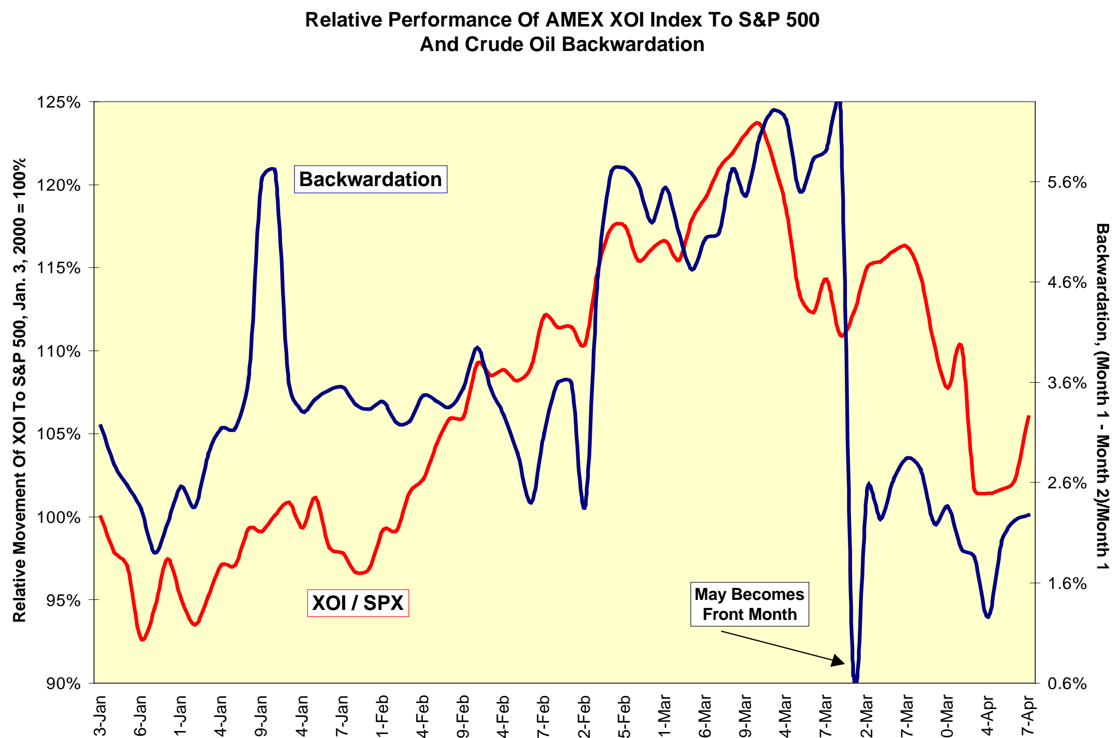
After The Fall

It had to happen. Greed-crazed buyers paid no attention to the fundamentals of their market and pushed prices up despite all manner of technical warnings. Volatility surged as prices trebled in a year's time. Headline-grabbing politicians materialized on cue. Finally, prices plunged more than 20% in a few days.

