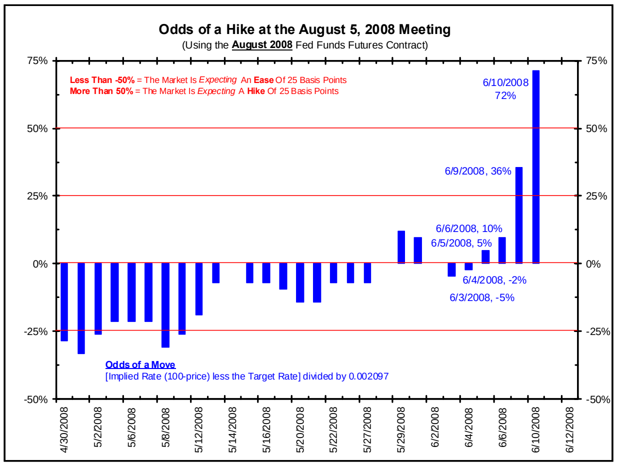
What I am arguing here is that the Market has a perception that this easy Fed policy is creating inflation, and that the Fed can no longer say, "We will do what it takes to fight the credit crisis." This is because "do what it takes to fight the credit crisis" implies that there is going to be inflation in the system, and the market is asking the Fed, telling the Fed, demanding of the Fed, "You deal with the inflation issue, as well." That's a nice way to say, "There are limits to what we are going to allow you to do in dealing with the credit crisis."

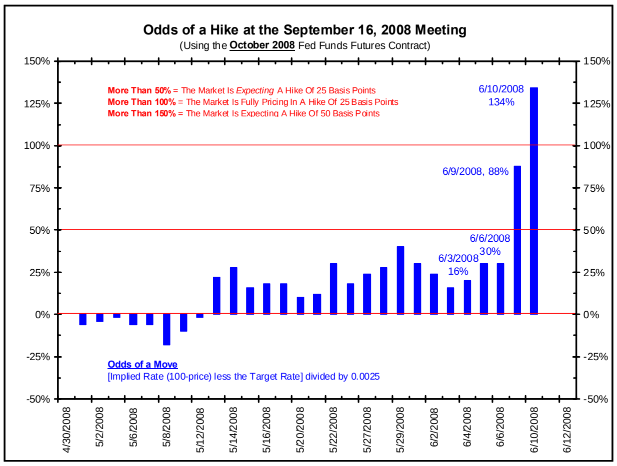
As I wrote here – this is from our *News Clips* product yesterday – in bold, on the left here, on Page 6

> "The market may be telling the FOMC that it has done all that it can in dealing with the credit crisis. From here on out, all attempts to soften the blow for financial firms will not work and only serve to heighten inflation expectations." So sick financial firms are on their own and should be allowed to fail. If they have had their chance and don't have their houses in order by now, then it's not going to happen, so let them go. Otherwise, the Federal Reserve will be pumping liquidity into the financial system and keeping the funds rate below the inflation rate for years. The Market now views this as unacceptable because the inflation that it will create will be worse than the chaos in the financial system it could possibly prevent."

There is this sea change now.

Go ahead and invent all the TAF auctions. Expand them. Give loans to the dealers. Change the rules at the discount window. Cut rates, cut rates, cut rates. Fine, fine, fine. You're dealing with the credit crisis.




But, now hold on a minute. You're also creating inflation, or the market believes that you're creating inflation. I'm not going to let you do anything or whatever it takes to deal with the credit crisis because all that you're doing is creating inflation for the rest of us. So this is going to start to play into the credit crisis, too, because the market is going to impose somewhat of a limit on the Fed because it wants the Fed to deal with inflation.

Now, remember that, in August, the Fed held and said that there wasn't a problem. The market demanded that they address the credit crisis and then, 10 days later, we got the intra-meeting ease. They cut 50 in September and said that was it. The Market demanded more, and they kept giving the Market more and more.

The market is now demanding that the Fed change course. I think that this is important. A lot of people have said that the reason that the markets have been behaving so poorly in the last two weeks is the series of speeches that Bernanke gave were a curveball or, they were out of left field.

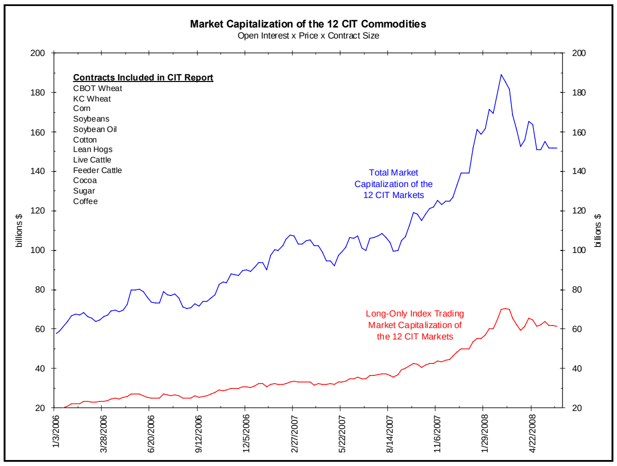
I think that, really, he is interpreting what the market wants from him, and he is trying to give them tough talk. The problem is that the market wants more than tough talk. I think that the market is going to demand action. And if he doesn't give the market action, then they are going to be severely disappointed.

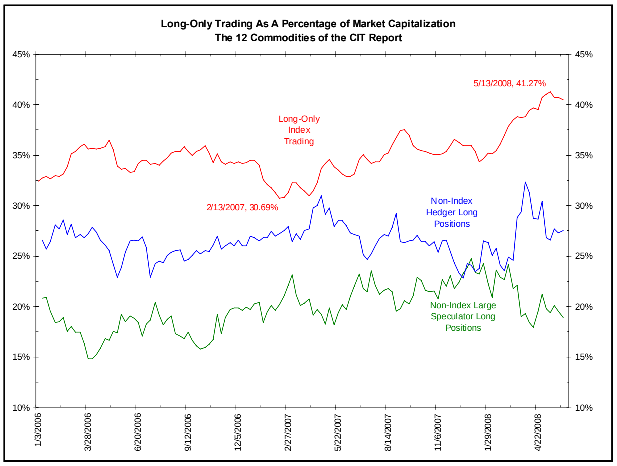
## Long-Only Funds And Monetary Policy

Page 7 – the rational response to the Federal Reserve running easy policy and creating an environment of inflation is for investors to look for investments that would benefit from higher inflation. They don't always look for the same thing every time. Every time we have a negative real funds rate, we get a different response from investors. This cycle – the negative real funds rate – is being viewed as an inflationary outcome. The last cycle in 2003 was being viewed as something to run you into real estate. Now it is being said, "How do I benefit from higher inflation?" And the popular investment choice now is the long-only commodity fund.

So as the Fed runs inflationary policy, the endowments in the trust that see that policy say, "We should continue to commit money toward investments that would benefit form higher commodity prices." The Fed does influence the price of crude oil. These markets are small. The commodity markets are small. There is a capacity problem. It doesn't take much money to go into those markets and push them higher. So as long as the Fed runs inflationary policy, they inspire – and I picked that word carefully – people to put their money into investments that would benefit from higher inflation, higher commodity prices, into these small markets, and they help to ramp up their prices. I know that Bernanke has been out there saying, "I can't control the price of crude oil." That's true. He can't create supply. He can't create demand. But he can inspire the speculative activities of the long-only funds. And he has been inspiring a lot of them lately.

If you look at these charts on Page 7, the CFTC – the Commodities Futures Trading Commission – does give us data on the size of the long-only funds for 12 commodities. They are listed in the top chart. Crude oil and gold are not on the list. I have asked the CFTC, and they have no plans to add them to the list anytime soon. The total market capitalization of those 12 commodities is around \$150 billion. You can own every futures contract outstanding for those 12 commodities for about \$150 billion.



