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Crude Interest

Interest rates and oil prices will continue to rise.

I'm far from alone making that statement. What continues to amaze me is the amount of folks who seemed to be blindsided by a pass so well telegraphed that even Brett Favre fans had to wince. The stock market, which supposedly had already priced in a .25% increase in the Federal Funds Rate (the short term interest rate that banks charge to lend each other money), fell last week after the announcement that raised rates by that amount.

Now what? Let's start with interest rates. Alan Greenspan in his 17th year with The Federal Reserve is pretty predictable. As I have shared with some of you already, the Fed doesn't raise or lower rates without a longer term strategy in mind. This rate increase signals a longer term initiative that began last week. According to Bloomberg data since 1987, when The Federal Reserve has increased the Federal Funds rate, it has averaged a total increase of 2.67% over a series of 6 to 12 steps. The rate stood at 1% before the recent increase, so we can expect that this rate is due to increase to around 4% before the tightening is over.

Banks were quick to respond to the U.S. Central Bank by increasing their prime lending rates by a similar amount. The long term bond market reacted rather coolly to the news. Remember, the Federal Funds rate is a short term interest rate which has no *direct* impact on long term rates. The key, however, is how the bond market interprets this signal. If most believe that inflation will remain muted, long term rates should stay relatively low. If however, the bond market believes that this is a signal that inflation is heating up, then folks who lend money in the form of bond purchases will require higher long term interest rates to cover that risk. I believe that the pendulum has swung about as far as it can in the form of low interest rates and that we are at the beginning of a decade long (or longer) period of rising interest rates. Bond market cycles are extremely long winded and tend to last 15-25 years. This cycle of lower rates actually began in 1981.

Oil is a bit trickier subject. I just read that the U.S. controls about 5% of the world's oil reserves but consumes about 25% of the world's oil production (I could not confirm these numbers with government sources). According to a recent study by BP (the oil company formerly known as British Petroleum) the world's proven oil reserves are sufficient to last 41 years (natural gas for 67 years and coal for 192 years based) based on current consumption.

Much as it would like, our government cannot print, or otherwise create more of this commodity. Although there is sufficient politically charged debate over the rate at which reserves are being drawn down, no one can logically dispute that it is happening. The tricky part is in determining how quickly alternative sources of energy will come on-line to replace oil. Many "experts" have claimed that oil prices need to be at $50 per barrel of crude before any alternatives are economical. We're getting closer to this number all the time.

Our belief is that interest rates and energy prices will continue to escalate. As such, we will continue to position portfolios with a bias toward shorter term maturities in fixed income assets and look to increase, where appropriate, exposure in energy related holdings.

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