

Oil, Inflation, the Dollar and Election Year

A Witch's Brew

Is it a brew, or the Perfect Storm? Maybe neither. We just don't know yet. But by November many things should become clear(er).

Pity the US Federal Reserve Board. It began 2008 facing a run-of-the-mill financial industry crisis. But, by March the Fed became the financier of last resort – literally a weekend bagman¹ for a Wall Street house that: (a) was not under the Fed's jurisdiction, but (b) was deemed too important to fail. Meanwhile, if that problem wasn't enough, the Fed's primary day job... manipulating the nation's money supply and short term interest rates...was faced with increasing evidence of an economic bugaboo known in modern times as Stagflation.

Gordian Knot

Dilemma: The Fed needs to hold borrowing rates low in order to blunt the impact of a rapidly fading US economy. A simple task. But, the rather sudden blowout of nearly all commodities prices and, hence, the cost of goods would normally steer the Fed toward bumping rates (several times), especially when the current interest rate is near an historic-low 2%. We believe the Fed should choose to bump soon²...and often, because the economy's need for low interest rates does not balance its opposite side: (a) not only are inflation fires rapidly scorching the countryside, but also (b) the relentless pounding of the US Dollar by other currencies has to cease, so that commodities prices such as oil (which the world market still quotes in dollars) can at least be slowed, and (c) other central banks are, and/or will be raising their interest rates.

¹In March, the Fed's balance sheet took on a \$30 billion capital loan made to JPMorgan Chase, collateralized by \$29 billion of illiquid mortgage paper dumped out of now-defunct Bear Stearns' investment portfolio.

²Regardless of who is/was its chairman, the Fed has a pronounced historical tendency to avoid any changes in interest rates within the 12 months before a presidential election.