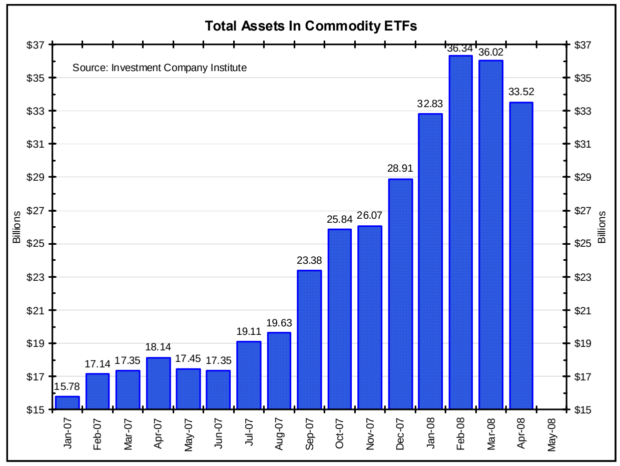



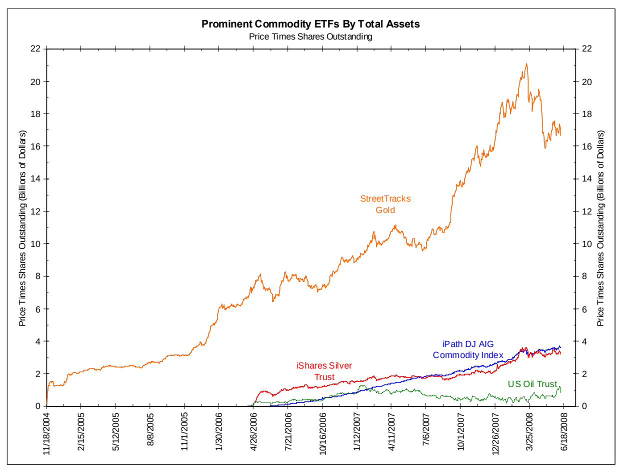

The long-only index funds – if you look at the bottom chart – account for 40% of the open long-side, open interest. The speculators account for something like 18%. As a matter of fact, if you were to look at this data – and we have talked about this in some prior pieces – our guess, yes, is that, if you were to back the long-only funds out of the traditional speculator, then the traditional speculator might be net short this market.

The traditional speculator – the hedge fund, the CTA, the floor trader – has been trying to pick highs in a lot of the commodities, and it has been a very painful experience for him. That is why we have also been arguing that, if they raise margin requirements – as there is a bill in Congress right now to raise margin requirements to 25 percent on energy futures – then they might just be chasing a seller out of the market. Long-only commodity funds are fully collateralized. They don't operate with margin. The hedge funds, the CTAs, the floor traders do operate with margin. And if they are net short the market, then you're just going to chase the seller out of the market, and can produce higher prices.

## This Is Also A Long-Only Commodity Fund

The last chart is on Page 8, at least in my section, and then I'll turn it over to Howard. I just also want to point out that commodity ETFs -- the GLD, the Street Tracks gold shares – these are also forms of long-only commodity funds that allow the public in order to get into this. The PIMCO Commodity Real Return fund and other real return funds like that – these are forms of long-only funds. Again, these are small markets and don't need much money to push them higher.




For the final part of the presentation, I wanted to also point out that while we've got this speculative activity, it is our belief that speculative activity does not occur in a vacuum. It does not happened just because it's Thursday, and we have decided that we want to ramp up the price of soybeans. Underlying that is typically a bullish fundamental, and speculative activity exaggerates the trend. That is what has been happening, is that the trend has been exaggerated. Without it, you still would have had a huge rise in the price of crude oil anyway. You still would have had a huge rise in the price of a lot of these commodities anyway. Their backdrop has been very bullish.

But if you wanted to take the speculative froth out of these markets, then I would argue that, if the Fed were to raise rates in the August meeting and in the September meeting, then those that are saying, "The Fed is running inflationary policy. Let me into long-only funds," might rethink that view; and it could bring some of the speculative froth out of the markets. But I don't want us to lose sight that the fundamentals are still – and have been for the last nine years – very positive on this market.

So as we turn to Page 9, I am going to ask Howard -- who has been writing a lot about this for us in the last several weeks and, in fact, has been writing a lot about this for many years but really ramped up the writing about this for the last several weeks – to come in and talk about what has been happening in the petroleum market. Howard, it's yours.

**Howard Simons**: OK, thank you, Jim. One conclusion that we pretty much have to state up front and that is not here in the Petroleum Section is let's not confuse commodity prices with inflation. We are going to have significantly higher food prices coming into the end of this year because of what is happening with the flood situation in the corn- and soybean-growing areas of the Midwest. If you are worried about higher corn prices or higher soybean prices, then the Fed could put the Funds Rate to 12 percent, and it's not going to put another ear of corn in a bin somewhere. This is largely out of control right now, in the short-term, of anything that we can do within reason in monetary policy. It is simply going to be a fact.

**Howard Simons**: OK, thank you, Jim. One conclusion that we pretty much have to state up front and that is not here in the Petroleum Section is let's not confuse commodity prices with inflation. We are going to have significantly higher food prices coming into the end of this year because of what is happening with the flood situation in the corn- and soybean-growing areas of the Midwest. If you are worried about higher corn prices or higher soybean prices, then the Fed could put the Funds Rate to 12 percent, and it's not going to put another ear of corn in a bin somewhere. This is largely out of control right now, in the short-term, of anything that we can do within reason in monetary policy. It is simply going to be a fact.

So, in saying this, let's turn back to the petroleum markets. Right now, we have a situation where this trend is getting to be increasingly uncomfortable to the people who are participating in it on both the long and the short sides. The fundamental petroleum demand continues to grow. It is an income-related phenomenon. As China grows, as India grows, as internal demand in the oil-exporting countries of the Middle East grows, it is offsetting any demand-dampening effects of higher prices. On the balance, their new supplies have yet to emerge, to drive prices lower. For whatever you're finding offshore Brazil, it's going to take a number of years to bring in. You're losing production at a rapid rate now in Mexico. You're losing in Nigeria. You're losing in Venezuela. You're losing in Russia because of the expropriations of the foreign producers there.

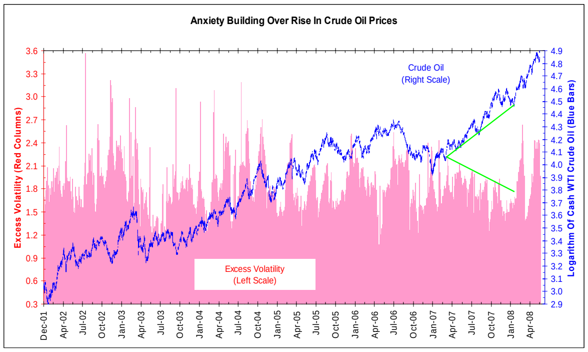
Part of this price increase is due to speculation as the weight of long-side money overwhelms a few natural shorts. There are very few natural shorts in petroleum right now. If you're a producer, especially in the West Texas intermediate contract, in the grades of crude oil that are deliverable to it – a lot of these fields were brought in being economic at prices of $10 to $20 a barrel. You're not looking to put a price floor in right now. There is very little forward short-side hedge demand. You have to be able to deliver into the NYMEX contract, as we will see later. You don't have to deliver into the ICE contract.

There is speculation. Well, so what? That is how a market is supposed to operate. It's supposed to find a point in which behavior changes. In U.S. demand, we're seeing some of that behavior change already. But that is being overwhelmed by demand growth elsewhere.