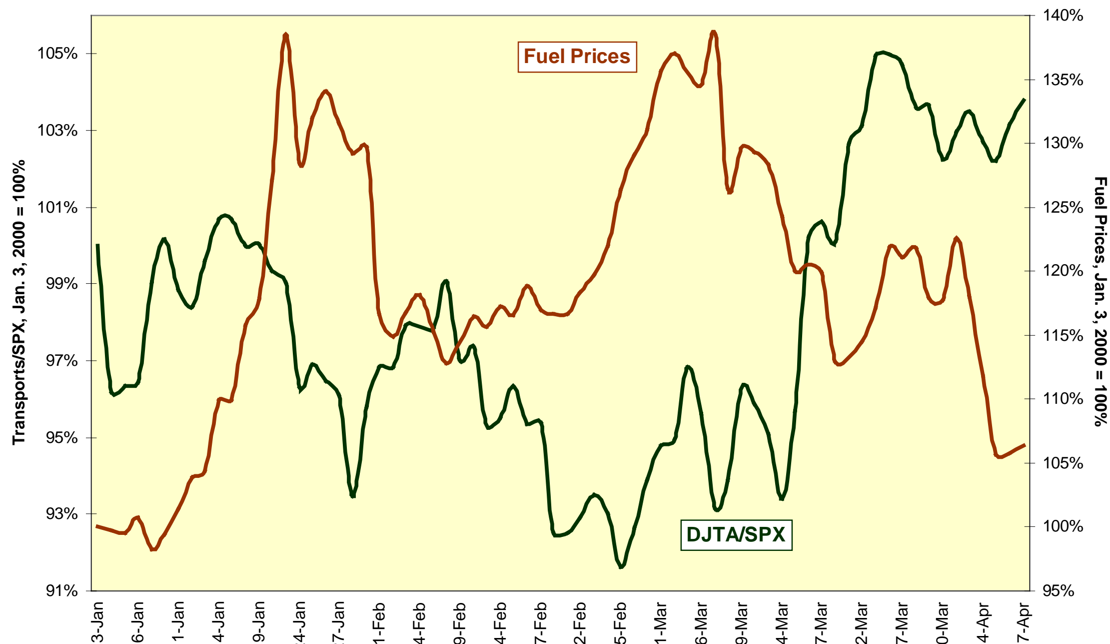
We are, of course, talking about the crude oil market. The word "fundamentals" should have been your tip-off. At least we didn't have to listen to Sen. Charles Schumer (D., NY) demand the creation of a Strategic NASDAQ/Internet Trust (SNIT).

The price of crude oil and its effect on financial markets has been discussed several times in this column (see "Hey Crude, Don't Make It Bad," October 27, 1999, or "Backwardation In Oil Stocks Rewards Patience," March 8, 2000). We opined in October the price of crude would not be inflationary if the Fed remained tight, which has been the case. We also suggested the underperformance of oil stocks would end, oddly enough, when both the price of crude oil and its backwardation -- the discount of forward-month futures to spot month futures -- started to fall. We also have discussed the great value in transportation stocks, (see "The Transports Not Taken," March 15, 2000) whose ten-month long bear market was only in part due to higher fuel costs. Now that oil prices have broken, at least for the intermediate term, what should we expect?

First, the oil stocks have continued to lag the S&P 500 over the past few weeks even though value stocks have performed relatively well since the beginning of March. This should not be too surprising; past breaks in backwardation have taken six to nine months to produce the general price trough required for a strong buy signal on the group.



The Dow Jones Transportation Average presents a more interesting story. By early March 2000, the Transports had fallen below their October 1998 low. We issued a buy signal based on the March 10 value of 2365; the index is at 2828 at the time of this writing, an increase of nearly 19.5% in only six weeks. The relative performance of the Transports bottomed on February 25, while the fuel price index -- a weighted average of 60% gasoline, 30% diesel fuel, and 10% jet fuel -- reached its peak on March 7. Some of the market unpleasantness of the past week was attributed to sector rotation, the selling of NASDAQ issues against the purchase of those suddenly lovable Old Economy stocks. The timing of the Transports' rise suggests differently: This index correctly anticipated a decline in its components' most important variable cost.



