

The Week

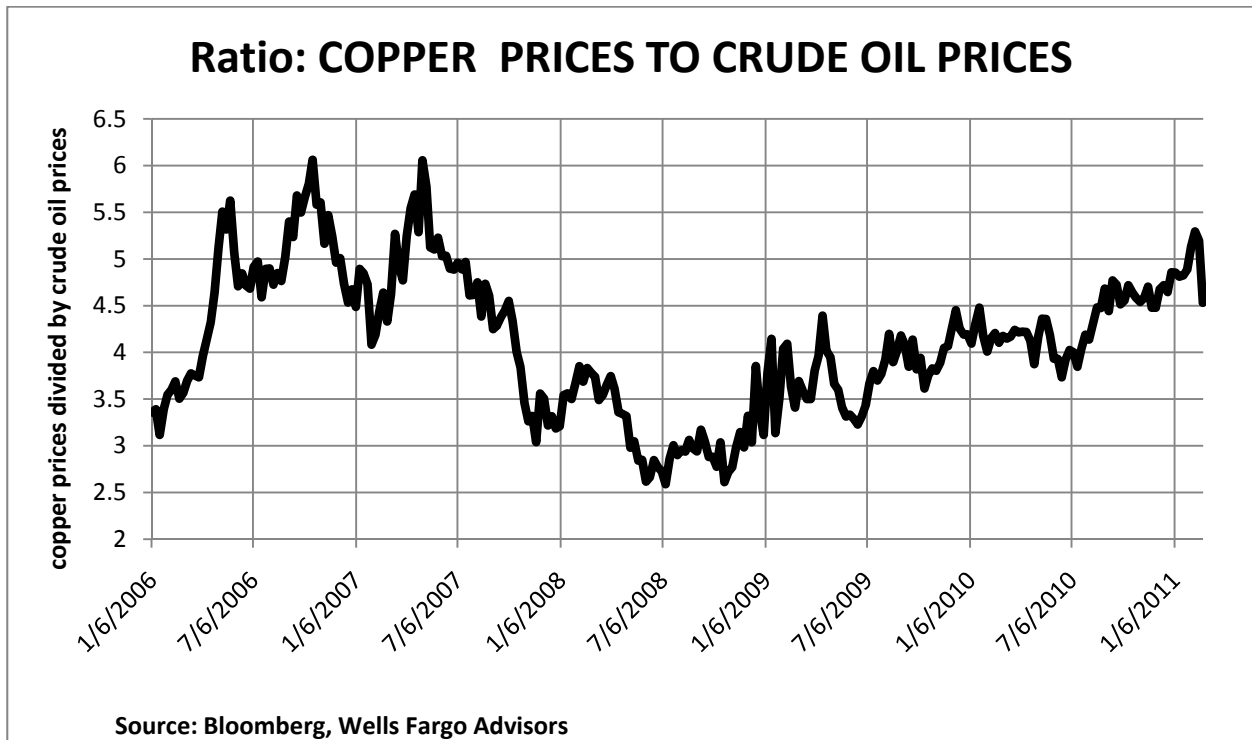
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Higher oil prices likely to slow growth not derail it

Many investors are probably wondering whether the recent increase in oil prices will push the economy back into recession. We do not think so. This report will examine why the economy is likely to slow down in response to the increase in oil prices not fall into recession again.

As consumers, we know that paying more for essential items like food and energy can take money away from other goods and services. But that does not mean that every increase in food and energy prices will derail the economic expansion. If you think about it, energy prices are higher today than they were during the recession. Yet the economy has expanded during the past 20 months at the same time that energy prices have increased.

Our work indicates that there is no specific oil price, which if exceeded, would cause the economy to falter and fall back into recession. Obviously, if the price of oil goes high enough, the economy could go back into recession. But there are several factors which determine what that price might be. First, if the economy is strong, oil prices can rise further before the economy falters. And second, if the increase in oil prices is perceived to be temporary, then a spike in prices may not hurt the economy. So let's look at these two factors.



Past performance is not a guarantee of future results.

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To begin with, it is important to know if the economy is strong or weak when energy prices are going up. This week's chart updates the comparison of copper prices to crude oil prices discussed in several previous reports. We look at this ratio because it can tell us whether oil prices are increasing too fast relative to the state of the economy.

The chart shows that during the past two years, the line on the graph has been moving upward, although not smoothly. If the line is increasing, copper prices are usually going up faster than oil prices are increasing. This usually means that the economy is strong, and rising energy prices are not likely to hurt the economy. If the line is decreasing, it usually means that the economy is weak and rising energy prices are likely to hurt the economy. In other words, the copper/oil ratio is a proxy for the impact of energy prices on the economy.

During the past couple of years, oil prices have occasionally increased faster than copper prices, and the line on the chart has dipped temporarily as it has during the past month. However, this is not a major problem. We would only be concerned if oil prices increased much faster than copper prices, and the line on the graph started to fall substantially. This would suggest that the economy was no longer strong enough to withstand the increase in oil prices and was at risk of falling back into recession. Fortunately, that is not happening. But if the turmoil in the Middle East spreads to Saudi Arabia, and oil prices go substantially higher in a short period of time, then the line on the graph could drop much more, indicating a bigger risk of recession.

The second reason that an increase in oil prices is not always bad for the economy is consumers and businesses do not usually cut spending if they think that an increase in the price of oil is just temporary. It is when consumers think that oil prices will stay high or increase on sustained basis

that they are likely to change spending habits. Fortunately, this is not happening either.

The crude oil futures market can tell us what traders and investors expect oil prices to do during the next year or two. Since the beginning of the year, the nearby price of U.S. crude oil has increased significantly whereas the deferred crude oil price for delivery of oil 12 months into the future has not increased nearly as much. This is telling us that traders expect the current turmoil to boost prices temporarily, and a year from now, oil prices may not be substantially higher.

We would be more concerned about the economy falling back into recession if the deferred price of crude oil was rising much faster than the nearby prices. That would signal that oil prices were expected to go up and stay high for a long period of time. This would probably dampen spending and hurt the economy more than a temporary spike in oil prices taking place now.

In summary, there is no magic price for crude oil that will cause the economy to fall back into recession. If the economy is strong, oil prices can rise modestly without hurting the economy. But, if the economy is weak, then even a modest increase in oil prices could harm the economy. Fortunately, the ratio of copper prices to crude oil prices suggests that the economy is strong enough to withstand the recent jump in oil prices, and economic growth is only likely to slow down, not stop. More important, the crude oil futures market is signaling that the increase in oil prices during the past month is likely to be temporary. Consequently, consumers and businesses are unlikely to change spending habits. If the markets were signaling that the increase in oil prices was going to get worse over the next year, then the risk of the economy falling back into recession would be greater. Together, these indicators are consistent with our view that the economy is likely to grow at a modest rate this year, not fall back into recession.

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