A huge headline shock here is, I mean, obviously, what happened last Friday. I've been in this market for 30 years, and it was still a sight to behold. This is, despite the headline shock, we have yet to derail the economy because the higher energy prices. The partial contribution to U.S. equity prices has yet to drive them lower, and it's yet to propel TIPS breakevens higher. The bottom-line conclusion here is that long-term energy prices are going up barring a global economic calamity. If you want lower crude oil prices, it's one of those situations where you better be careful what you wish for.

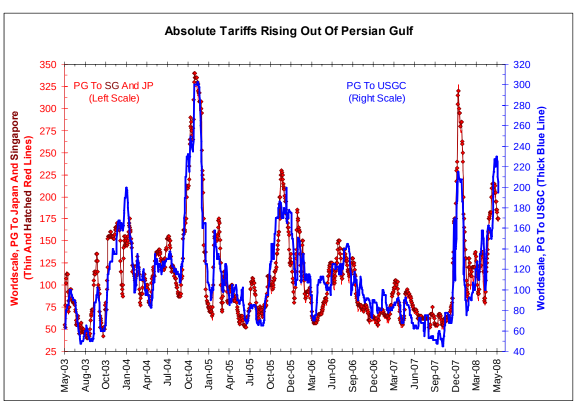
### Anxiety Building Over Uptrend

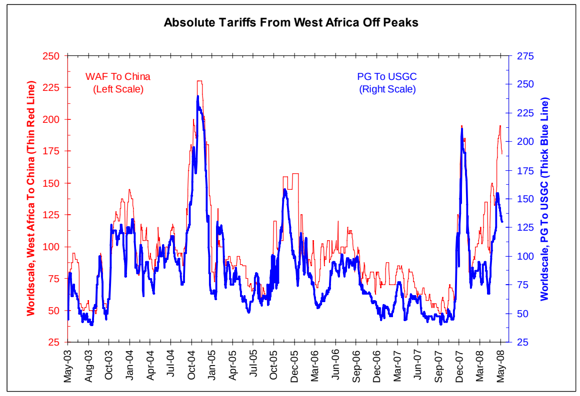
The chart on Page 10 is one that I have used over the years. I had to switch to a semi-log scale here on the price because we've doubled in the last year. Those roseate bars are the ratio of implied volatility to an underlying high-low close volatility. As those rise, the market is getting more anxious about a price trend. It had fallen throughout the initial phases of the increase, where you see these offsetting green lines. Now, it's coming up. And that excess volatility tells you that the people who are on the long side are getting much more anxious about the continuity and the sustainability of the trend. I wrote a couple of weeks ago that this break is going to be a sight to behold. It went down about $6 or $7 and turned right around and made a new high.




## Tanker Rates Bullish, But Not Alarming

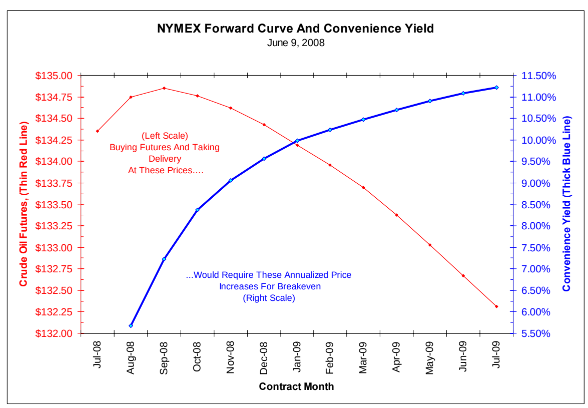
Now let's turn to Page 11. This was something that Morgan Stanley wrote about last Friday that was part of that moonshot, which is tanker rates. Remember that oil on the water is a form of inventory to arrive. So if you're going to be buying more crude oil, then it's going to show up in higher tanker rates. You don't see anything particularly alarming here, although it is bullish. The tariffs rising out of the Persian Gulf – I don't care whether I'm going east into Asia - Singapore, and Japan - or swinging around Africa to the U.S. Gulf Coast, those are rising. The absolute tariffs from West Africa, though, are coming a little bit off of their peaks – that's Nigeria, Angola, both to the U.S. Gulf, and then increasingly to China. The simpler refinery structures in China; the marginal refiner has to use, the more expensive light, sweet crude oil, and they're buying it increasingly out of West Africa. So you do see rising demand there that is bullish.

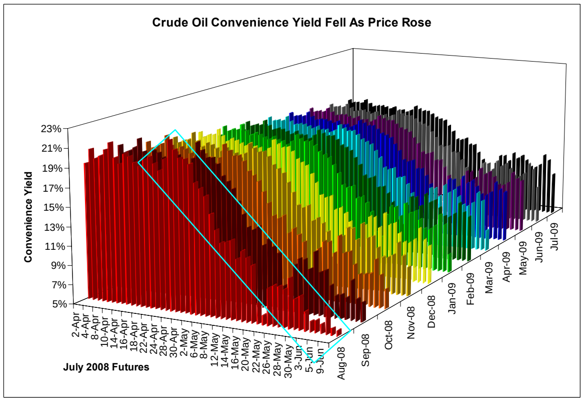



## Forward Curve And Convenience Yield

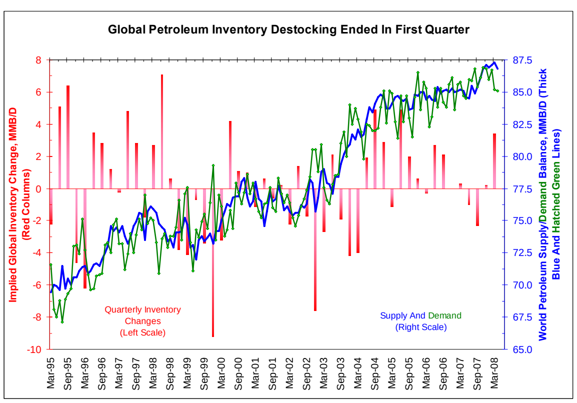
On Page 12, these forward curve and convenience yield charts – a lot of people have said, "Well, crude oil is in contango." That's a categorically false statement. Crude oil, in the first few months, may have a positive slope in the carry structure. But when you account for the interest rate costs of holding it, and you account for the physical storage costs, you still have what is called a positive convenience yield. It's going to cost you money to buy and hold inventories. But that becomes a breakeven – that blue line on the top chart – at a fairly modest level of price increase. Moreover, as the price of crude rose, the convenience yield fell. So it's getting to be more and more economic to buy more crude oil, put it in inventory as a form of insurance against future price increases. That demand is bullish.

