

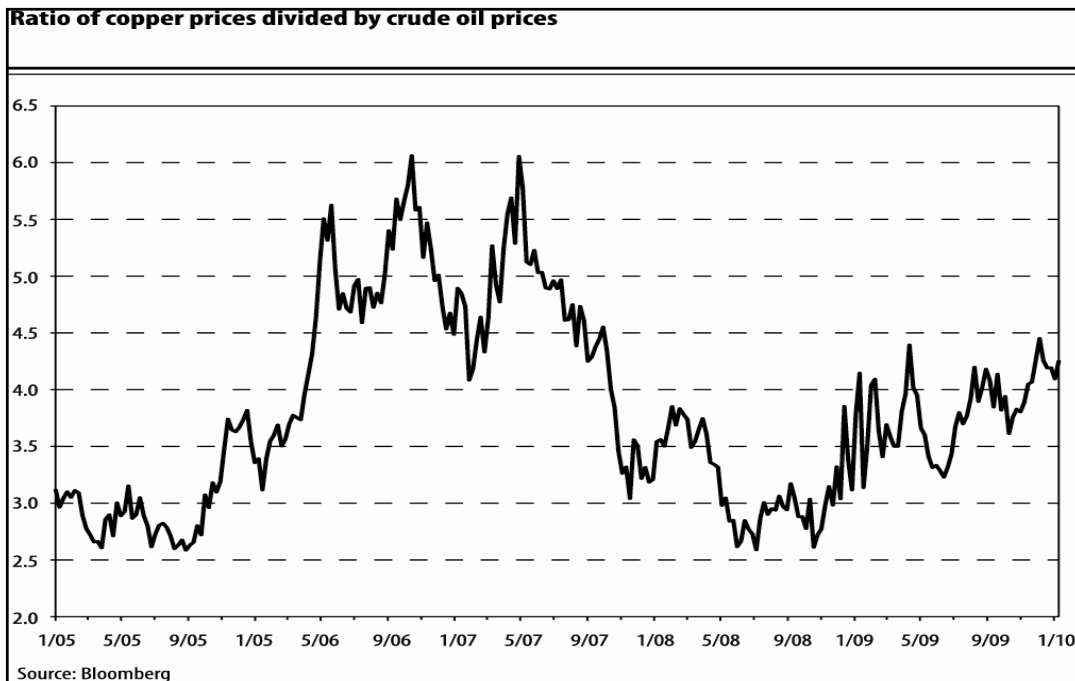
# The Week

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*Gary Thayer, Chief Macro Strategist*

## **Are increasing oil prices hurting the economy?**

- It is easy for consumers to see when energy prices are rising. That's because higher gasoline prices are posted in bright signs along the roadway. However, it is not as easy for investors to know when higher energy prices are going to hurt the economy and the markets. Fortunately, some simple comparisons can tell us when energy prices are rising too fast and when the economy is likely to suffer.
- Crude oil prices hit a new 15-month high in early January. This news might lead you to think that the economy is going to suffer. However, the relationship between energy prices and the economy is a little more complex than simply higher energy prices hurt the economy and lower prices help. Sometimes, higher energy prices reflect a growing and healthy economy. Therefore, it is important to have some basis to draw a distinction between times when energy prices are rising too fast and when they are not rising too fast.
- Copper is an important economically-sensitive commodity whose price tends to rise and fall as the economy expands and contracts. This makes copper prices a good indicator of when the economy is getting stronger or weaker. During the past year, copper prices have increased as the U.S. economy transitioned from recession to recovery. By using copper as a benchmark, we can see that oil prices are not rising too fast.
- History suggests that the economy suffers when oil prices rise faster than copper prices increase. As long as energy prices do not rise faster than copper prices, then rising energy prices are not necessarily bad for the economy. Fortunately, energy prices have increased more slowly than copper prices during the past year. This means that increasing energy costs are probably not hurting economic growth. Of course, oil prices can sometimes move counter to the trend in the economy if supplies are disrupted or increase substantially. Therefore, it is useful to look at alternative scenarios.
- The best-case scenario for the U.S. economy would be rising copper prices and declining oil prices. This could happen if OPEC increased production, causing oil prices to drop, at the same time that the economy was expanding, pushing copper prices up. These lower oil prices would boost an already healthy economic expansion.
- The worst-case scenario for the economy would be when copper prices are declining and oil prices are rising. This could happen if oil supplies were tight at the same time that the economy was weakening, pushing copper prices down.
- The current environment is neither the best-case nor worst-case scenario. Rather, with oil prices rising more slowly than copper prices, the economy is probably still healthy and not hurt by higher energy costs.



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- This week's chart looks at the recent history of the ratio of copper prices to crude oil prices. When the line on the graph is going up, economic conditions are improving. When the line on the chart is going down, economic prospects are deteriorating.
- This chart shows that copper prices increased faster than crude oil prices during the boom of the last decade, especially during 2006. That was when the Chinese economy became an important driver of global economic growth. Energy prices were increasing during that period, but not so fast as to derail the boom.
- Energy prices did not start to increase too fast until 2007 and early 2008, causing the line on the graph to go down. That was when oil prices finally rose above \$100 per barrel and speculators began to worry that global oil supplies could not be increased any further.
- More recently, the copper/oil ratio has been moving higher as copper prices increased faster than oil prices increased during the past year. This is a healthy situation and is consistent with the main theme from our 2010 outlook to position for recovery not recession. The U.S. economy is expanding moderately, and commodity prices are rising in line with that growth. Using this indicator, we would not expect the economy to falter because of rising energy prices unless some unexpected event caused oil prices to increase dramatically faster than copper prices. If that happened, we would probably change our outlook.

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