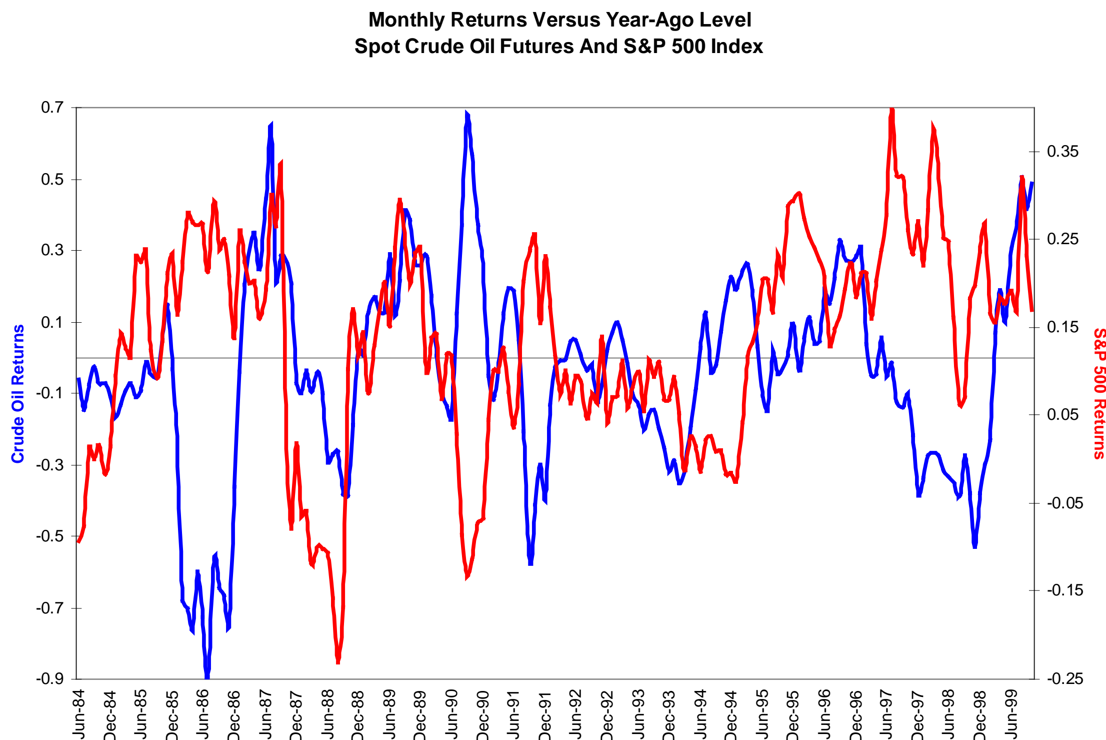
Hey Crude, Don't Make It Bad

Correctly or not, inflation and higher prices for crude oil have been linked forever in the public mind since the first oil shock of the 1970s. While economists debate the cause and effect relationship, most market observers of the past quarter-century would conclude higher oil prices are inflationary and thus bad for financial markets. This effect results from two factors. First, the implicit tax increase caused by the higher trade deficit; the U.S. imports nearly 10 million barrels per day of crude oil and refined products, which means every $1.00 per barrel increase increases gross imports by $300 million per month. Second, the Fed reacts to the higher price indices by increasing short-term interest rates.

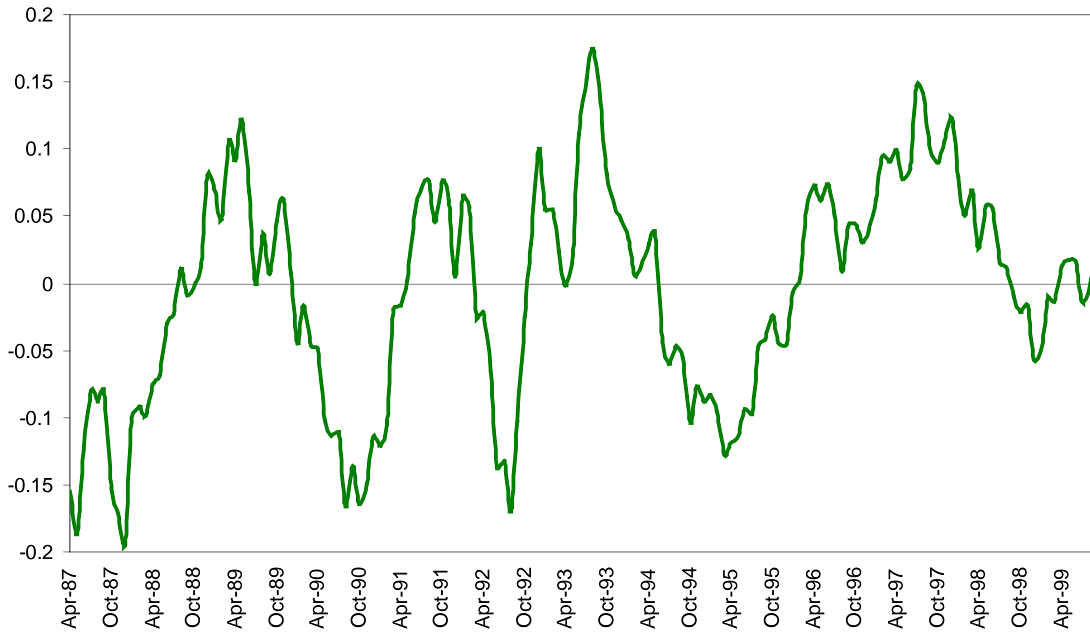
A chart of the monthly returns on spot crude oil futures and the S&P 500 cash index seems to underscore the negative impact of higher crude oil prices. In some periods, such as the 1986 price collapse, the Persian Gulf War and its aftermath, and in the 1997-1998 global commodity price collapse, the effects have been quite obvious. However, there are two periods, the year following the 1988 low in oil prices and the 1995-1996 crude oil rally, when the two markets appear to have marched in lockstep.