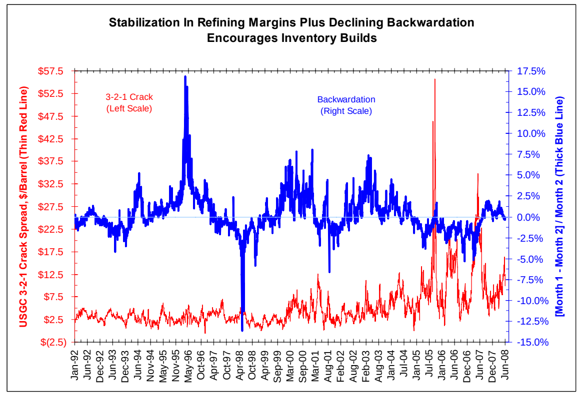





## Inventory Accumulation

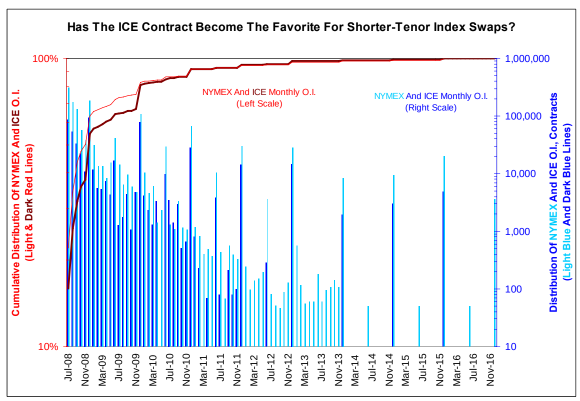
If we turn to Slide 13 here, looking at the global inventories, unfortunately, these data are just coming in a couple of months behind. It used to be that, in the oil industry, you could analyze the U.S., and everything was kind of a residual and moved in the same way. Marginal demand, marginal supply is outside of the U.S. market right now. We don't have very good data. And the most important number of all – the production capacity out of Saudi Arabia – is a very closely guarded state secret. So we only have to infer here. We stopped destocking inventories at the end of the first quarter. That's the series of lines and bars in this top chart on Page 13. And in the bottom, we see that stabilization in refining margins, which had been collapsing, plus this decline in backwardation encourages inventory builds. Anything that is going to increase the incentive to buy, to run a refinery, to build inventories is going to have a bullish effect on price.




## Speculation's Domicile

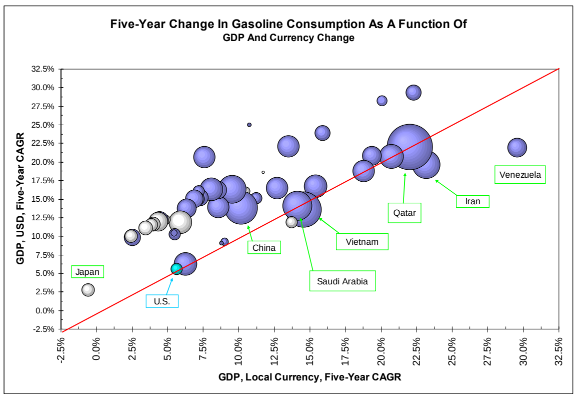
Page 14 tried to address this issue of speculation in the long-only funds. The ICE has two big advantages over the NYMEX here; one is that it is an out-of-U.S. exchange -- technically a British exchange – so your positions are not reported there. Second, it's a cash-settled contract as opposed to physically delivered. The West Texas Intermediate contract is delivered to a pipeline terminus in Cushing, Oklahoma, meaning that you have to actually get the crude oil there or make alternative delivery arrangements in the EFP Market.

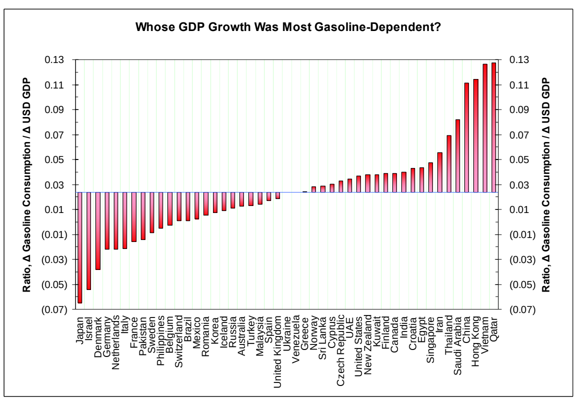



What we see here in the pattern of the open interest is that the ICE Contract looks like it has become a favorite for the shorter tenor Index swaps used by the long-only funds. I don't think that any moves here to restrict the activities of long-only funds in the U.S. are going to be particularly productive unless you coordinate them, not only with the ICE but also with the Dubai Commodity Exchange and anybody else who might arise, because if you can simply move these swaps and the pricing and hedging to an offshore exchange where your regulation is probably not going to be as intense, and you actually achieve nothing other than taking the business out of the U.S.

## Global Income Elasticity Of Demand

If we turn, then, to Slide 15, we get to this global income elasticity of demand. Here, we took a look at the five-year change in gasoline consumption as a function of GDP. I did this both in a local currency – the X-axis – and a U.S. dollar-adjusted Y-axis basis. The size of those bubbles is the rate of change. Clearly, the larger bubbles off to the right are places where you've either nationally subsidized local gasoline prices such as Iran and Venezuela, or you have a very rapidly growing economy. It's the slow-growth areas on the left side, in those white bubbles that you see the price effect. So higher prices are lowering and dampening demand in the developed world.

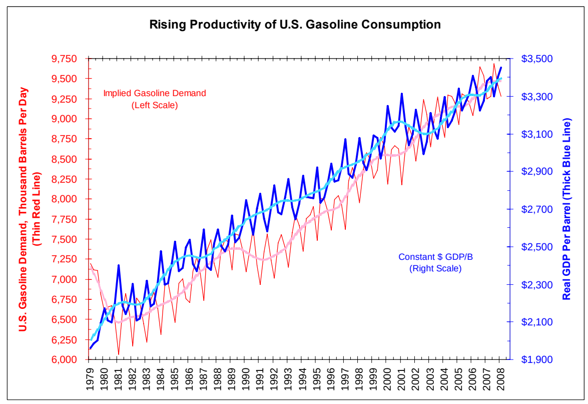


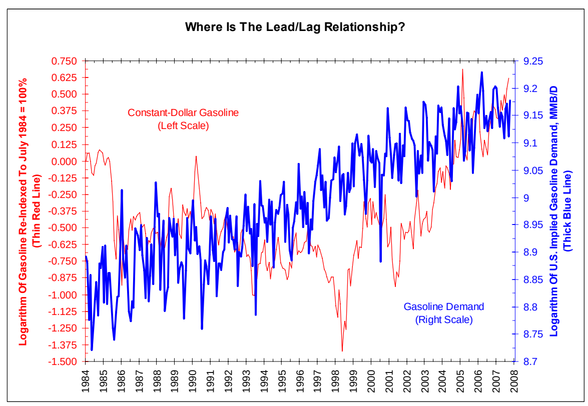




The rising income elasticity is simply overwhelming that outside of the G-7 or OECD economies. That is unlikely to change. And, as I said earlier, it's one of those cases of "Be careful what you wish for" because, if you raise interest rates enough to the point where somebody dies, which is the usual thing that we do when we start raising interest rates – I mean, after all, what Paul Volcker did it in the early 1980s, we managed to kill Mexico, and we managed to kill Argentina. So we should be careful what we wish for on this. There is probably no level of U.S. interest rates that is going to slow down the growth in these areas. The oil exporters are now getting revenue in at a rate that is absolutely unprecedented in human history. They are going to be a little bit sloppy in what they do because they have no idea of how to spend it wisely or invest it wisely; it's just coming in too fast.

**Gasoline Prices And U.S. Productivity**

If we turn to Slide 16, it's a point that I have been making in the U.S., that our implied gasoline demand has actually been rising on a seasonally adjusted basis pretty much on a straight line over a time. I took the American Petroleum Institute data here, which goes back to 1979. If we then adjust that for its productivity – that blue line – we find that we keep adding economic value. You're not going to change behavior if you have to spend \$4 on a gallon of gasoline and create \$5 of economic output when you do it. If you spend \$4 on a gallon and create \$3 out of it, then you're going to change your behavior.

