Armchair Economics

Perspectives from an everyman for the everyman

Could Oil Become The New Gold?

October 2009

We humans can be pretty simple creatures. We have numerous little habits. One of the most common is how we greet each other over the phone. “Hey Doug, long time no talk, how ya doin’ these days?” The most common responses used to be “a okay”, or “same ole same ole”, or “doing great, how about you?” Lately though my response has been a little different. “Got my seat belt on tight . Have a hold of the safety bar with a death grip. Trying to stay on this roller coaster ride!”

Roller coaster for sure. Not long ago every asset class was knocking the cover off the ball. We had solved the economic cycle “problem”. Growth was great. Oil went to almost $150 a barrel without inspiring inflation. We were bullet proof, invincible. It was like a luxury cruise along the Mediterranean. Ahh…life was good…until it wasn’t. Little did we know.

In short order virtually every asset class was NOT the place to be. Markets went into a tailspin. From almost 1,600 in October 2007 the S&P collapsed to 690 in March 2009. Now we are back to around 1050, a 50% increase six months later. In July of 2008 oil peaked at almost $150. Seven months later it hit $33. And then in another seven months it rose to $75. With this kind of roller coaster how can we keep the pig snout hot dogs, hydrocarbon cheese nachos and refined sugar cotton candy down?

It’s hard to figure out whom to believe these days. In early June Arthur Laffer wrote a WSJ editorial suggesting our money supply explosion would lead to massive inflation and significantly higher interest rates. Just a couple days after Laffer’s op-ed Goldman came out with a report suggesting the Fed’s “Big Balance Sheet” would not necessarily lead to inflation. “We’re about to turn the corner”, says Bernanke a few weeks ago. Is Laffer out of his mind? Is Goldman the new propaganda machine for its benefactor? Is someone cooking the books in Washington?

Who to believe? What investment strategy should we deploy? Ride the momentum wave? Get hammered by the sucker’s rally? All will be fine because this is the United States of America?

Surely it is naïve to believe the last two years of economic calamity can result in a quick and sustainable rebound, but that is pretty much what happened after the last two recessions. “This time is different”, is a perspective normally preceding proof it is not. But some times things are different. There are short cycles and then there are long cycles. The fly’s life cycle is certainly shorter than that of the turtle, so we must be careful of looking through fly eyes.

Discussed in last month’s Armchair was some debate over the dollar. Will it rise, will it fall, will it continue to confuse? With few currency alternatives to the dollar it would seem very difficult for a collapse to occur as the dollar bears and gold bugs suggest. If you diversify out of dollars what do you diversify into? Beyond the Euro and the Yen there seem few choices and neither of those two look that appealing. They both seem to already have their version of “mature market share”.

For ages the historical safe harbor has been gold. Today’s circumstances really get gold bugs excited. Buy gold and when the dollar collapses you will either be rich or at least able to afford some nachos to go with your Lone Star beer. But why is gold the ultimate store of value… because it has been historically? What made gold the ultimate store of value in the first place?

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In ancient times…now doesn't that sound like the start of a great argument…gold was the ultimate store of value. But no, it really wasn't. In really ancient times salt was the ultimate store of value. Gold became valuable only after there was enough food to afford some luxury. Salt was the original commodity of choice since it assisted in the storing of food…the store of value. You gotta eat before you can afford to buy jewelry.

A commodity of necessity was the original store of value. But once food became less of an issue then a commodity of luxury became the store of value. That commodity of luxury has been able to remain the store of value for a millennia or two. I guess that says pretty good things about man's ability to emerge from the cave and sustain himself.

Is gold today still the ultimate store of value? Maybe, but maybe not. Maybe luxury is once again being replaced or at least supplemented by necessity.

No one in the developed world really needs much gold. Sure we want some for our wedding rings and for the jewelry that adorns our beloved women. And maybe we need a small amount for our industrial products. But we really don't need that much gold. What we do need today is oil. Just like salt many millennia ago, oil is a commodity we can't live without.

Gold bugs have been around "forever". They are still around today. Bill Bonner's 2001 book, "Financial Reckoning Day", projected our current economic challenges and suggested the trade of the decade would be gold. He was pretty much on the money. In 2001 gold was trading around $275 an ounce. Today it is trading around $1,000 an ounce. That's about a 3X return on investment. Not too bad given the equity market for that same period is flat at best.

What has oil's return been since 2001? Well it started out in 2001 around $25 a barrel and today it is around $75 a barrel. Hmm…that's also about a 3X rate of return. Oil has matched gold as the best asset class this decade. Does this mean oil is as good as gold, could it mean that oil is the new gold, or could we be in the midst of a transition? The minimum take away seems to be that oil today is just as good a store of value as gold, a safe harbor for investors.

We can sort of live without gold but there is no way we can live without oil. In addition, the investment market for oil is bigger, broader and deeper, more liquid than gold. This makes oil easier and maybe safer to trade than gold. So what happens if oil becomes the new gold? Let's go back to our "dollar problem".

The world is awash in dollars. Competitive and emerging economies are not liking the dollar as the reserve currency. They want alternatives.

Beyond the market mature Yen and Euro, last month's Armchair suggested global dollar holders have three alternatives…the dollar continues to grow as the world's reserve currency, currency holders gradually diversify to smaller float but more attractive currencies like those from commodity based countries, or dollars find their way home to the U.S. One other non-currency alternative seems available. You can buy commodities like gold and oil.

Since oil is the larger, broader and deeper market one might conclude it will get substantial investor attention. But the repercussions of the move into oil are not good. The more dollars that chase oil, the higher oil's price will go. Remember gasoline prices in the summer of 2008? Thank goodness they came down when they did. But what if they don't come back down next time?

The consequences of dollar diversification into oil would likely inspire inflation, or as the massive oil price climb of the 1970's inspired, stagflation. Most everyone seems to believe the output gap in production capacity and labor is way too large to inspire demand-induced inflation. But could fear of the dollar's value inspire increased investment allocation to oil, leading to commodity-induced inflation, or stagflation?

This is one of the many conundrums (July Armchair) we seem to have in America. We are kind of in a damned if you do, damned if you don't situation. We feel a need to "stimulate" our economy in order to combat asset deflation and unemployment growth. Yet our stimulus tools of growing debt and Fed printing press put pressure on the dollar's value. Any fear of holding dollars could inspire investment allocation drift to oil. One might even suggest some of this sentiment is already built into today's oil price.

As Milton Friedman said, "Inflation is always and everywhere a monetary phenomenon". In this case it might not be the printing of dollars that results in too many dollars chasing too few goods. Instead, loose fiscal and monetary policy might inspire investment allocation drift to oil, leading to commodity-induced inflation, or in the U.S., another round of 1970's style stagflation. Prices would rise because our manufacturing "partner", China, would be significantly affected by oil price rise. They would eventually have to pass on price increases or eat their profits.

If Washington isn't careful it could drive dollar holders into oil and if that happens we could be in for another 1970's style round of stagflation. Hmmm… could this have something to do with the CFTC's current focus on reducing the amount of "speculation" in commodity markets?

Keep those seat belts tight. Catch a firm hold on the safety bar. This roller coaster ride may have plenty more peaks and valleys ahead.

Douglas A. Leyendecker
713-862-3030
doug@armchaireco.com