

Did The Federal Reserve Save Us From OPEC?

The society of those who believed three years ago the world's economy could withstand crude oil prices in excess of \$60-65 per barrel is a small one. After all, the experiences of 1973-74, 1979-89, 1990-91 and again in 2000 when crude oil prices over \$30 were enough to tip the economy into recession.

Several reasons for our continued prosperity in light of pain at the pump have been offered, most prominently that the current higher crude oil prices have been caused by strong demand, not by the supply shocks associated with the first three episodes of higher prices. Crude oil, like all physical commodities, is subject to process margins; if buyers gain more economic value from their output than they paid for their crude oil input, demand will not fall.

But previous experiences with high crude oil prices erroneously led us to believe they always would be painful for financial markets. The first oil shock of 1973-74, which occurred more than two years after President Nixon imposed wage and price controls on an economy already wracked by inflation, produced an indelible association in the public mind that the later event – high crude oil prices – produced the earlier event, inflation. It is far more convincing to argue higher inflation produced higher crude oil prices, but once this perception of higher crude oil prices creating inflation formed, it formed indelibly.

That the first set of oil shocks damaged financial markets severely cannot be argued. U.S. stocks witnessed severe bear markets, bonds plunged as inflation expectations and interest rates rose, the dollar weakened and corporate credit spreads, the premium borrowers had to pay over the Treasury rate, widened.

The Federal Reserve's Role

The common thread in all of these developments was the belief, once again based on the 1973-74 experience, was the Federal Reserve would adopt a lax monetary policy in response to the economic stress of higher crude oil prices. Given a choice between higher inflation and recession, the market believed, the Federal Reserve would opt to risk inflation in the short-term and try to offset the stress of higher crude oil prices with easier credit.

Paradoxically, it was this belief the Federal Reserve would ride to the rescue that produced the negative responses in financial markets. Inflation is, after all, a monetary phenomenon, and the market understood that today's monetary largesse would be tomorrow's inflation.

Thus the Federal Reserve's grand social experiment in driving short-term interest rates to 45-year lows by early 2004 presented it with a problem. They communicated to the market in May 2003 these policies were extraordinary measures designed to forestall the risk, no matter how minor, of deflation. Once that risk was defeated, they would have to swing full-circle to withdrawing the excess liquidity without shocking the economy with a sudden move back to much higher – and much more normal – interest rates. They needed a strong signal to begin this process, and they received it on April 2, 2004, the date on which a very strong employment report for March 2004 was released.

This date represented a sea change in monetary policy. All of the subsequent charts reviewed in this article extend from the immediate aftermath of September 11, 2001 through late-August 2005 and are split by color-code at this date. This is done to illustrate just why the Federal

