The Long & Short of It
Quarterly Newsletter
Second Quarter 2022

Over the last few quarters, we have dedicated many pages to monetary policy and credit cycles. This quarter we will examine another component of inflation and dollar stability, the price of crude oil.

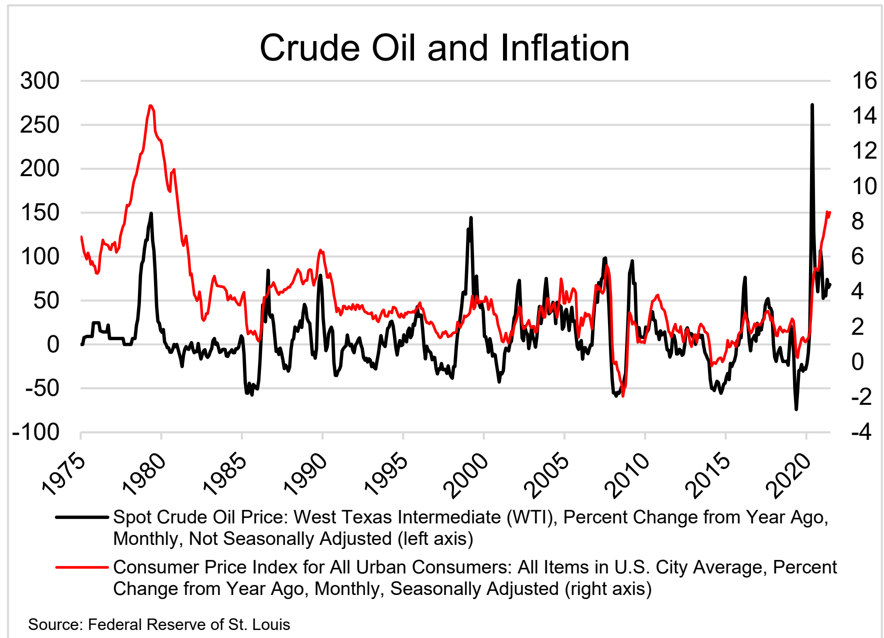
> *Milton Friedman said, "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."*

This is truer than most can imagine. Yet the money supply is so closely tied to petroleum that inflation can also be described as a petroleum-based phenomenon. Crude oil is an input in the vast majority of goods that humans produce. When more money is printed while the supply of oil is restricted, oil becomes more expensive. The production, packaging, and transport costs of associated goods subsequently increase, passing some of the costs on to the consumer and keeping output from meeting the rising demand of more available dollars chasing these goods. Altogether, prices go up. Voilà, inflation. Petroleum therefore might be the world's premier driver of pricing across the economy after money supply.

Oil is so crucial that ownership and access are power. In an age of runaway deficit spending and ESG mandates, oil may be the new reserve currency.

Why is Crude Critical?

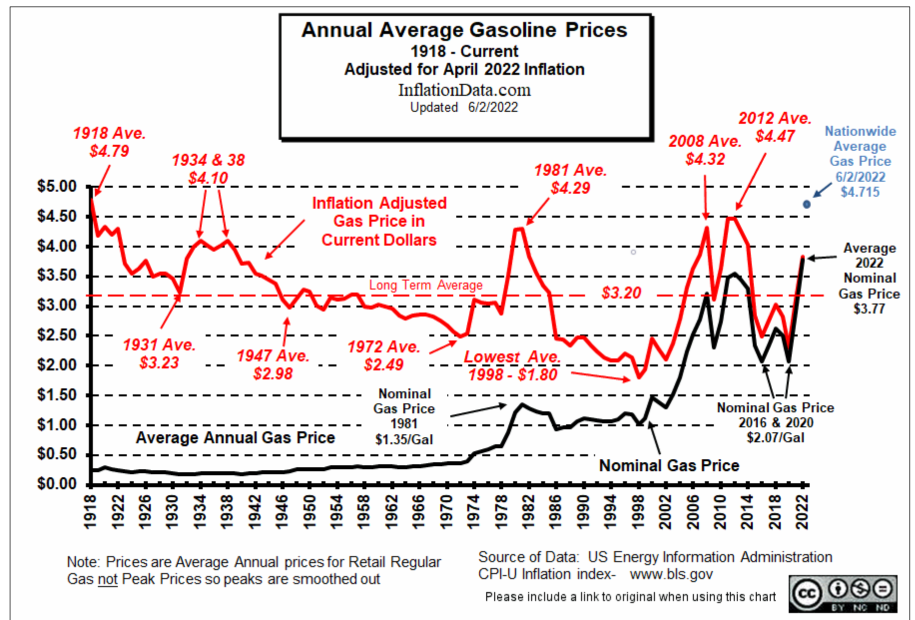
Crude oil is essential to life as we know it. Our housing, health, and food supply would all be affected by the elimination of oil. Petroleum distillates are used in the making of a very wide variety of essential goods and their packaging. Farmers feed the world utilizing petroleum (fuel, fertilizer, and equipment). Electric vehicle batteries and the heavy machinery needed to mine their required lithium all require plastics made from petroleum. Few goods can be packaged or shipped without petroleum distillates. No steel/metals can be milled without petroleum-based solvents. A small sample of goods that typically utilize petroleum are listed below:



