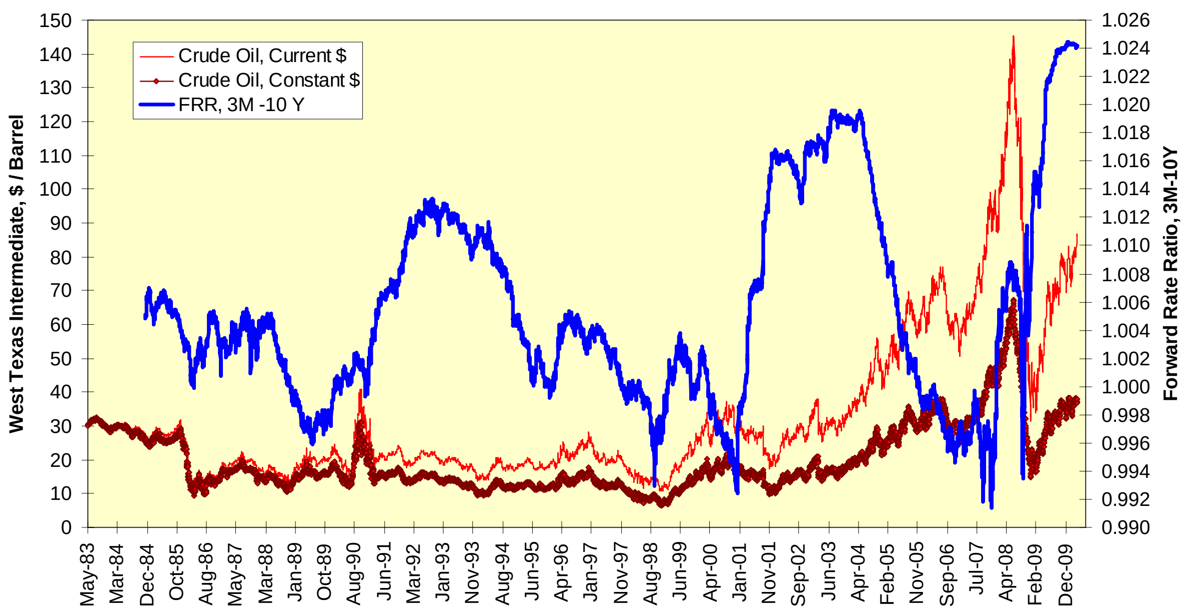
If You've Got The Money, Honey, Don't Buy the Crude

The phrase, "acting like a Zulu," passed into English during the Anglo-Zulu War of 1879 to disparage the brave warriors who charged into superior defensive positions. The very same English were to repeat this exercise on more numerous occasions and with much greater loss of life during World War I.

All of this brings me to those monetary Zulus who charge headlong into every situation armed not with a spear but with a certainty any and all commodity price increases can be laid at the feet of the Federal Reserve. As I noted the one and only market regime when crude oil and the S&P 500 were negatively correlated for any length of time was the period between August 2007 and May 2008 when the Federal Reserve first started to pour money on the floor, I felt duty-bound to explain the non-linkage between excess monetary creation and crude oil prices a little more fully. Even with the benefit of hindsight, crude oil's doubling-plus from $70 to $145 and collapse below $35 over a sixteen-month period demands some sort of explanation.

Let's look at the nominal (current-dollar) and inflation-adjusted (constant-dollar) price of crude oil against two financial variables as shorthand for monetary largesse, the shape of the yield curve between three-month LIBOR and ten-year Treasury notes and the dollar index. The yield curve will be denoted as the forward rate ratio (FRR), the rate at which we can lock in borrowing for 9.75 years starting three months from now divided by the ten-year rate itself. The more this FRR exceeds 1.00, the steeper the yield curve and, by extension, the looser the monetary policy. This FRR hit its all-time high in 2003-2004 only to see that steroid-induced episode under Greenspan left in the dust by an even higher high in 2009-2010 under Bernanke. These two are sort of like Mark McGwire and Barry Bonds without the benefit of a decent baseball game intervening.

Are Crude Oil And The Yield Curve Related?

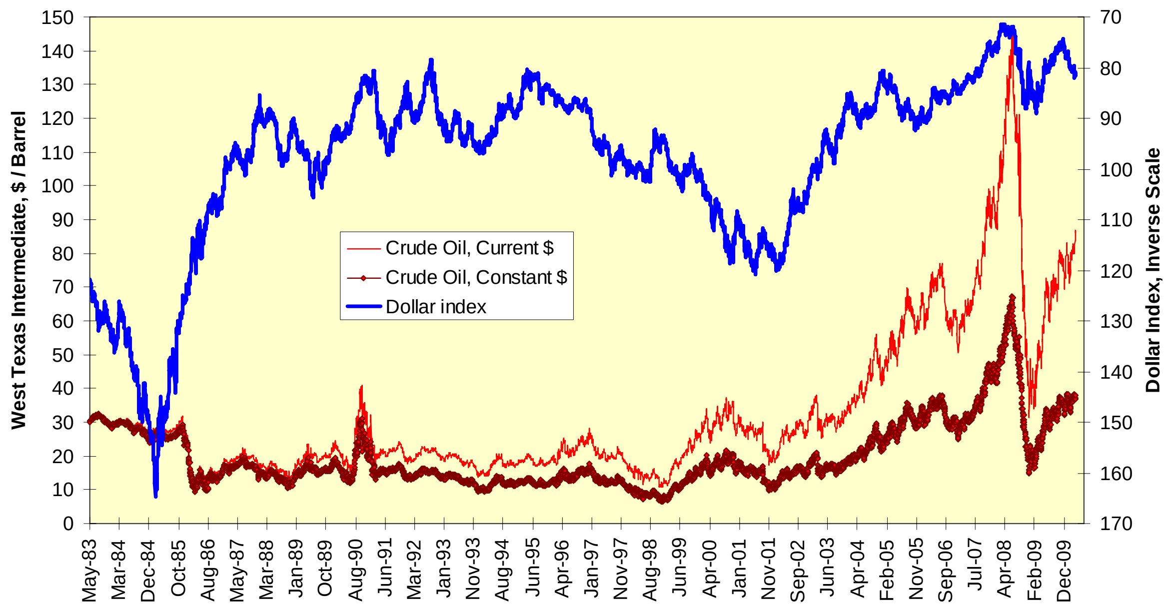


Stare at that chart. Remember that a causal relationship must work in all times or have a powerful fundamental argument for why it did not work in a given situation. Does the FRR seem to lead the price of crude oil either expressed either way? How can you explain the bull market in crude oil extending almost continuously between 1999 and 2008 while the yield curve flattened during 2004-2006?

About all you can say here with any economic accuracy is the 2001-2004 stimulation of demand via low interest rates was satisfied with accelerated production-linked demand for crude oil from China and elsewhere. This collapse in demand certainly overrode the effects of a steep yield curve regime in 2008.

We can overlay the dollar index against the same crude oil charts and engage in a similar narrative. A massive weakening of the dollar in 1985-1988 did nothing to push crude oil prices higher, and a steady dollar rally in 1995-2000 did nothing to push crude oil prices lower. Yes, there have been some recent time segments when crude oil and the euro have been linked, but one should never confuse anecdotes with analysis.

Are Crude Oil And The Dollar Related?



If and when credit conditions tighten – a statement and not a forecast – do not rush out and sell anything you have that might be linked to crude oil. If this tightening occurs within a period of strong global economic growth, the energy sector will do just fine on a relative basis.