Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Barreling Along

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David Gitlitz

The bad news is that oil is at $55. The good news is that the Fed isn't panicking.

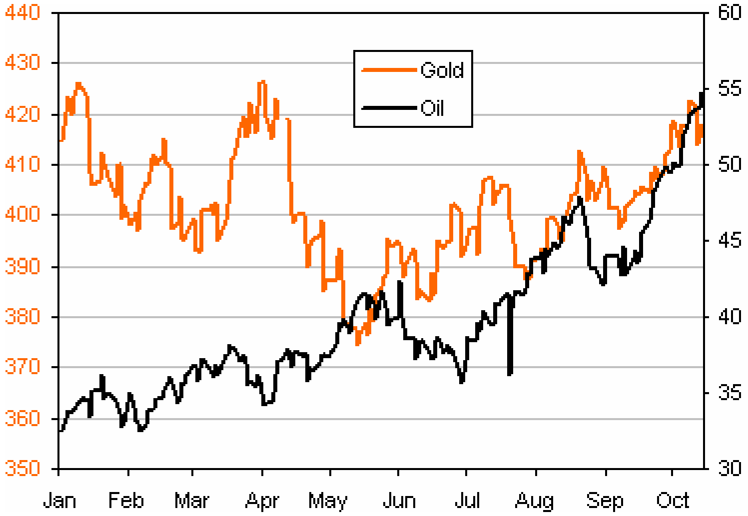
In early trading Wednesday crude oil first dropped by more than $1.20 per barrel to below $51.60 before abruptly turning higher to make back the lost ground within about four hours, and continued rallying to close the session more than $2 above the lows. Perhaps a keen-eyed analyst somewhere was able to divine the fundamental forces at work in such volatile trading activity, but we're not aware of any. Certainly, major press organs had access to no such expertise, judging by the wholly unconvincing rationalizations on offer. For example, the best the **AP** could come up with to account for the abrupt swing from falling to rising prices was that "as oil traders became less bullish about U.S. inventories and worries grew about Hurricane Ivan's lingering impact on production in the Gulf of Mexico, prices began to soar."

Unless the market is suffering from collective bipolar disorder, we're skeptical that such sudden mood shifts by traders can explain the quick drop in oil prices followed by their even more pronounced ascent. On a day when no new information could explain such sharp swings, the wild action Wednesday helped crystallize for us that rather than fundamental supply and demand factors, a major influence on price movement in this recent period has been sheer speculation on the price movement itself. If there is such a thing as a "bubble," that is its definition.

That's not to say that the oil market is completely divorced from reality. Yesterday's price jump of another dollar, to just below $55, at least could be explained by news of a decline in distillate inventories, which could leave refiners scrambling to meet winter heating oil demand. Nor do we dismiss the effect of short-run disruption to **Gulf of Mexico** operations caused by Hurricane Ivan, or the risk-averse inventory build that has been seen during this price run up over the past four months so. In the past month alone, however, **NYMEX** benchmark crude has risen by more than $10, fully 25%, and a good part of that can be attributed to the froth of an overheated speculative environment.

Certainly, $55 oil appears on no list of variables auguring for optimal economic performance. We'd agree with estimates suggesting that if oil prices were sustained at these levels, quarterly GDP growth would stand to be cut by as much as half a percent. Fortunately, though, sensitive market-based indicators suggest the drag of higher energy costs is being offset by the underlying strengths of this expansion, powered by robust levels of risk-bearing and capital formation. Nothing we've seen dissuades us that we're now well into a second half that could record growth of 4.5% to 5%. And if we're right that oil trading recently has been driven largely by speculative dynamics, the downside risk in current prices appears considerable.

Frankly, though, our analysis suggests the bigger risk posed by the oil price spike is not slowing growth but accelerating inflation. Last week, we noted that movements in oil and gold prices had moved into much closer correlation early last month, suggesting that the risk of **the Fed** accommodating the oil price bulge in the general price level intensified appreciably with oil



trading above $42 (see ["Scary Kerry"]() October 8, 2004) The behavior of gold in response to the tumultuous oil trading this week underscored the linkage. On Wednesday, as oil opened weak, gold dropped below $410 for the first time in more than two weeks. As oil recovered and shot higher through the day, gold followed suit. Today, with crude hugging the $55 plateau, gold again poked above $420. We note, though, that while trading in the two commodities has been closely aligned, the price of gold in the past several sessions has lagged somewhat behind the levels otherwise indicated by its recent relationship with oil. This could be an indication that, at the margin, the smart money in gold is betting on a significant oil price correction.

Meanwhile, we were pleased today to hear Fed chairman **Alan Greenspan** downplay the macro impact of rising oil prices, which suggests he is not yet considering slowing the Fed's rate normalization schedule in an ill-advised attempt to "offset" the drag on growth. At the same, however, he gave no indication that he appreciates the particular risks to dollar purchasing power posed at this point, with the potential for rising energy prices to be monetized by still-easy Fed policy.