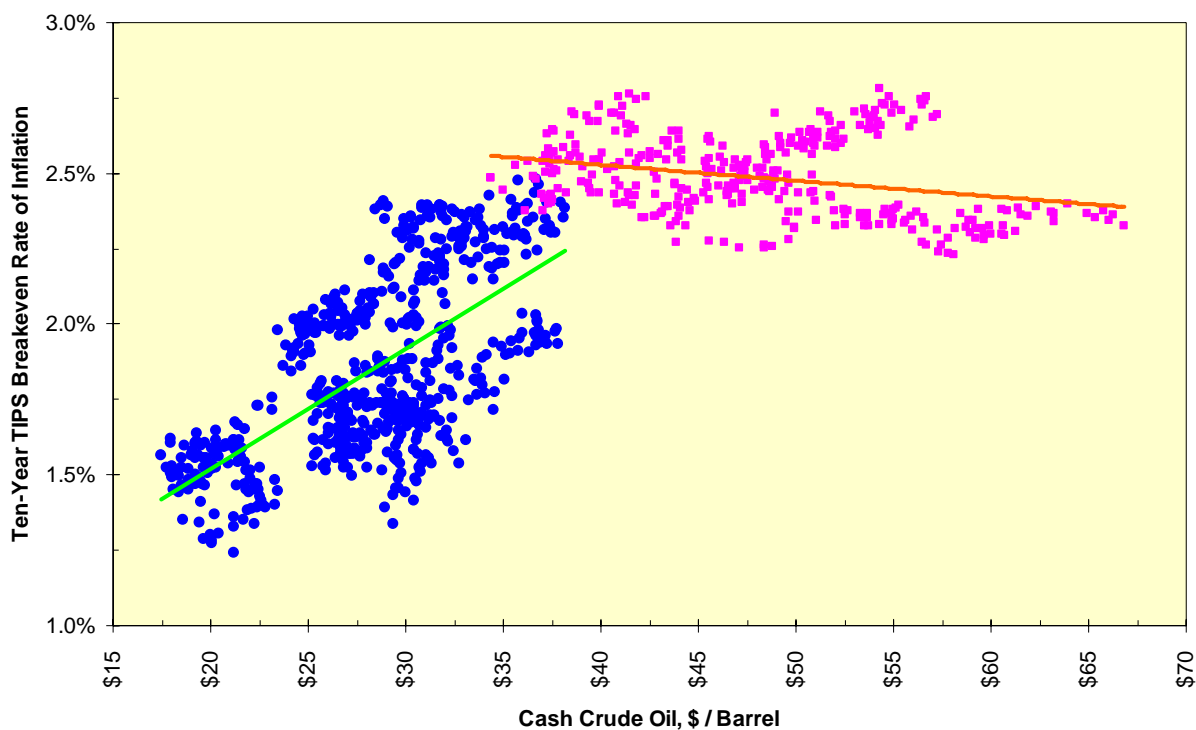
Reserve's change in monetary policy was so instrumental in preventing damage to financial markets from a near-doubling in crude oil prices.

Inflation Expectations

We can now estimate, albeit imperfectly, the market's expectations for inflation as measured by the Consumer Price Index via the Treasury Inflation-Protected Securities (TIPS) market. The yield spread between regular ten-year Treasury notes and TIPS approximates the market's expectations for the average annual rate of growth in the CPI over the next ten years. This approximation ignores the embedded options in TIPS, such as government honesty in calculating and reporting the CPI, the tax rate on the accrual of principal within TIPS and the put option on deflation.

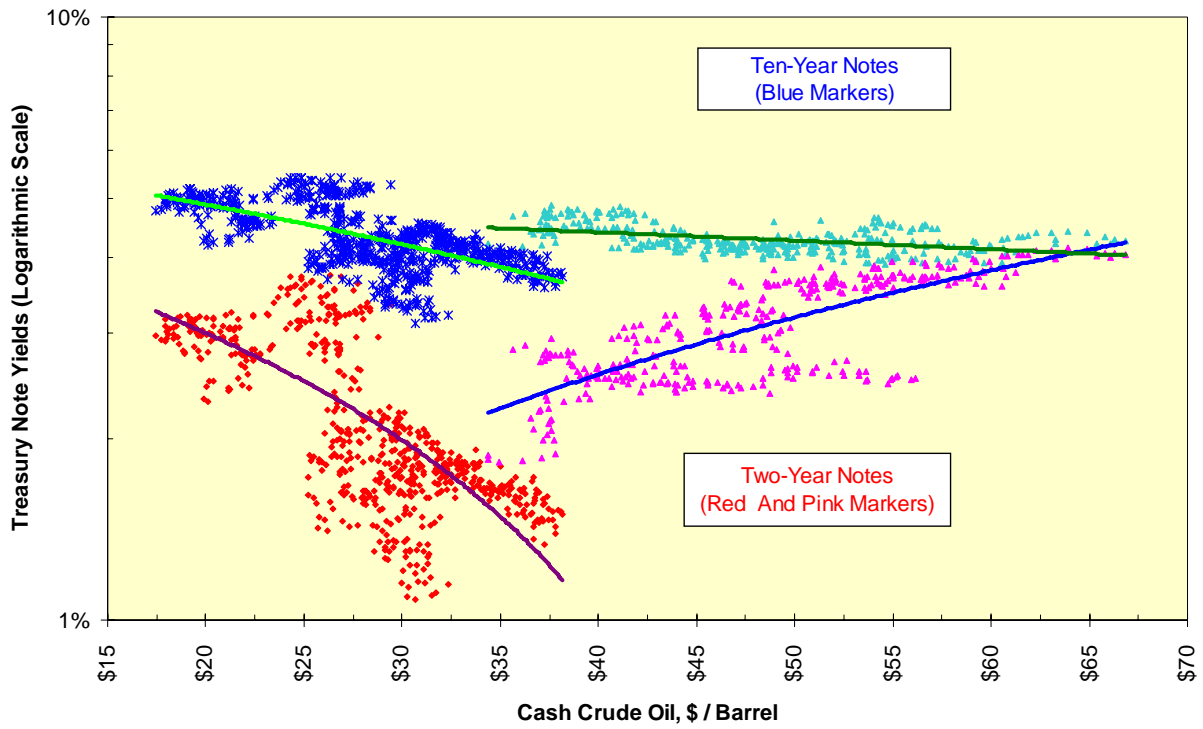
If we map these inflation expectations against crude oil prices in Chart 1, we see how the relationship prior to April 2004 was positive (green trend line). After April 2004, the relationship between inflation expectations and crude oil prices turned negative (orange trend line).

