

OIL TIME



As Commodity Inflation Strikes Oil Finally Makes its Move

Alberta Oil Sands 1981 via [flickr](#) | Edited by Gregor Macdonald

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Howard Lindzon
Discusses Value
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OIL TIME

Commodities took off in the Autumn of 2007 when the FED first started to fight the credit crisis. Are we seeing a repeat of this action, here in 2010? If so, this time the cauldron of higher prices could burn even hotter, as a global currency war has broken out on the back of the FED's dollar devaluation. But what happens if oil, the master commodity, joins the action and bolts higher? Last week suggest just that: Oil time?



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A NOTE FROM THE EDITOR

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OIL TIME—Asset reflation in the month of September was quite powerful, not only moving stock market indexes but the full spread of commodities from the grains to the metals. Peter Schiff actually has a [very funny video this weekend](#) citing each commodity’s individual move the past 4 weeks, compared to the stock market. “Corn was up 12% in the month of September...that box of Orville Redenbacher popcorn in my cabinet?...that beat the stock market in the month of September.” Indeed, as many have started to point out, the breadth of the FED’s current reflationary policy which admittedly is taking the stock market higher has now triggered even larger moves in hard assets. Moreover, the beggar-thy-neighbor policies which have now circulated throughout the world, as most countries are now trying to fight Dollar Decline, are also behind the advances in cotton, coffee, and copper. As these new Currency Wars gets underway, however, one commodity in particular has been lagging behind the rest: oil. And that’s surprising. But last week, oil--appropriately named the master commodity--finally made its move and closed Friday back above 80 dollars a barrel. And that potentially spells trouble for the economy.



The 18 month long stock market rally out of the deep lows of March 2009 has had no shortage of detractors. The whining and the griping has been quite audible for some time, with few let-ups. However, the ascent of equities in 2009 was more encouraging when it took place without the concurrent advance in food costs. The CCI, the [Continuous Commodity Index](#), which is an equal-weighted commodity index preferred by market historians, actually did have a strong advance in 2009 but had quieted down for the first half of 2010. In the past three months,

Indexes

INDU 10829 TNX 2.53 GOLD 1318.93 VIX 22.50 SPX 1146.24 DXY 78.034

StockTwits.TV: Howard Lindzon and Todd Sullivan



There are concerns emerging again about the Financials. [The Philadelphia Bank Index](#) (favorite of Don Coxe) is going nowhere fast, and there are new problems in the mortgage market. Some of the higher profile market mavens are talking about fresh damage in the space, as layoffs appear on the horizon. Well, who better to address these issues than Howard Lindzon and Todd Sullivan.

Todd feels March 2009 truly marked the low for the financial sector, in the sense that catastrophic risk is now well behind us. And yet, Sullivan also sees that for the large players, the sector is essentially unable to hook into growth. He likes the smaller players, which of course makes sense as the system attempt to recapitalize. Recapitalization, on a smaller scale, should be able to take better advantage of the economy's marginal attempts to recover. Excellent detailed coverage. [Watch the show here.](#)

[StockTwits.TV](#) can also be taken as an iTunes subscription.

that index is up over 12%, however. What's particularly concerning is that this move, until last week, had taken place without a push from oil prices. If a large new advance in oil prices now unfolds, the FED's present reflationary course could run into some political resistance that all markets are not currently discounting. At the moment, every asset on the planet is being repriced of course in [anticipation of QE 2](#). The psychology of oil prices is endlessly fascinating if for no other reason than people become anchored to the extreme highs and the extreme lows, while ignoring what really matter for the economy: the prices in between. The illusion therefore is that the global economy was hit with oil prices at 150 dollars a barrel, and then recovered on the back of 35 dollar oil. In truth, those price levels existed for only brief periods of time. The global economy, more accurately, struggled to keep up with oil's price advance starting back in 2004. And, there has hardly been any relief from "high oil prices" post the industrial collapse and financial crisis, contrary to popular thinking. In fact, the average price of oil for 2010 through the first 9 months of the year is on course to be the second highest annual average price ever, on a nominal basis. 2010 average annual prices at 77.91 per barrel are only exceeded by 2008's average of 99.67. Even 2009 prices, at a 61.95 annual average, exceeded the 2005 average of 56.64. When we consider that *40.00 dollar oil* was regarded as outrageously high (and unsustainable) back in 2004, and that OECD economies have been paring back *discretionary* oil use for over 8 years now, how shall we assess 75 dollar oil? That's easy: 75 dollar oil is incompatible with growing economies in the OECD.