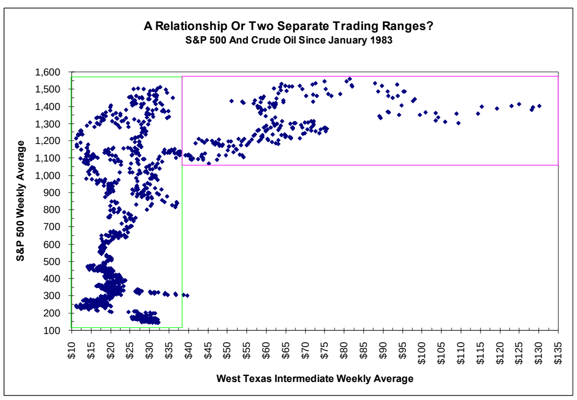


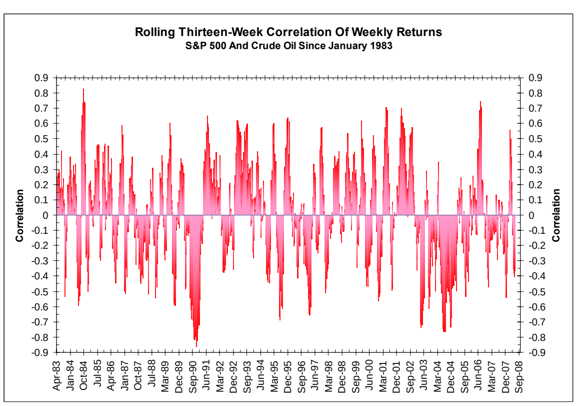

If we look at the slide on the bottom, which is comparing gasoline demand in the blue to its constant dollar level here, then you really don't see very much of a price elasticity effect, and you don't see very much of a lead-lag effect. Price elasticity of demand is kind of a nice theory, but it has to be blended in with productivity changes, increased efficiency of engines, lower energy usage in capital stock to have an overall effect on demand. So the U.S. picture here -- which we are still the largest gasoline consumer and energy consumer in the world – shows that the price effects are not exactly what you would expect on a demand side, and we haven't seen any supply effect to speak of because of higher prices.

### Crude Oil And U.S. Equities

I'm trying to get to Slide 17 here, which is the relationship between crude oil and equities. Whenever I write this one, I say to myself, "People are going to think that you're absolutely nuts. What do you mean that higher crude oil prices don't knock the stock market down?" Well, I went back to January of 1983 here, which is more than 25 years. And if you map the S&P 500 weekly average and West Texas Intermediate weekly average, what you really see here are two trading ranges; one is vertical, with the price below $40, and one is horizontal with the price greater than $40. Nowhere in here do you see a negative relationship. As a matter of fact, if I wanted to put a loglinear trend line in both of those boxes, then both of them would be moving slightly from the southwest to the northeast. It would be positively sloped.




If I take a look at the rolling 13-week account, a quarterly correlation of weekly returns there, then we find that it is sometimes positive and sometimes negative, which says that the relationship is essentially random, that there is no long-term and there is no short-term negative correlation of returns.



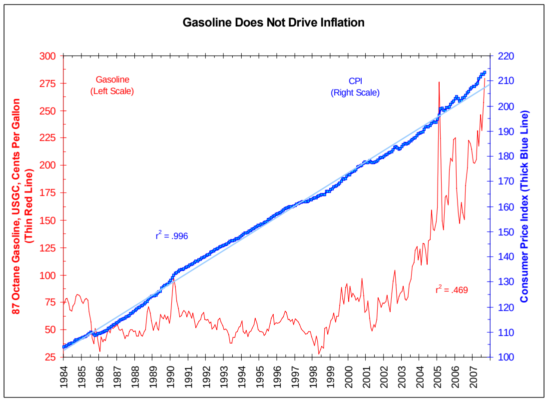

### Industry Group Impact

This leads me to the table on Slide 18, which I crank out every few weeks, which is to say, "What is the industry group impact?" The cells on the left here are all of the industry groups in the S&P that have a negative beta to crude oil prices. And it is a very long list – 62 industry groups. The betas tend to be fairly low. It's a very short list on the right – 16 – and the betas tend to be very high and tend to have a large weight in the index itself. So if I sum these, then I get a positive -- not a negative – net contribution of rising crude oil prices in the U.S. stock market. The data sample here, in case you're wondering, goes back to May 2003. This was the day when we declared war on deflation. I am happy to report that that war is proceeding very well. We should win it at any time now.

**Crude Oil Beta-Weighted Impact On S&P 500**

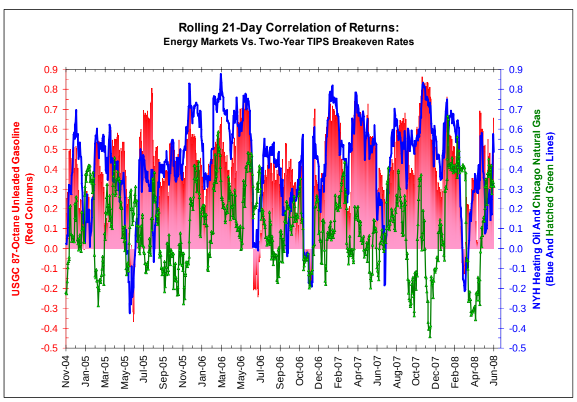
| | SPX Weight | CL Beta | Weighted Beta | | SPX Weight | CL Beta | Weighted Beta |
|---|---|---|---|---|---|---|---|
| Pharmaceuticals | 5.85% | 0.048 | -0.28% | Integrated Oil & Gas | 8.23% | 0.291 | 2.39% |
| Other Diversified Financial Services | 3.17% | 0.079 | -0.25% | Oil & Gas Equipment | 2.49% | 0.437 | 1.09% |
| Computer Hardware | 4.35% | 0.031 | -0.13% | Oil & Gas Exploration | 2.26% | 0.445 | 1.01% |
| Integrated Telecommunications | 3.10% | 0.042 | -0.13% | Oil & Gas Drilling | 0.76% | 0.471 | 0.36% |
| Industrial Conglomerates | 3.27% | 0.039 | -0.13% | Diversified Metals & Mining | 0.39% | 0.325 | 0.13% |
| Diversified Banks | 1.58% | 0.075 | -0.12% | Oil & Gas Refining | 0.28% | 0.373 | 0.10% |
| Hypercenters & Superstores | 1.42% | 0.083 | -0.12% | Steel | 0.44% | 0.193 | 0.08% |
| Communications Equipment | 2.67% | 0.043 | -0.12% | Gold | 0.18% | 0.289 | 0.05% |
| Systems Software | 2.91% | 0.039 | -0.11% | Construction & Farm Machinery | 1.09% | 0.048 | 0.05% |
| Semiconductors | 2.19% | 0.045 | -0.10% | Fertilizers & Agricultural Chemicals | 0.63% | 0.081 | 0.05% |
| Household Products | 2.29% | 0.038 | -0.09% | Aluminum | 0.27% | 0.139 | 0.04% |
| Multiline Insurers | 1.27% | 0.067 | -0.09% | Multiline Utilities | 1.14% | 0.028 | 0.03% |
| Air Freight & Logistics | 1.00% | 0.079 | -0.08% | Construction & Engineering | 0.23% | 0.131 | 0.03% |
| Investment Banking & Brokerage | 1.59% | 0.047 | -0.07% | Agricultural Products | 0.20% | 0.114 | 0.02% |
| Regional Banks | 0.87% | 0.083 | -0.07% | Gas Utilities | 0.11% | 0.115 | 0.01% |
| Healthcare Equipment | 1.99% | 0.035 | -0.07% | Construction Materials | 0.07% | 0.038 | 0.00% |
| Thrifts & Mortgages | 0.57% | 0.120 | -0.07% | | | | |
| Tobacco | 1.43% | 0.047 | -0.07% | | | | |
| Asset Management & Custodial Banks | 1.28% | 0.049 | -0.06% | Subtotal: | 18.76% | | 5.45% |
| Home Improvement Retailers | 0.72% | 0.084 | -0.06% | | | | |
| Property & Casualty Insurers | 1.09% | 0.053 | -0.06% | | | | |
| Movies & Entertainment | 1.50% | 0.037 | -0.06% | | | | |
| General Merchandise Retailers | 0.41% | 0.128 | -0.05% | | | | |
| Drug Retailers | 0.81% | 0.064 | -0.05% | **Total:** | **83.72%** | | **2.34%** |
| Life & Health Insurers | 1.21% | 0.042 | -0.05% | | | | |
| Consumer Finance | 0.73% | 0.064 | -0.05% | | | | |
| Aerospace & Defense | 2.73% | 0.017 | -0.05% | | | | |
| Data Processing & Outsourcing | 0.82% | 0.054 | -0.04% | | | | |
| Soft Drinks | 1.91% | 0.022 | -0.04% | | | | |
| Biotech | 1.37% | 0.030 | -0.04% | | | | |
| Department Stores | 0.38% | 0.087 | -0.03% | | | | |
| Broadcast & Cable TV | 1.03% | 0.028 | -0.03% | | | | |
| Restaurants | 0.87% | 0.032 | -0.03% | | | | |
| Healthcare Distributors | 0.40% | 0.070 | -0.03% | | | | |
| Packaged Foods | 1.35% | 0.020 | -0.03% | | | | |
| Semiconductor Equipment | 0.44% | 0.056 | -0.02% | | | | |
| Food Retailers | 0.37% | 0.066 | -0.02% | | | | |
| Apparel Retailers | 0.28% | 0.073 | -0.02% | | | | |
| Airlines | 0.09% | 0.227 | -0.02% | | | | |
| Hotels | 0.32% | 0.059 | -0.02% | | | | |
| Specialty Stores | 0.23% | 0.076 | -0.02% | | | | |
| Application Software | 0.43% | 0.039 | -0.02% | | | | |
| Computers & Electronics Retailers | 0.21% | 0.071 | -0.01% | | | | |
| Automobile Manufacturers | 0.19% | 0.077 | -0.01% | | | | |
| Apparel & Accessories | 0.22% | 0.052 | -0.01% | | | | |
| Insurance Brokers | 0.24% | 0.038 | -0.01% | | | | |
| Auto Parts & Equipment | 0.16% | 0.050 | -0.01% | | | | |
| Environmental Services | 0.20% | 0.037 | -0.01% | | | | |
| Leisure Products | 0.12% | 0.056 | -0.01% | | | | |
| Household Appliances | 0.14% | 0.048 | -0.01% | | | | |
| Publishing & Printing | 0.23% | 0.027 | -0.01% | | | | |
| Personal Products | 0.18% | 0.035 | -0.01% | | | | |
| Office Electronics | 0.10% | 0.041 | 0.00% | | | | |
| Casinos & Gaming | 0.09% | 0.046 | 0.00% | | | | |
| Distributors | 0.06% | 0.069 | 0.00% | | | | |
| Specialty Chemicals | 0.21% | 0.016 | 0.00% | | | | |
| Housewares & Specialty Stores | 0.13% | 0.026 | 0.00% | | | | |
| Motorcycle Manufacturers | 0.08% | 0.041 | 0.00% | | | | |
| Diversified Commercial Services | 0.07% | 0.046 | 0.00% | | | | |
| Photo Products | 0.03% | 0.045 | 0.00% | | | | |
| Healthcare Facilities | 0.02% | 0.057 | 0.00% | | | | |
| Paper Packaging | 0.05% | 0.024 | 0.00% | | | | |
| Subtotal: | 64.96% | | -3.11% | | | | |