Chart 1: Crude Oil And Inflation Expectations



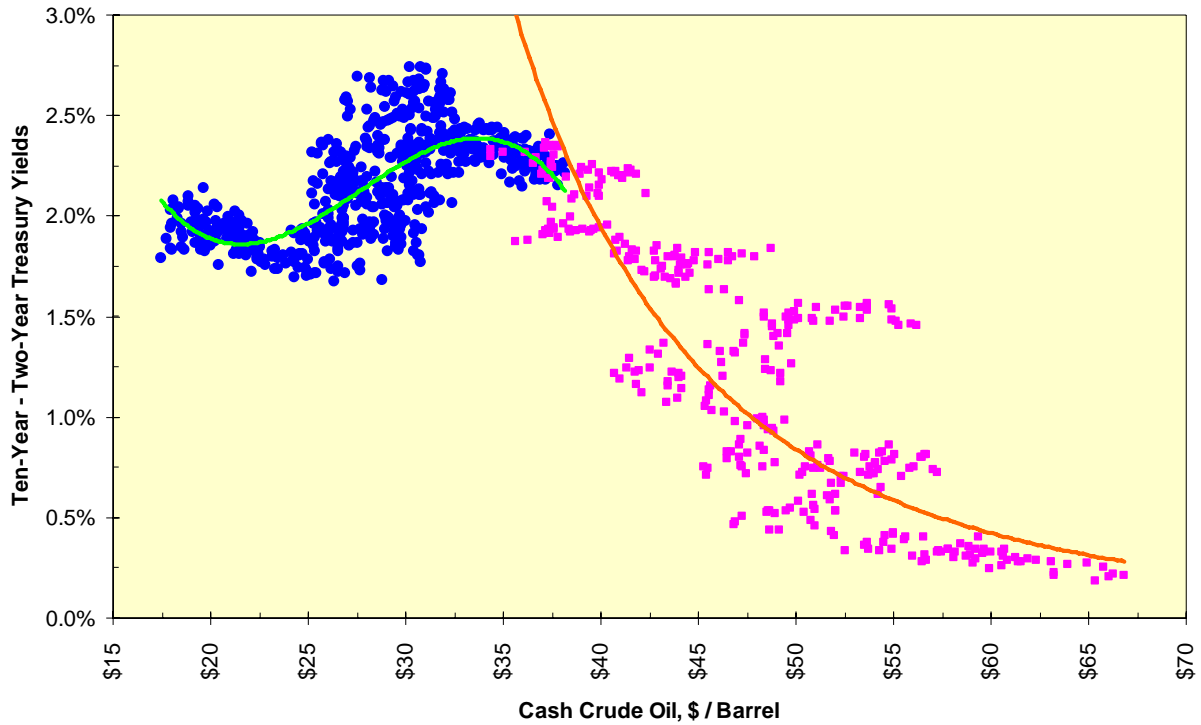
The reduction in inflation expectations is linked closely with changes both in interest rate levels and in the shape of the yield curve itself. Let's map both two-year and ten-year note yields before and after April 2004 against crude oil prices. Prior to April 2004, two-year note yields (red markers) were in a pronounced downtrend; after that date, the trend turned solidly higher. The yield on ten-year notes, however, remained in a weak downtrend even as crude oil prices shot higher; this suggests the tax effect noted above was part of Alan Greenspan's conundrum as to why long-term rates had not increased.