As is usually the case, the unexpected relationship contains the most interesting information. Oil markets worldwide are denominated in U.S. dollars, so any increase in oil prices produces an increased demand for the greenback by importers -- and an increased supply in the hands of exporters. Oil exporters then have to decide whether to finance the U.S. trade deficit directly in the form of portfolio investment or indirectly through the purchase of real goods and services from both American and non-American sources.

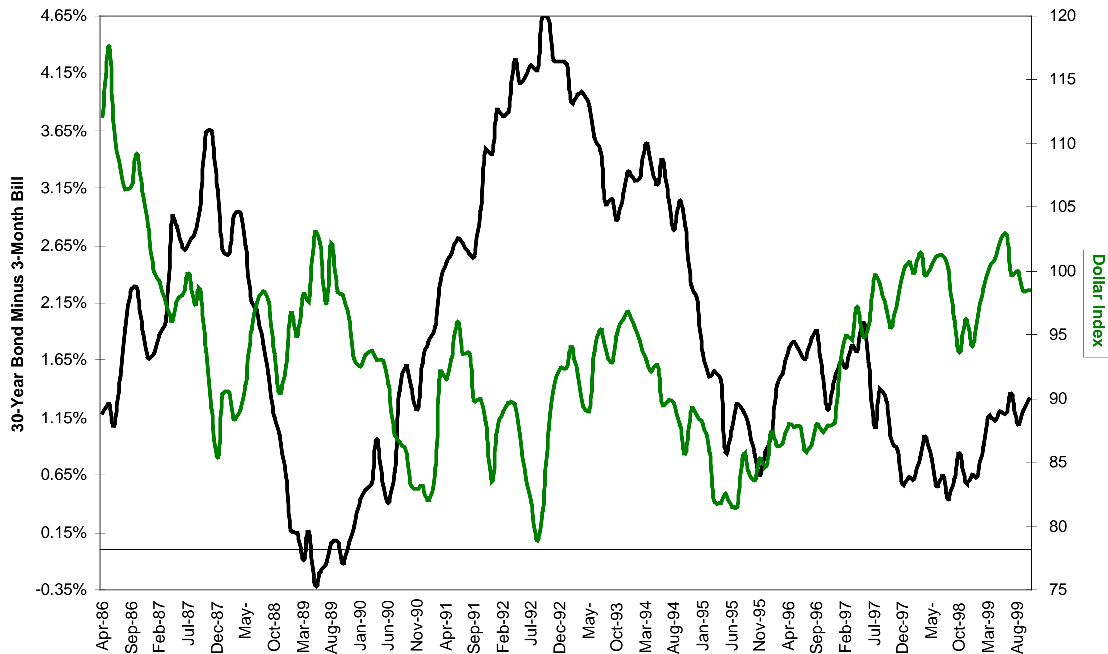
If the strength of the dollar is in fact a linking variable between oil prices and equities, we should expect to see a strengthening of the dollar during those periods when both stock prices and oil prices are rising, and we do. A strengthening dollar encourages foreign dollar holders, oil exporters included, to hold financial assets.

Monthly Returns Versus Year-Ago Level
Dollar Index



Despite its weakness against the Japanese yen over the past year, which might be more properly interpreted as yen strength, the dollar has been quite stable on a trade-weighted basis. An overt strengthening of the dollar index would depend on a further flattening of the yield curve, which would require another tightening by the Fed. Tight monetary policy produced both an inverted yield curve in 1989 and a fairly flat curve during the 1995-1996 crude oil rally, which produced a stronger dollar, which allowed the U.S. financial markets to weather both the Fed's moves and higher oil prices.

Monthly Dollar Index Versus Yield Curve
April 1986 - October 1999



The U.S. yield curve, however, has been getting steeper, not flatter. The bond market is anticipating an increase in inflation not yet visible in either the standard price indices or in commodities other than oil. Other commodity price increases, such as those in cattle or gold, are readily explained by singular events; just because the vicious commodity price deflation of mid-1997 to mid-1999 is over, it does not stand to reason we are in a 1970s-style commodity inflation.

Tough Love, Alan

What policies are in order in such an environment? First, the Fed needs to signal its willingness to flatten the yield curve. Second, it needs to accept the resulting stronger dollar even though it may exacerbate the U.S. current account deficit. Third, the implied tax increase of higher oil prices needs to be offset with real and simple tax cuts. If these policy prescriptions echo those of recent Nobel Laureate Robert Mundell, so be it. This was the policy mix that ended the stagflation of the 1970s, and what's so bad about that?

How do we profit from this mix, if followed? First, let's stay long crude oil for a while: It's in a bull market that will challenge $30 before it is through. Second, the dollar should do quite well against the euro, and the Canadian dollar should do well against the greenback. Third, bonds may finally be ready to start outperforming stocks for the first time in years.

What's the downside? We can refuse to stay ahead of the curve on inflation, monetize higher crude oil prices, keep the current high tax rates, and remember just how much fun we had during the Carter administration. Come to think of it, commodity traders did have fun back then, and that's a topic we're sure to revisit in the months ahead.