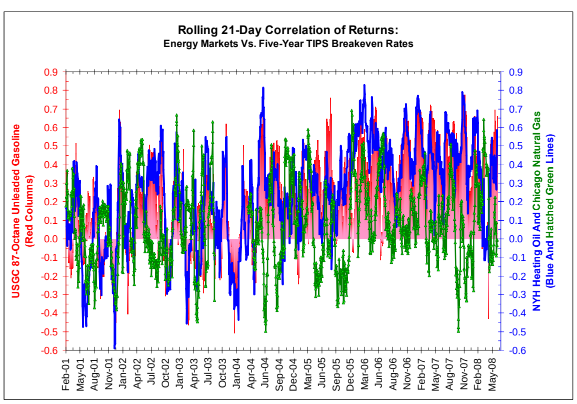
On Slide 19 are gasoline prices and U.S. inflation. If I take a look at the gasoline price here and take a look at the CPI, I find that I can run a timeline through the CPI and get an $r^2$ of .996. That's almost perfect. If I do it for gasoline, then it's 0.469, so I can explain more than twice the variance in the CPI by just taking out a ruler and putting it in over a timescale on the calendar than I can by using gasoline. Everybody associates higher gasoline prices with higher inflation. I think that the causation clearly goes the other way around. It certainly did in the 1970s, where we had higher inflation leading first to a grain shock then, then to an oil shock. Remember that Richard Nixon imposed wage and price controls in August of 1971. We didn't have our first oil shock until late 1973. It's very difficult to cause something to happen two years previously.




## Energy Prices And TIPS Breakevens

And then if we look on Slide 20 of "Energy Prices and TIPS Breakevens," everybody wants to say that forward-looking inflation reflects CPI, which should reflect gasoline prices. Here again, these correlations tend to be low. They seldom exceed 0.8. They sometimes go negative. I did this for the one-, two-, five-, and 10-year TIPS, though I just displayed the two and five here. It's very difficult to say that we should be trading TIPS off of energy prices. Here, I used natural gas, heating oil, and gasoline, so I took three different markets.




What is the reason for this? It's because TIPS are massively distorted by two things; one which I have written about for years, is that you're actually short a call option on government honesty. If you believe that the non-seasonally adjusted CPI – the all-urban one – is an accurate statement of your own consumer price index, then let me know immediately. They are in control of how they report this number. The second is the TIPS breakeven is the residual between the nominal Treasury and the inflation-adjusted Treasury. If you get the flight-to-quality, then you're actually buying insurance against a financial crash elsewhere, that has very little to do with expected inflation; and yet that knocks the TIPS breakeven down, even when we clearly have rising inflation.

With that, that concludes what I wanted to speak about this morning. So I guess, Jim, that we should turn the Conference back to questions now.

## Questions & Answers

**Bianco:** Yes, thanks, Howard.

A couple of things about questions – we do encourage questions. We have found that the best way to encourage questions is to tell people that we will use only your first name in a question. So be on the lookout for your first name in the question because the anonymous nature of it, I think, encourages more questions.

I already have two emailed questions that have come in, and we've got some on hold. So let me start with the emailed questions.

The first one is from **Max**. The question is, "What do you make of the history that shows that the Market is typically very early in expecting a renewed tightening cycle after an easing cycle?"

I would agree with you, Max. The Fed is very easy. We just went to 2% at the last meeting. And we're already starting to price in one meeting on hold, and then that we're going to hike one meeting after that. So this has been quite the quick turnaround if it does play out the way that it has.

I guess that the answer I would give to you is twofold. This is unique in that the Fed has been responding to a credit crisis more than it has been responding to the economy.

And, second of all, it is clearly the case that the Fed is at a point with the funds rate that they are below what we would consider to be neutral. They are clearly in an easy mode or an easy period, so it's not like we're debating whether or not 2% is the appropriate rate. I think that debate has been pretty much settled even by many governors. It's too low, but it's too low with reason. So it's not surprising to me that, if the funds rate is too low, then we could quickly see a change from that we just eased at the last meeting, hold it this meeting, and the Market might want to look to hike at the next meeting.

The next emailed question comes from **Jeff**. It's more of a procedural question about the chart on Page 8, about commodity ETFs. He's asking whether commodity ETFs includes the London ETFs or just U.S.-registered. The answer is that it includes just U.S.-registered. As the chart shows, the source is the Investment Company Institute. And the Investment Company Institute covers only the U.S.-registered ETFs. And even though it is only the U.S.-registered ETFs, it has more than doubled in the last year. And we do know that there is quite a number of ETFs, again, another version of the long-only funds that trade on the London exchanges.