Chart 2: Crude Oil And Treasury Notes



If we restate the information in Chart 2 in terms of the spread between ten-year and two-year yields, we can see just how much the nature and tenor of the yield curve switched after April 2004. As crude oil prices have moved higher, the yield curve has flattened (orange trend curve).

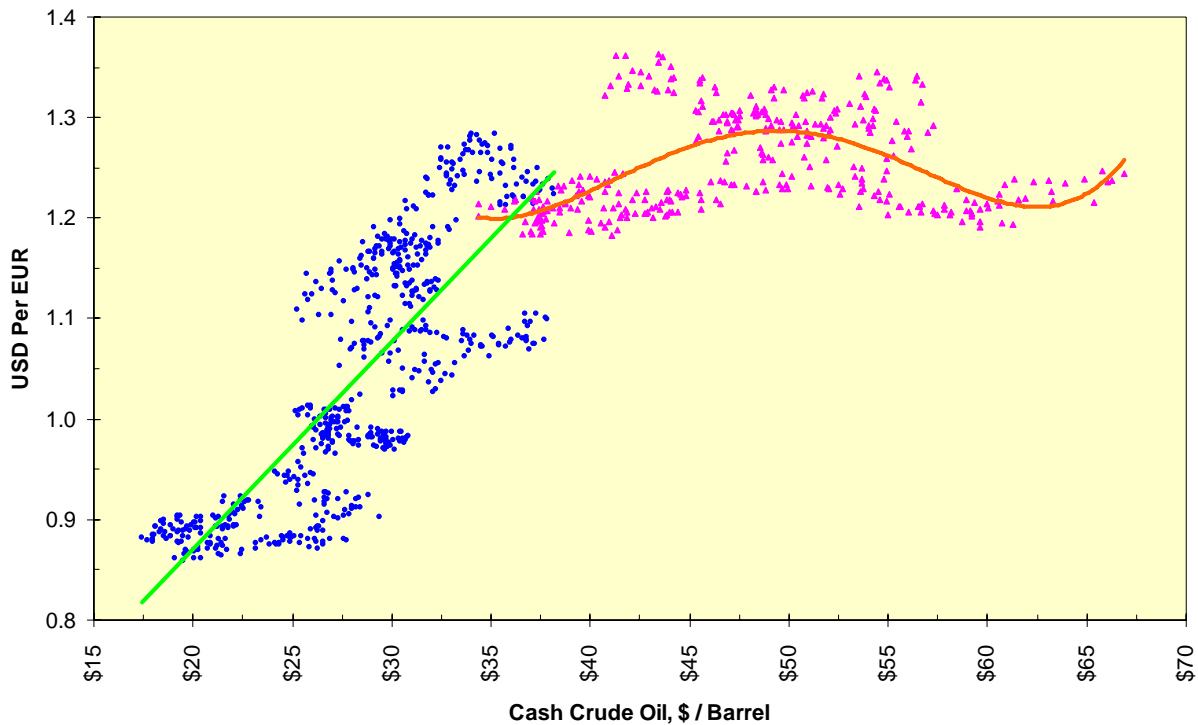
Chart 3: Crude Oil And The Yield Curve



The Dollar

Fewer subjects evince more vocal responses from the partially educated than the course of the dollar. The exchange rate between the dollar and the euro is explained best by interest rate differentials between the two currencies; some commentators have tried to explain it with crude oil prices. Prior to April 