

## Oil and Gasoline Prices – Close in Economic Impact

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### 2011 Outlook

**GDP GROWTH:**  
3.0%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

Gasoline prices are rising, and fast. Since August of last year, unleaded gasoline futures prices have risen by 78.0 percent. Additionally, during the last year, unleaded gas prices have risen by 47.0 percent. The last time we saw this type of upward move in gasoline prices ended in June of 2008 when gasoline prices had increased by 49.0 percent from the previous year. If it seems like déjà vu – well it should. The entire upward move in gasoline prices has occurred since August of last year.

This piece attempts to outline why oil and gasoline prices have risen, and potentially how much impact this move may have on consumption patterns as we head into the summer months.

### The Building Blocks

To most U.S. consumers, commodity prices are vague inputs of little attention. Ask the average consumer his thoughts on cotton, soybean, aluminum or iron ore prices, and most could care less. Oil, conversely, is a commodity to which most Americans pay some degree of attention. This is due to a reasonably strong correlation between oil and gasoline prices. During the last 10 years, the correlation has been 0.95 between these two commodities. Meaning, 95.0 percent of the time as oil prices move up and down, gasoline prices do the same. Consequently, U.S. consumers are aware of and sensitive to oil prices.

Historically, if oil prices increase by \$10.00 per barrel, gasoline prices tend to increase by roughly \$0.25 per gallon. Taken on a macro level, for every \$10.00 increase in oil, consumer behavior is impacted by \$35 billion on an annualized level. So, for every \$1.00 increase in the price of a gallon of gasoline, consumers are putting an additional \$140 billion into their gas tanks annually.

We live in an economy where Gross Domestic Product (GDP) is \$14.1 trillion. Consumption represents about 70.0 percent of that total, or \$9.8 trillion. Given the data above, \$140 billion is 1.4 percent of total consumption. Consequently, it is fair to say, without behavior adjustments (lowering the amount of gasoline consumed) for every \$1.00 increase in the price of gasoline, consumption slows by 1.4 percent. Once again, this is prior to adjustments which consumers will of course make as gasoline prices increase.

## Potential Impact

Given the building blocks, it appears to us that growth in total consumption is set to slow by roughly 1.1 percent prior to behavior adjustments by U.S. consumers. Given the fact that consumption represents roughly 70.0 percent of overall GDP, the negative impact on the total economy may be roughly 0.8 percent due to rising gasoline prices. We have been seeing many economic pundits decrease assumptions as to how rapidly the U.S. economy will grow in 2011. We are in this camp. Most now believe the U.S. economy will grow in the 3.0 percent range for all 2011. If oil prices remain elevated, we believe the impact on the economy may indeed be greater than many are now forecasting. Last year, the U.S. economy grew at 2.7 percent. We may see a repeat this year of 2010, due partially to rising oil and gasoline prices. But for the time being, we are maintaining our view that the U.S. economy appears to be positioned to grow in the 3.0 percent range for all of 2011.

## And The Answer

Are oil prices inflated due to speculation in the markets — as some in Washington would want you to believe? Probably. Are oil prices inflated due to the overall ban on drilling practices within the U.S. and our waters? Yes. Are oil prices inflated due to different needed gasoline *blends* mandated by local or regional regulations? Probably. Are gasoline prices high because of taxation policies? Yes. All of these issues are politically charged. Our view holds that the most significant reason oil prices are high has little to do with any of the above. To understand why we believe oil prices are high, simply look to the Middle East.

During the last 12 months, oil prices have risen by 35.5 percent. Since January 21, 2011, (the day when street protests started in Egypt) oil prices have risen by 27.5 percent. Consequently, a full 77.0 percent of the increase we have seen in oil prices for the last year has occurred during this time of unrest within the Middle East. Now Egypt is not a major oil producing state, but the level of unrest and uncertainty this brings to the *marginal supply* of oil is making prices move upward rapidly. If gasoline prices rose due to the politically-charged statements from the paragraph above, the surge in prices since the beginning of the Egyptian riots would not have taken place. Consequently, the evidence shows that much of this latest spike in oil prices is due to the uncertainty the Middle East is releasing on the rest of the world, laced by concerns of oil supplies.

## Long-Term Thoughts

Recently I had a conversation with one of our clients who broached the issue of U.S. energy independence. The question was – “If we in the U.S. produced as much oil as we could domestically, would our demands be met?” In other words, is our ability to be energy self-sufficient simply a matter of political and technical limitations? Our research indicates the U.S. currently does *not* have the productive power to create energy self-sufficiency. If the Federal Government allowed unfettered drilling on U.S. property (both lower 48 and Alaska), and oil and gas drilling were allowed with no restrictions offshore, we would not have the capability of producing enough oil to be truly self-sufficient. Technological advances would be needed to accomplish this feat. Oil shale properties would need to be exploited with technologies and techniques not yet in existence. We as a country remain captive to oil imports. So, for the time being, we have no apparent choice but to import oil.

This raises questions as to substitution and demand modification. Should we as a country make the necessary infrastructure investments to support and build delivery systems and alternatives to oil consumption? We believe the answer to this is yes. We are very supportive of the *right type of investments which need to be made* in the U.S., which will supplant our need to import oil. *Natural gas exploitation seems in our minds to be the most rational alternative to oil consumption going forward.* We see little opportunity in the true alternative energy space which makes economic sense at this time, on a massive nationwide scale. This is due primarily to the investment and benefit trade-off analysis, which needs to be made rationally and without emotional bias. In most cases, alternative energy schemes tend to need special tax treatments to remain economically viable. For the long term, this type of favoritism by the government, given current debt structure, may not be sustainable.

## What About Demand

There are many critics who in the past have claimed that Americans use too much energy. Following is one favorite statistic these folks use regarding the amount of energy the average American uses: The U.S. represents 5.0 percent of the world population, but consumes 20.0 percent of worldwide energy. This is good information, but only tells part of the story.

As of 2009, the U.S. generated 25.9 percent of the world's GDP. In other words, with only 5.0 percent of the world's population, we produce more than a quarter of the world's economic output. We use 20.0 percent of the world's energy to produce 25.0 percent of the world's output. To be fair, we are not producing the same *type of GDP* that others are – we are more of a service-based society than in the past. Consequently, we should use less energy per unit of GDP than others. However, using the simple “5.0 percent of the world's population and 20.0 percent of the world's energy” is too simplistic. Other issues need to be taken into consideration.

## Final Word

Oil prices are high. Since the lows in 1985, oil prices have risen by 747.0 percent. Gasoline prices have risen dramatically, and in our opinion are driven primarily by supply and not demand issues. Oil and gasoline price increases are starting to impact consumer behavior. We in the U.S. need to become aware of the solution to these issues, which needs to be driven on a national scale. A solution appears to be nowhere in sight at this time. Until this happens, we should expect the supply side of the equation to dominate the pricing picture until prices become a hurdle to sustained economic growth.



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