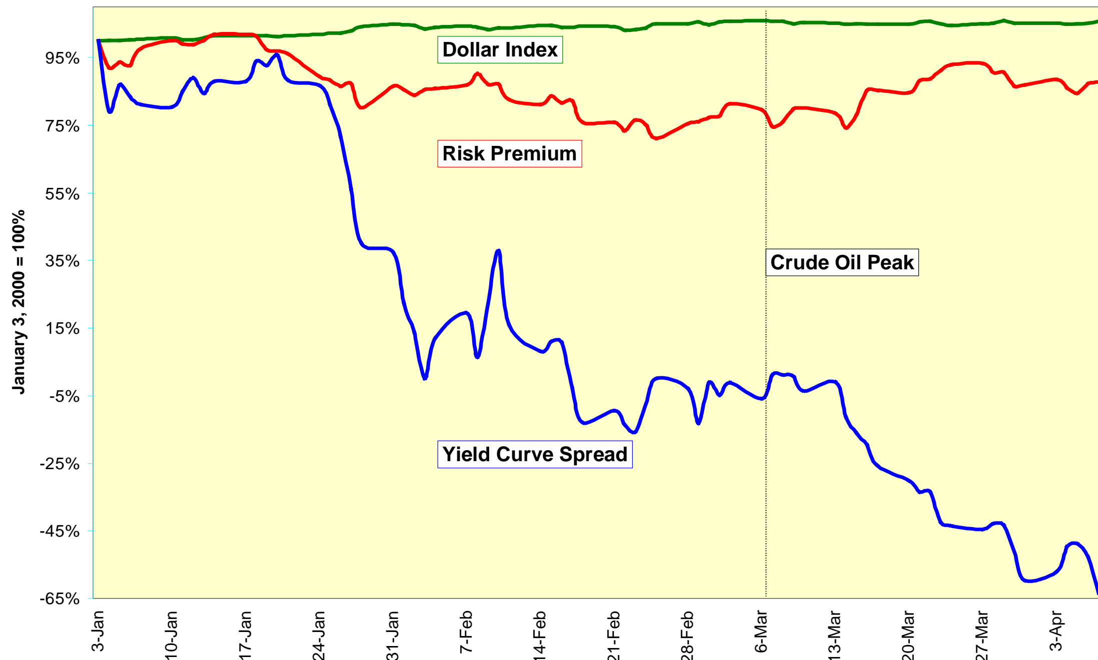
A Matter of Interest

The knee-jerk reaction associating higher crude oil prices with increased inflation has been debunked yet one more time. Get used to it: Next time oil prices rise, we'll have to slay this dragon again. Inflation is a difficult concept to measure correctly with the consumer price index as this index includes a heavy energy component. Moreover, the CPI assumes no rational economic behavior such as price elasticity of demand, the quaint notion that demand falls when price rises. Better, market-derived, measures of inflation include the strength of the dollar, the slope of the yield curve, and the risk premium in equities relative to bonds (see "Inflation Isn't Lurking In The Fields," December 8, 1999).

The logic for each of these being a good inflation indicator is compelling. If inflation is a monetary phenomenon, then nothing should flash a warning sign of excess dollar creation faster than the currency market. Similarly, an increasingly positive yield curve spread indicates bond investors are demanding a higher yield to compensate for inflation risk as the central bank drives short rates lower. The risk premium for equities, defined here as the P/E of the S&P 500 less the reciprocal of the 10-year Treasury note yield, should shrink if investors believe higher inflation is imminent.

None of these phenomena have been present so far in 2000, either before or after the crude oil price peak. The dollar index has been quiet, almost suspiciously so, in the presence of higher U.S. interest rates. The Treasury yield curve has inverted, (see "Moving Ahead Of The Curve," January 26, 2000) which is always a sign of tighter monetary policy and declining inflationary expectations. Finally, the premium of equities to Notes, which had been declining from mid-January to late-February, has been increasing. The effects of crude oil price movements, both higher and lower, are difficult to discern in any of these measures.

Inflate This: The Market's Not Worried



From a macroeconomic viewpoint, there's no bad news associated with lower oil prices. They act as a tax cut for the economy, something Congress does not wish to bestow upon the "rich," a category that includes you, dear reader. This little bit of fiscal stimulus will offset higher short-term interest rates, just as both the yield curve inversion and the stronger stock market have done.

Conclusion? We've weathered the higher oil price storm quite nicely. Bring on the next crisis, please.