2004, lower short-term interest rates in the U.S. weakened the dollar (green trend line). After April 2004, the steady rise of short-term interest rates in the U.S. stabilized the dollar and rendered its apparent relationship to crude oil random.

Chart 4: Crude Oil And The Dollar-Euro Exchange Rate

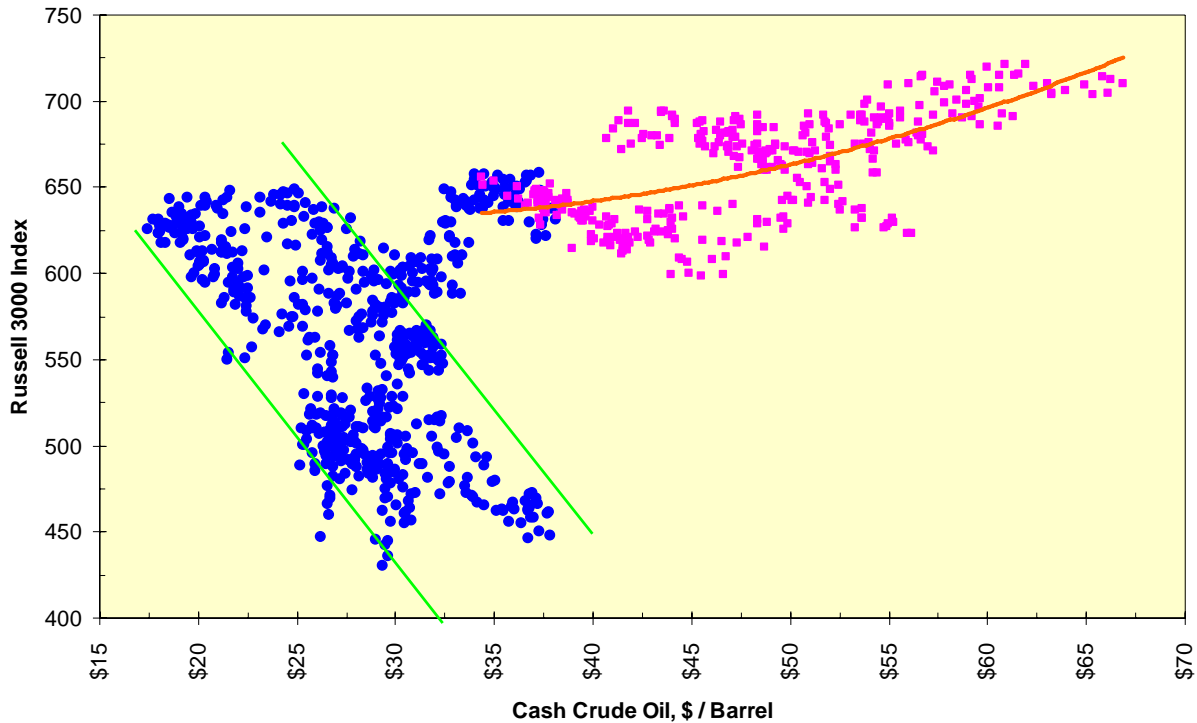


Corporate Bonds And Stocks

Let's say, just for the sake of argument, you are running a market-oriented television network and need to keep traders' attention. What do you put in the "bug" in the corner of your screen besides the old standbys like the Dow Jones Industrials? Crude oil prices seem like a good entry; the implication is these prices must have something to do with stock prices.