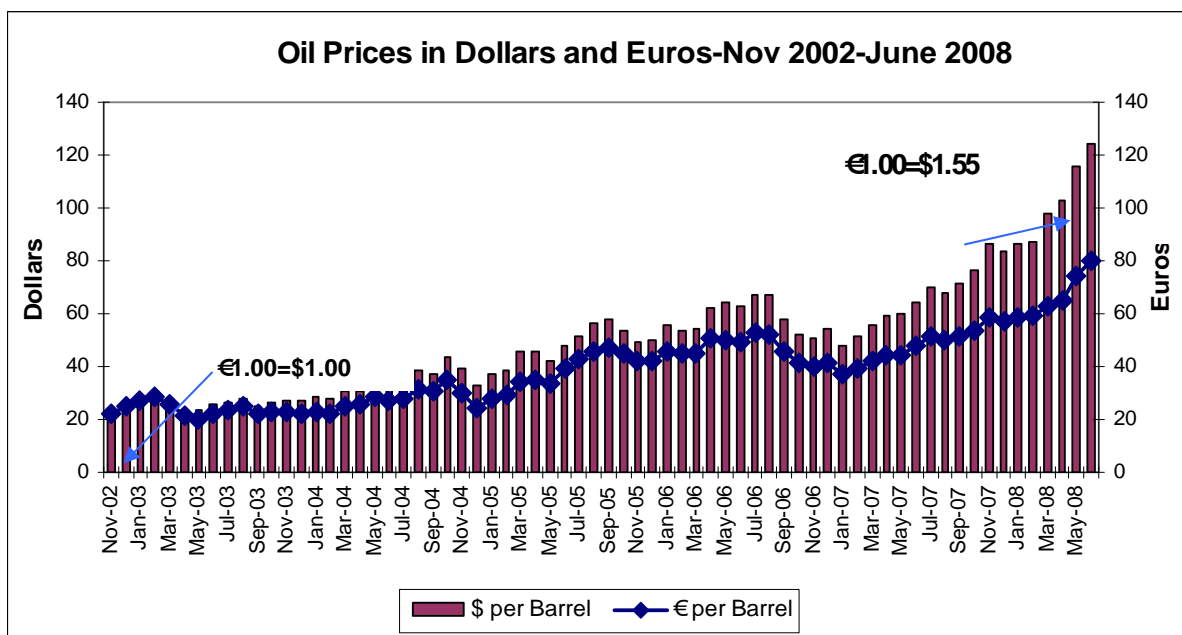
Election-Year Swamp Gas

As luck would have it, all things economically bad have not only converged, but they have done so in a presidential election year. Americans of all flavors hold a persistent belief (nurtured by the media) that US presidents "manage" the economy. We have already seen the thinly-sliced substance of what passes for a major campaign "issue". It goes like this: Sen. McCain trips over his tongue, off-handedly mentioning to some reporters that economics is not one of his long suits. Democrats proceed to weave that comment into a major headline and, presto, Sen. Obama wins full credit with the voters for his economic prowess, simply by not debating that subject. So, we are set to witness autumn campaigns that will surely be aimed at showcasing each candidate's deepest sympathy for the lost jobs, busted budgets and mortgage foreclosures of an undefined group of voters known as "Working Americans". Sympathy, indeed, is all that candidates (or sitting presidents) actually have to offer for families' economic stresses caused by a cyclically slowing economy.

Oil Pricing Anomaly

In all countries, the price of a barrel of oil (42 US gallons) is priced in US Dollars. Ergo, if the value of the dollar declines against other currencies, the oil price *must* increase in dollar terms, even if the price is steady in non-dollar-based countries. Case in point: In late 2002, one dollar was equal in value to one Euro. So, one barrel of oil cost less than \$25 and would have cost the same amount of Euros. But, by the end of June 2008, after the Dollar had declined by more than 35% against the Euro, a barrel recently cost almost \$130, but would have only cost about 80 Euros.

The chart on the following page shows the price of oil since 2002....the dollar-price shown in red bars and Euro-equivalent price (not actually quoted in the marketplace) shown as blue points.



Inflation: It is what it is...Or is it?

The US Government has a rich tradition of measuring things. Various departments oversee macro-economic stats on which stock and bond market traders place great importance.... unemployment, jobs growth, money supply, housing prices, etc. Indeed, the Government (meaning the President and Members of Congress) has found that political careers often surge and wane with news of government-issued statistics. So, if you're an elected office-holder and re-election is what matters most, isn't it logical that you would wish to manipulate unfavorable statistics into not-so-bad ones?

In the US, the measured cost of goods and services, the Consumer Price Index (CPI), has tended to increase a bit more than 3% per year. While that number may seem quite tolerable, over a 10-year span, prices balloon by more than one-third.

In 1973-74, as the CPI soared into embarrassing double-digits, President Nixon cajoled Federal Reserve Chairman Arthur Burns into a project that led to re-naming the CPI as "headline inflation" and created a new measure called "core inflation" (the CPI, minus its annoyingly volatile food and energy components). Ten years later, President Reagan's Bureau of Labor Statistics decided that changes in housing prices were also a troublesome influence on the CPI; so, the housing price component was replaced by a new "Owner Equivalent Rent" element.

Woe is Social Security

Social Security benefits are annually adjusted to recognize some, but not all increases in the CPI. Since all taxpayers must pay for those inflation adjustments, literally everyone has a stake in measuring them.

Over the Social Security system's history, it has collected vastly more tax revenue each year than it has paid out in benefits and operating costs. The system's original design called for this excess cash flow to be held in a trust fund, though investment of it never amounted to much beyond murky good intentions. In the 1960s, President Lyndon Johnson had a strong political need to camouflage the exploding deficits from his dual wars on Vietnam and US poverty ("guns and butter"). He did so by simply combining Social Security's strong net positive cash flows with all the other revenues and payouts of the federal government (the so-called Unified Budget). That gimmick, controversial at the time, worked well politically. Aside from Candidate Gore's "lockbox" idea, no US President or Congress has dared to propose restoring Social Security to its original trust fund status. *But, this cash cow will turn into a rapidly escalating net cash drain, beginning just 9 years from now.*

If the Social Security system actually did have a functioning trust fund and that trust fund had a bona fide investment program (it doesn't; its mythical trust fund "invests" all of its cash in non-marketable federal IOUs), inflation-adjusted benefit payouts would not be a problem for the system.