Of course, there remains the persistent (though much diminished) complaint that "supply and demand doesn't justify" current oil prices. This complaint is now at least five years old, and has never had any data support. So, it appears it's little more than an emotional lashing-out, principally

derived from a lack of understanding. The big-picture perspective to understand the problem is that crude oil production has not risen for over 5 years now. The technical lens to understand the problem is that, shockingly, 75 dollar oil may no longer be a sufficiently high price to bring the new barrel of oil in Non-OPEC. This is non-trivial in a couple of different ways. First, even as late as 2008, and even with severe inflation in exploration and lifting costs, it was thought by industry analysts that 60 dollar oil would be enough to bring on new supply in Non-OPEC. But this was just as we were learning that annual declines from existing fields in Non-OPEC were approaching 7.00%. In addition, combined with the misunderstanding that OPEC has tons of spare capacity, Non-OPEC provides 60% of global oil production so OPEC's ability to fight decline in Non-OPEC has also been constrained. Finally, much of the oil market continues to trade on short-term, 30 day timeframes that are only directed towards one basic function: clearing at-the-market supply. This of course has never been a predictor of future prices. The oil prices that really matter, and have always mattered, are the average levels that extend over time.

Autumn 2010 is shaping up to look alot like Autumn 2007 when the FED first starting fighting the effects of the burst credit bubble. By early 2008 a very nasty food and energy inflation was underway and that is precisely what's underway once again. Friday's ISM report indicated [sharply higher input prices](#), a warning shot for earnings and stock prices. Wages and employment are punk, of course, so the ability of companies to pass on higher costs to consumers is close to nil. A nice discussion of these realities comes from [Russ Winter](#) at the Wall Street Examiner. And if oil joins the bottle rocket action in commodities and gets itself significantly higher--say from now through Winter into Spring--then it's difficult to see how this does not affect

Reality at High Speed



The United States' tragicomic relationship to rail transport has a number of key features. Defining 90 mph as "high-speed" is one. Historically, for example, many countries in the OECD have been building high HSR for over 40 years, from Japan to France and Germany while the US went in the opposite direction. Second, the US policy towards rail transport in general has been either so hostile or simply dysfunctional that Americans can't even remember a time when most cities had streetcars and lightrail--hence the cultural barrier to building train transport now. But what really seems to define US policy towards rail is mythology.

This is the very spot-on observation made this week by Dave Cohen, [who writes on his blog](#): "There is not a single High-Speed Rail line under construction in the United States." Indeed, and it is truly amazing how many articles are printed each week, composing the very small amounts of seed money provided by the government into the false notion that the US is "[playing catch-up on high-speed rail](#)." Perhaps this is just an age-old case of illusion being preferable to reality.

Re Fi Me



In late Summer a rumor swirled that Fannie and Freddie, now fully under the control of the US Government, would be used as levers to offer a universal refinancing option to the nation's homeowners. The details of the rumor were intriguing: there would be no application process or LTV calculations. Instead, the government would simply apply, across the board, a new lower 30 year fixed rate to existing homeowners. As [Calculated Risk pointed out](#), this was likely nonsense.

Nonsense? In a narrow sense, yes. But isn't the FED's intention in a second round of QE to have precisely the same effect? This was the excellent point made this week by John Lekas, who appeared as a guest on [Yahoo's Tech Ticker with Henry Blodget and Aaron Task](#). Lekas' view is that the FED wants to get the 30 Year Bond Yield down to 2.75%. At that level, he sees not a national ReFi event led by Fannie and Freddie per se, but, provided even more broadly by the whole banking system. While Lekas thinks this finally sets the stage for a consumer recovery, he still sees housing falling another 20% before the pain finally ends.

big states like Florida, California, and Texas that are very leveraged to oil prices. The problem with the FED's present reflationary course is that it does not distribute itself broadly enough through the economy to really do much to ease the debt burden. If every homeowner owned 100 ounces of gold, and a silo full of corn, then yes: that would offset their debt burden. But they don't of course. The irony is that we've already been down this road before. The last time it blew up the housing market. This time, it may be the dollar, or perhaps even treasuries, which fall to the inflationary pressure. Speaking of which, when does the market start to recognize that inflation-adjusted returns on Treasuries are close to turning negative? At 2.5% yields on the 10 Year, some QE 2 induced "reflation" in the oil price should finally convince Treasury holders of such propositions.

--Gregor Macdonald, 3 October--Amherst, Massachusetts