It may seem logical, but what percentage of your own net worth has derived from being logical? If we run the same map of the Russell 3000 stock index against crude oil prices pre- and post-April 2004, we see how stocks were declining during the Federal Reserve's rate-cutting escapades (green channel lines). Once the economic news improved and short-term interest rates started to move higher, stock prices recovered and began to move exponentially higher (orange trend curve) even as crude oil prices set record after record. That's it, then: The business news shows are telling you crude oil prices are going higher to get you feeling bullish.

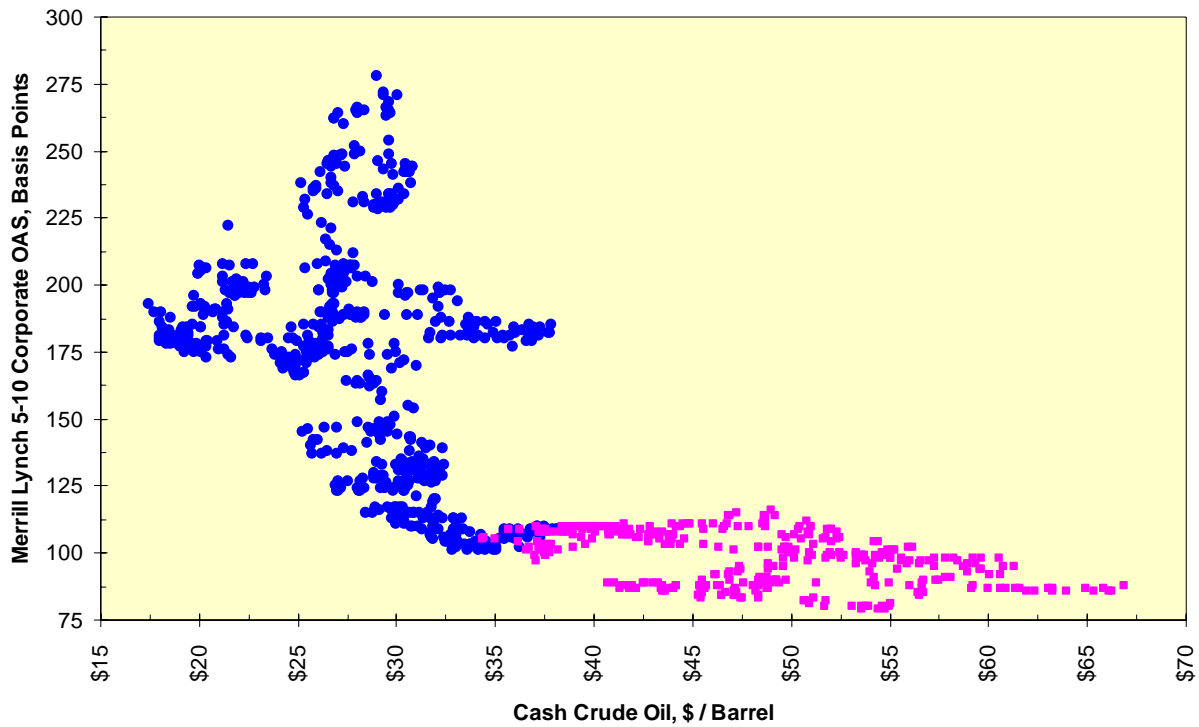
Chart 5: Crude Oil And Stocks



It may be news to many stock-oriented traders, but stocks veritably float on a sea of corporate bonds. If a corporation's debt is in trouble, its stock is unlikely to rise unless a corporate event such as a merger or leveraged buyout intervenes. One common way to measure the risk of corporate bonds is the option-adjusted spread, or OAS. The higher the OAS, the greater the risk premium associated with the bonds and by extension, the lower the price investors should be willing to pay for both corporate bonds and stocks.

