The Week

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The Oil Problem

- It has become apparent that the short-term direction in equities is tied to the price of oil. Since early June, oil prices and the S&P 500 have exhibited a strong inverse relationship. When oil prices fall, equities rise and visa versa. Over the long run, oil prices and the S&P 500 are positively related; both tend to be supported by stronger economic growth. Thus, this short-term situation is a deviation from long-term behavior and is an important signal for future market action.

- There is a myriad of factors supporting oil prices. Supplies are generally tight. OPEC excess capacity is estimated to be a mere 2.5 million barrels per day (mbpd), with Saudi Arabia representing 62% of that capacity. Demand growth in the emerging economies has boosted consumption. In addition, the weak dollar has encouraged financial investors to hold crude oil via financial instruments which has boosted demand.

The key concern to the equity markets is tied to inflation and economic growth. Some investors, worried about rising inflation, have been purchasing commodities in attempt to hedge their portfolios. At the same time, rising oil prices put pressure on inflation and could prompt the Federal Reserve to raise rates in a downturn. As we mentioned in the June 16 report (**Horns of a Dilemma**), if the central bank is forced to raise rates in a downturn to quell inflation expectations, the likelihood of a more significant recession increases. In the harshest recessions in the post-war period, the 1973-74 and the 1981-82 recessions, the Federal Reserve raised rates during the downturn, exacerbating the contraction. *Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio. Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.*

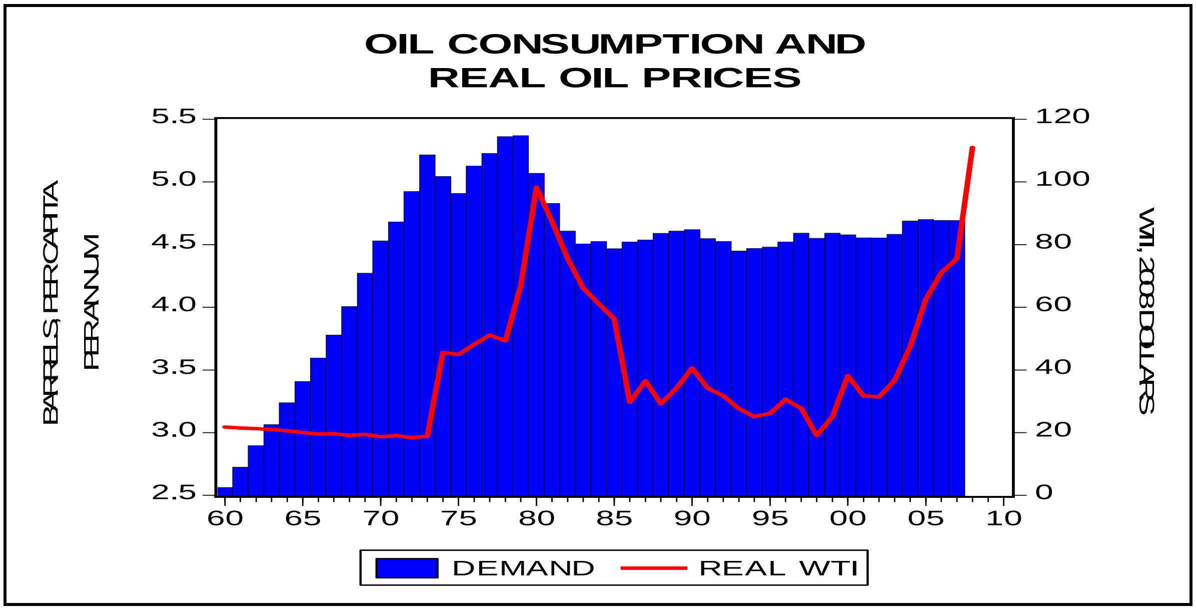
- We believe that the Bernanke Federal Reserve will first attempt to control inflation expectations by other means than raising rates. We have seen "jawboning" by Federal Reserve officials, indicating the board is concerned about inflation. We still expect G-7 intervention at some point to boost the dollar and ease inflation fears.

- In our tactical tilts, we remain cautious. Compared to our capital market assumptions, we currently underweight equities and overweight fixed income in attempt to reduce portfolios exposure to equity market volatility. We expect to maintain this stance until it becomes clear that the current slowdown/recession is a more typical one and not a replay of the deeper recessions mentioned above.

- In this week's chart of the week, we examine the impact of a secular change in oil demand and the potential long-term impact on oil prices.

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:



For illustrative purposes only. This does not reflect the performance of any specific investment.
Past performance is no guarantee of future results

Sources: Census Bureau, British Petroleum, Wachovia Securities

The bars on this chart show per capita, per annum oil consumption. In other words, last year, each human being on the planet consumed, on average, 4.7 barrels per person. In comparison, U.S. consumption is 25.1 barrels while China is 3.0 barrels. The line on the chart shows West Texas Intermediate oil prices, adjusted for inflation to May, 2008.

From 1960 into the early 1970s, oil demand by this measure grew at a relentless pace. The first oil shock slowed the demand slightly, but its growth resumed into a peak at 5.4 barrels in 1979. The second oil shock led to a significant change in consumer behavior. This measure of demand declined to just under 4.5 barrels and grew by only 0.2 barrels over the past 23 years.

What is notable is that the decline in oil demand after the second oil shock was permanent. On a global basis, demand per person remained steady, meaning that demand growth was primarily a function of population growth alone. Current inflation adjusted prices are at a level consistent with the last major change in demand behavior.

Recent news is suggesting a secular change in consumer behavior. In the latest reporting week, the Department of Energy indicated that total product demand is running nearly 2% below last year. In general, U.S. product demand usually rises by 1.5% to 2.0% per year, simply from population growth and economic expansion. Car sales suggest fuel efficiency is paramount and public transportation ridership is increasing rapidly. These changes are consistent with a secular change, not just a cyclical change, in consumer behavior. If consumers react in a similar fashion to the current shock as they did in the early 1980s, by 2015, global demand would decline to 76.3 mbpd from the current 85.2 mbpd. We believer this would be OPEC's nightmare and potentially the permanent solution to high oil prices.

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