The next question is a call-in question. It comes from Brian. Brian, are you there?

**Brian**: I guess that I just wanted to play Devil's Advocate a little bit with the discussion about Chart 16, the conclusion of which seems to be, on the bottom chart, that price effects don't have much impact on the demand side. And I'm trying to square that with – and I'm not an expert on the energy business or the oil market, but I'm seeing big surges in public transit, ridership, miles driven down, SUV sales falling, airlines taking planes out of service. Can you help me to reconcile those anecdotal pieces of information with the conclusion that you drew out of the graph?

**Simons**: What is really surprising there is that, if you looked at the week-by-week gasoline demand numbers – and if you're sitting in front of your Bloomberg, it's APIDMGID Index – if you just do an HP on that, that's APIDMGID – if you look at those numbers there, you'll see, OK, we're down a little bit from our mid-May levels. But if you look where we were seasonally adjusted – let's say even a year ago – it's not anything significant. And we don't know right now whether this is a price effect or whether it's an income effect. With the previous patterns, whenever we have had gasoline price spikes, you get a short-term reaction – I'm going to keep the car in the garage. I'm going to get on the train. I'm going to walk. I'm going to take a bicycle. I'm going to do something to reduce my gasoline demand, and then it creeps back – that has been the pattern going back for 30 years to the first gasoline shock.

So, yes, we've had a little bit of a drop-off here in a couple of weeks. But we haven't seen a sustained trend where we can point to a growing negative price elasticity of demand.

**Brian**: OK, thank you.

**Bianco**: Sure, thanks. The next question is another emailed question. It comes from **Mike**. Howard, I think that this question is probably better for you.

"Why has gold not been validating this recent heightened concern over inflation? Is it that the gold market believes that the Fed will, in fact, hike as necessary?"

**Simons**: Gold has been reacting counter to its fundamentals for a long time here. It's something that I have looked at, both in terms of reported inflation, expected inflation, dollar-adjusted related to short-term interest rates. What I think has happened here is that you have had a significant drop in gold demand worldwide, which has been coming out of India, which has always been the largest gold importer. There, I think that it is a price shock where, traditionally, the household wore its wealth in the form of gold jewelry on the woman of the household. So now you physically need to less gold to wear the same amount of wealth. And it is also, "Well, can we find another way of storing accumulated savings other than gold jewelry?"

So there are a lot of factors that are going on. Gold peaked a long time ago while we were still – let me get an exact date here – cash gold peaked on March 17, which is the Bear Sterns bailout date. It fell off pretty significantly after that, and inflation expectations have risen after that.

Gold is actually not a very good hedge against inflation. It always surprises people; this piece that I did and have updated a few times that says over the last 25 years, you were actually better off on holding T-bills than you were holding gold as far as an inflation hedge is concerned. That tends to drive gold bugs absolutely up a wall.

**Bianco**: OK, next question. The next question is from Michael. Michael, are you there?

**Michael**: Yes, hi. One of the implications on the Government Bond Market – you said that U.S. Treasury yields have all backed up significantly, as have the European bonds. What is your position in terms of the government bonds?

**Bianco**: The yield curve is most likely going to continue to flatten as we continue to talk about whether or not the Federal Reserve is going to raise rates this summer and into the fall. That will primarily come from a position of short rates moving up faster than long rates.

And I do think that, in this environment, you're going to have a very difficult time in getting a severe down-move in government bond yields barring a calamity in the stock market. If you are bullish right now on government bonds, then you're betting on probably one of two things. You're either taking the view that inflation is not a problem, or you're taking the view that we're going to have another train wreck – another August or another March – in the U.S. stock market.

At this point, while I do think that U.S. stocks could head lower, I'm not ready to go all the way out and say that they are going to fall part a la March just yet. They are going to go down, but that's more of a thing about the rate of change as opposed to the direction of change.

Howard, did you want to add anything to that?

**Simons**: I have been expecting the bond yields to rise for the better part of five years from now. One of these days, I'm going to be right. The simple fact of the matter is that you're not getting a positive after-tax real-adjusted rate of return in holding almost anybody's government bonds. That makes them a rather suspect investment if and when we can pick up asset returns elsewhere. And with rising inflation, bonds tend to be a very poor long-term investment.

**Bianco**: OK, Michael, did you have a follow-up to that?

**Michael**: Yes, just the Chart 3 on Case-Shiller – existing home sale prices have actually adjusted to the point where someone would say that prices are stabilized, yet this is not depicted in the Case-Shiller. How do you reconcile these two?

**Bianco**: Mainly because of the construction of the two indexes. The Case-Shiller Index is a measure of existing home prices only in the major cities, either the Case-Shiller 10, which is the 10 largest cities, or the Case-Shiller 20, which is the 20 largest cities, whereas the Census Bureau's measures of existing home prices is a survey of the entire Country.

We do have a bifurcated real estate market in the United States. The large, urban areas are where we had the big run-up. You can see that in Case-Shiller where they go up to almost 15%, 16% a couple of years ago, which would have been the highest level in many decades. And we have had a big collapse. But in the rural areas, they have never experienced quite the giddiness of the real estate market. So they're not getting the collapse in the real estate market to the degree that we're seeing in the cities.

Case-Shiller did a measure back over 100 years, whereas existing home sales goes back only about 30 years. Case-Shiller has become the kind of favorite measure of the market to look at. So that's why we have been focusing on it. But I think that, in large part, it comes from the construction of the two indices.

Do you have a final follow-up to that?

**Michael**: No, thank you very much.

**Bianco**: Thank you. That takes are, at least, of the calls that we've got. But we do have a couple of more emailed questions.

**Fiona** asks, "What is your view of oil demand from Asia in the emerging markets? How quickly do you expect to see subsidies being lifted on local energy prices in these economies?

"Will lifting or reducing the subsidies have a meaningful effect?" Howard, did you want to take that one?

**Simons**: Well, oil demand is going to rise as a function of income. If we have a macro-calamity in China, a macro-calamity in India, then oil demand will fall. You cannot expect people who have waited 30, 40 years to get their first car to say, "You know what? I'm going to stay on the bicycle. I'm going to stay on the moped. I'm going to walk." No, you'll hear, "No, I want my car. I've worked my whole life for my car."

The growth in industrial demand in China has not slowed at all. There are people who have said that China has stockpiled a lot of diesel fuel going into the Olympics, to make sure that everything runs smoothly there, that they are using residual fuel oil in place of coal for electric power generation to lower the pollution, and so that may have a drop after August.

I don't expect to see radical lifting of subsidies because the typical political reaction to that is rioting in the streets. And governments tend to try and avoid that. So the subsidies are going to be lifted gradually to the point where they don't produce rioting. That will have something of an effect on demand at the margin. But, once again, that gets offset by macro growth. So I'm looking for continued growth in the Asian markets and the emerging markets in general, especially in the oil exporting markets in the Persian Gulf.

**Bianco**: We've got a couple of more emailed questions. Another one on crude oil comes from **Nina**.

"Traditionally, U.S. consumption of oil via gasoline consumption was the biggest hog of daily consumption on a worldwide basis. Can you estimate the potential reduced demand in numerical terms for U.S. consumers based on historical experience of the 1970s, and put the same type of estimate numerically for the emerging market consumer. At what rate is daily usage increasing as measured in millions of barrels per day for the emerging markets, broadly speaking?"