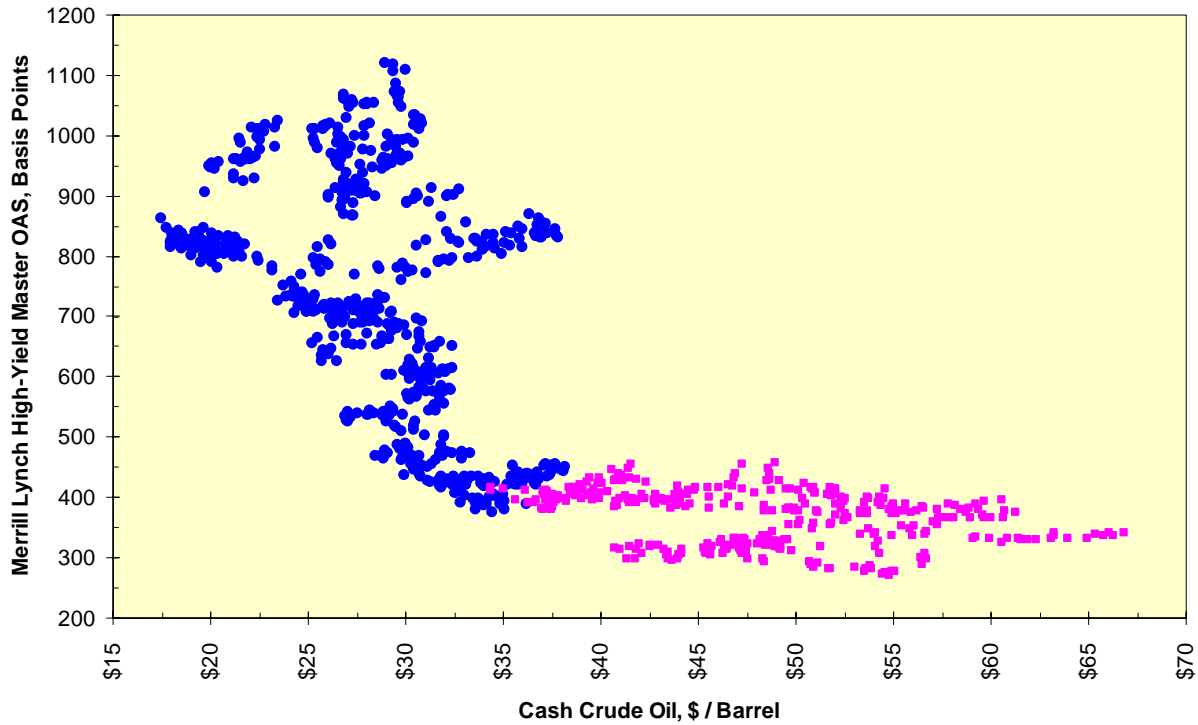
If higher crude oil prices are raising the costs of capital for corporations and stressing their balance sheets, then we should see OAS levels rise alongside crude oil. This clearly is not the case for investment-grade bonds as measured by the Merrill Lynch 5-10 year corporate bond index' OAS. These levels were far higher in the lower crude oil price environment and continued to narrow after the Federal Reserve began raising interest rates.

Chart 6: Crude Oil And Investment-Grade Corporate Bonds



What was true for investment-grade bonds was true as well for their high-yield cousins, sometimes castigated as “junk” bonds. The OAS of the Merrill Lynch High Yield Master index exhibits the same pre- and post-April 2004 pattern seen for investment-grade bonds. If these issues are more fragile, they certainly were not broken by either high crude oil prices or higher short-term interest rates.

Chart 7: Crude Oil And High-Yield Bonds



There we have it: Higher crude oil prices have been associated with higher stock prices, lower corporate bond risk, a firmer dollar, lower inflationary expectations and stable long-term interest rates. Alan Greenspan had been Chairman of the Council of Economic Advisers under President Ford, and he saw firsthand the damage done in the 1970s from a loose monetary policy in the face of higher crude oil prices. By leaning against the wind, he made sure the inflation genie stayed in the bottle, and for that we all can be grateful.