Wachovia Securities

The Week

FINANCIAL SERVICES GROUP: ADVISORY SERVICES • INVESTMENT STRATEGY

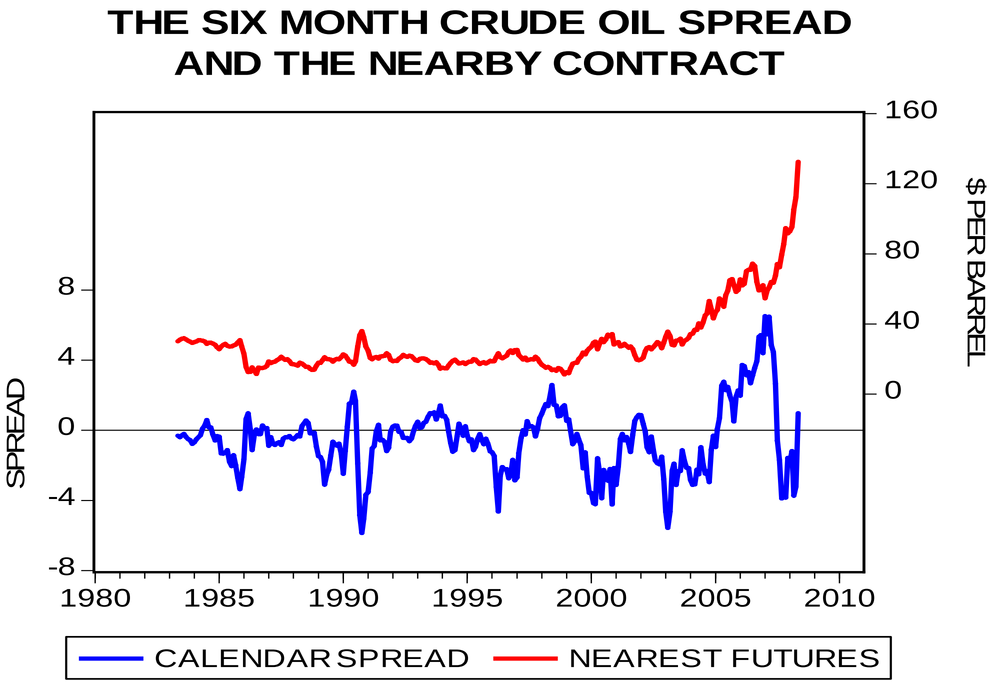
May 27, 2008 **Bill O'Grady, Chief Investment Strategist**

The Oil Problem

- It was a choppy week for equities last week as oil prices moved to historic highs. The uptrend seen since the St. Patrick's Day lows remain in place. As we mentioned last week, the S&P 500 is a bit extended, up over 11% from the recent lows. This impressive rise would suggest a period of digesting these gains is probably in the offing, which probably explained last week's consolidation. But, at least so far, we are not seeing enough economic weakness to prompt a larger decline. For example, last week, leading economic indicators (LEI) for April were released and were modestly higher than expected. In addition, the six-month change in the LEI index, though still negative, is rising from lows seen in January.
- The bullish case for stocks rests on the current economic downturn being a "garden variety" recession. As we noted last week, if this is a typical recession, and our estimate that it started in December is true, then we should see a market recovery commence by mid-summer. If this recession turns out to be a more profound one, more like the 1973-75 or the 1981-82 type, then we believe a much larger downturn in equities is likely. Thus, it's important to look for factors that could have a significant negative impact on the economy.
- The price action in oil has the potential to be such an event. The bullish case for oil, simply put, is that there is scarce excess productive capacity. For most of the last century, specifically from 1933 to 2004, a "swing" producer, either the state of Texas or OPEC, held production off the market to keep prices higher than a completely free market would generate. What society gained from the swing producer was the existence of excess capacity that could be brought to market to offset a price spike from geopolitical or weather events. Thus, we did see spikes in prices but they were unable to be maintained. However, in 2004, it became apparent that the combination of rising demand from the emerging markets and the lack of investment in production exhausted OPEC's excess capacity. Thus, as oil prices rise, the cartel is unable to bring enough supply to market to lower the price.
- Given that supply is constrained, the only way to significantly reduce prices is by weakening demand. In the long run, this will likely be accomplished by consumption reducing technologies. For example, the development of plug-in hybrid cars should be a significant bearish event for oil. We would expect such cars to become available two years from now and over the next decade, their widespread use both here and abroad will likely ease consumption demand.
- Unfortunately, in the short run, we believe there are likely only two factors that could turn prices lower. The first would be slower global economic growth. Although U.S. oil consumption has been falling, global demand continues to rise. What is unknown is whether or not oil prices have increased enough to weaken the global economy and press demand lower. This week's Chart of the Week suggests the term structure of oil is signaling plentiful prompt supplies, which should contain prices. The second factor would be decisive dollar support by the G-7. Although the long-term ties of the dollar and oil are tenuous, recently the weak dollar has been blamed for the rise in oil prices. A stronger dollar would likely weaken bullish psychology surrounding commodities and push oil lower.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:



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Sources: Haver Analytics, Wachovia Securities

On this chart, the upper (red) line shows the nearby NYMEX crude oil futures price. The lower (blue) line shows the spread between the first and sixth month contract. Usually, the term structure of oil trades backward, meaning that nearby prices trade at a premium to the deferred contracts. In fact, from 1982 until 2004, this was the case 73% of the time. The rest of the time, the market was in contango, a condition where nearby oil prices trade below deferred prices.

In general, contango is a bearish condition for oil prices, as it signals plentiful prompt supplies. From 1982 until 2004, the correlation of the calendar spread and the nearby price is a negative 61%. Correlation is defined as the relationship between two variables. A negative correlation indicates the two variables move opposite each other, in this case, 61% of the time. From 2004 into mid-2006, when consumers were building inventory, the market went into persistent contango, which was positively correlated at the 56% level. A positive correlation, in contrast, means two variables move together,. Finally, since then, the correlation has reversed, becoming negative again at the 72% level.

The oil market's recent move into contango could signal the current bull market may be facing headwinds in our view. In effect, the contango market suggests that current supplies are adequate, which is depressing the nearby contract compared to the later dated ones. Although the development of a contango in this market is usually a bearish development, it may still take some time for the bullish psychology in the oil markets to adjust.

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