**Simons**: I don't have a concrete answer for that because the data are simply not that reliable, nor is it that timely. We do know from the experience in the late 1970s and early 1980s that short-term price elasticities were fairly low in the OECD world, and then they got to be fairly significant in the early 1980s. But we also know that there is an offsetting income elasticity of demand that is greater than that in the long-term. Once again, unless price does something just utterly outrageous, I don't expect to see demand fall. I cannot give you a concrete volumetric number on that.

**Bianco**: OK, we usually limit this to an hour. We've got three minutes left, and I've got three more questions, so let's see how we do here. The next question is from **Richard**.

"If employment shows no net growth between now and November, will the Fed be able to tighten? If oil goes to $100, won't that take the heat off of the inflation story to the point where the Fed won't have to tighten for that reason? If oil is at $150, won't the economy stall as consumption X energy collapses? Would anyone think that oil has yet reached a stable place?"

Let me take a stab at this one. If employment shows no net growth between now and November, will the Fed be able to tighten? There have been a lot of studies that have been thrown out on the Internet, at least from Wall Street, being emailed around that the Fed has never tightened while we have had negative payroll growth. And most of those studies go back to only 1989. If you take those studies back into the 1970s, I do believe that you might have found a period or two where that happened in the 1970s.

Furthermore, if you wanted to turn that argument around, since 1989, this is the only period of negative payroll growth that has also seen heightened inflation expectations. Typically, when we get into a period of negative payroll growth, demand is coming off, the economy is moving lower, and people are not expecting increasing inflation, that's since 1989. So I know that everybody has been emailing that around, saying, "The Fed doesn't tighten when we've got negative payrolls." Yes, but we also don't see inflation expectations going up with negative payroll since 1989. Take them back to the 1970s, and you can find an example of that.

The second half – if oil goes to $100, won't that take the heat off of the inflation story to the point where the Fed won't have to tighten for that reason? I would argue that, yes, it would. If you were to see oil go back to $100, then at least it would back everything up. But, first, oil has to go back to $100 before we can actually see that. I mean, if it goes back to $50, then that would help, too, or if it went back to $10, then that would help. It doesn't mean that it's going to have to happen there. And so, yes, if oil were to go back to $100…

And the final part of this – and I'll let you take a stab at this, Howard, is, if oil is at $150, then won't the economy stall as X energy collapses? $150 is only, what, 6% or 7% percent from where we are right now?

**Simons**: Every $10 that -- we keep waiting for the lights to turn off, and it hasn't happened. Let's face it, if I came in here two years ago and said, OK, I'm bullish on crude oil. I think that we're going to go to $135, first, nobody would have listened to me. Second, I wouldn't have believed it myself. And, third, I would have believed that it would have caused a complete collapse in economic activity.

Right now, what we see is a huge boom in the export sector, in construction, engineering, and services to the oil exporters. So, yes, you're hitting consumer activity, but you're not necessarily slicing activity in the materials sector, in the industrial sector, export-oriented service sectors. That is one of the reasons why we have been able to accommodate the higher oil prices.

Believe it or not, there are gainers from it as well as losers. When you take a look at the steel industry, for example, if you drill an oil well, then that's the steel for 58 cars going down into the ground. It's a very big stimulus to demand.

**Bianco**: Two more emailed questions, and then we'll wrap this up, because I think that they're somewhat interesting – one for me and one for Howard. The first one is from **Steven**.

"If Fed policy adjusts to allow weaker banks, other financial institutions to fail, then isn't this a calamity for the stock market?"

If the question is whether the Fed allows financial institutions to fail, then, yes, that's a problem for the stock market. But if the question is if the Fed does whatever it takes to save these weak financial institutions at the expense of higher inflation for everybody else, then that's also a calamity for the stock market.

It is a difficult position that the Fed is being put in right now. As I said earlier, early on, from August until maybe six weeks ago, the Fed was able to attack this credit crisis without consequence. Now, the consequence is perceived to be higher expected inflation because the Fed is running easy policy. So the question becomes – and let's put it straight up – straightforward, "Which is worse for the economy – if a firm like Lehman Brothers or a firm of Lehman Brothers' statue fails, and let everybody on Wall Street pick up the pieces or whatever we want to define as 'fails,' or do whatever it takes to save them and stick everybody else with higher inflation expectations?" So it's not just a one-choice thing -- save the financial institution to hold the stock market together. Saving the financial institution now has a cost.

The last question is for you, Howard, from **Neal**.

"Has muted CPI increase been masked by shipping our wages to China? Now that China is experiencing wage inflation, will we see the increased gasoline price as a better indicator of CPI in the U.S.?"

**Simons**: Well, there are a couple of interesting questions there because what we had before whenever we lowered monetary policy, was that it got easier as we created asset inflation. This is the first time that we have been stimulative in the last 25 years and have created price inflation. We haven't seen it in wages yet. So as the pricing power of companies has increased wages haven't because we have a global market now in wages, not only in the industrial sector but, increasingly, in anything that could be done over the Internet in the information-based sector. So, yes, there has been upward wage pressure in China as a result of the transmission mechanism of the yuan staying in a managed peg, managed revaluation against the dollar.

Is gasoline a better measure of inflation? It's really hard to say because, remember, gasoline is a consumed resource, not a static resource. I think that you have to look at it as something that is a constant market basket as opposed to a single commodity rule. One of the reasons why, for centuries, you could use gold as a monetary proxy is because you don't consume it. But gasoline is consumed. It disappears. It has production constraints. It has all manner of external factors. So I would not look to gasoline as a measure where inflation is going to be just the same in that I wouldn't look at anything in the food sector coming up as saying what inflation is going to be. Now, this is not an argument in favor of core inflation, which I think is nonsense. But it's simply saying that we are going to have a crop failure or a crop shortfall. Does that mean that we have higher inflation because we had rain in the Midwest, in May and June that flooded the fields? That's a much harder argument to make.

And, incidentally, I want to turn back to a previous question there that Jim had answered. By letting firms fail, you kind of avoid the Japanese mistake in the 1990s, where they kept a lot of their banks brain-dead by not letting any of them fail. At some point, you're just going to have to say, "You know what? You made a bet. You lost. You're out of business. We're not going to try and save everybody by creating inflation because it's not going to work. Somebody is going to have to die here."

**Bianco**: I said that was going to be the last question, but I lied. We have one more that came in, Howard. I thought that it was worth answering.

"Forecasters are predicting $200 oil like Goldman. What are your thoughts about the future price of natural gas? And when do we see a substitution effect of natural gas for oil or gas fuels for coal or for oil?"

**Simons**: Well, the short-term in natural gas is very bullish because, over the last decade, we have been drilling and not replacing reserves to the extent that we thought that we would. You can find natural gas relatively easily through large parts of the country. But you cannot find the so-called elephant fields that you really need. So natural gas is kind of a dwindling resource in this Country. Until we get large-scale importation of LNG – liquefied natural gas – we're going to see a very high natural gas price environment.

I wrote a piece about a week or two ago saying that this is going to be the next energy primal scream, is when people start getting their heating bills this winter. This is because natural gas is going to remain at $10 to $12 minimum going forward. And that is at risk if we have any hurricanes later this summer and early this fall. If we get a repeat of 2004, 2005 in the Atlantic hurricane season, then we could have a disaster in home heating at the same time that we're having a crop shortfall in corn, at the same time that we think it's a good idea to feed a third of our corn crop to yeast instead of to people and livestock. So we are looking at some very significant rising of price levels in both food and energy.

**Bianco**: OK, let's wrap it up there. We ran a little bit long. I try to keep it to 60 minutes, and we're at 68 minutes. But I saw that enough people were hanging on the line that it was worthwhile, and these were good questions.

So I want to thank everybody for joining us on our Monthly Conference Call. We will talk to you again next month. Bye-bye.

**END**

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