Solvents, Diesel Fuel, Motor Oil, Bearing Grease, Ink, Floor Wax, Ballpoint Pens, Football Cleats, Upholstery, Sweaters, Boats, Insecticides, Bicycle Tires, Car Bodies, Nail Polish, Fishing Lures, Dresses, Tires, Golf Bags, Perfumes, Cassettes, Dishwasher Parts, Tool Boxes, Shoe Polish, Motorcycle Helmet, Caulking, Petroleum Jelly, Transparent Tape, CD Player, Faucet Washers, Antiseptics, Clothesline, Curtains, Food Preservatives, Basketballs, Soap, Vitamin Capsules, Antihistamines, Purses, Shoes, Dashboards, Cortisone, Deodorant, Footballs, Putty, Dyes, Panty Hose, Refrigerant, Percolators, Life Jackets, Rubbing Alcohol, Linings, Skis, TV Cabinets, Shag Rugs, Electrician's Tape, Tool Racks, Car Battery Cases, Epoxy, Paint, Mops, Slacks, Insect Repellent, Oil Filters, Umbrellas, Yarn, Fertilizers, Hair Coloring, Roofing, Toilet Seats, Fishing Rods, Lipstick, Denture Adhesive, Linoleum, Ice Cube Trays, Synthetic Rubber, Speakers, Plastic Wood, Electric Blankets, Glycerin, Tennis Rackets, Rubber Cement, Fishing Boots, Dice, Nylon Rope, Candles, Trash Bags, House Paint, Water Pipes, Hand Lotion, Roller Skates, Surf Boards, Shampoo, Wheels, Paint Rollers, Shower Curtains, Guitar Strings, Luggage, Aspirin, Safety Glasses, Antifreeze, Football Helmets, Awnings, Eyeglasses, Clothes, Toothbrushes, Ice Chests, Footballs, Combs, CD's & DVD's, Paint Brushes, Detergents, Vaporizers, Balloons, Sun Glasses, Tents, Heart Valves, Crayons, Parachutes, Telephones, Enamel, Pillows, Dishes, Cameras, Anesthetics, Artificial Turf, Artificial limbs, Bandages, Dentures, Model Cars, Folding Doors, Hair Curlers, Cold Cream, Movie Film, Soft Contact Lenses, Drinking Cups, Fan Belts, Car Enamel, Shaving Cream, Ammonia, Refrigerators, Golf Balls, Toothpaste, Gasoline.

Of course, there is only so much petroleum in the earth to be extracted. Finding substitutes, especially for oil's main use, energy, is a very wise goal. Oil is also a pollutant, another important reason to find substitutes. But identifying substitutes that are more abundant, less polluting, and relatively cost-efficient has proven difficult.

Despite its profound cyclicality, the rise in the price of oil has only taken place in nominal dollars. In other words, adjusted for inflation, crude oil and gasoline prices have been in a stable-to-declining range for the last 100 years. In fact, during this last post-credit crisis economic expansion, real and nominal gas prices peaked in 2012 and declined through 2020. How did inflation not rise during the economic expansion from 2012 to 2020? The rise in domestic oil production in the 2010s clearly played a key part in that good fortune. Since then, US oil production declined due to the pandemic and the low price of oil has yet to recover to its pre-pandemic level.



The supply of petroleum is not yet available to meet the return of post-COVID demand. Drillers and refiners require time to make plans, raise capital, and increase production. All of these plans must be weighed against a predictably unpredictable regulatory environment. So, despite whatever impact recent policy shifts and the war in Ukraine have had on the price of crude oil, there are three primary reasons for oil's current short supply that are less discussed: 1) the extremely low prices seen in 2018-2020 that drove many domestic producers to shut in wells and/or stop drilling new ones, 2) the reduced demand for petroleum in 2020-2021 due to COVID shutdowns, and 3) the shortage of oil workers during peak COVID.

As demand began to recover, the existing restrictions on oil supply played a major role in inflating energy prices and the inflationary pressures we see today. Mr. Friedman remains correct though, in that the major reason for today's inflation is the extraordinary expansion of the money supply, this time due to COVID-19-related stimulus measures, as well as the failure to remove some of that supply fast enough after economic activity levels began to return towards normal. The increased amount of printed money while the supply of goods, services, and energy is restricted has allowed the bidding up of prices to levels that would not have been seen otherwise.

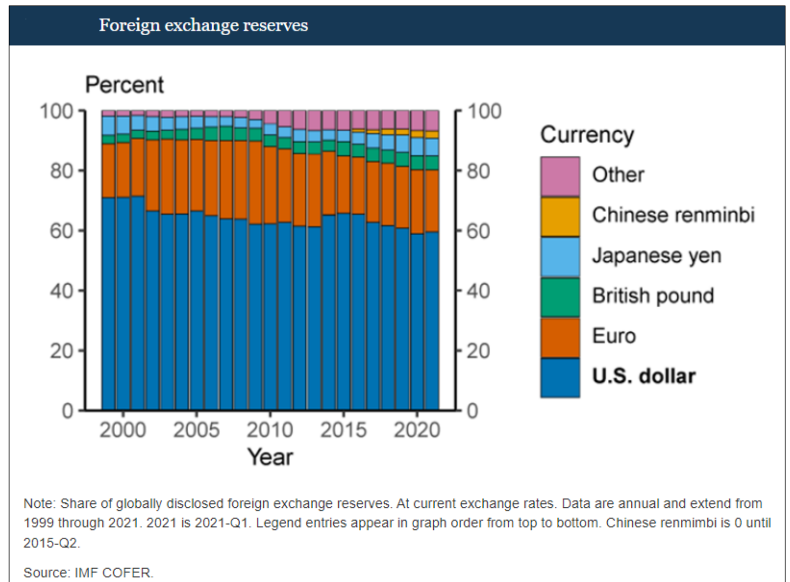
Petrodollars as a Store of Value

Now for a bit of history on how oil and the dollar became so intertwined, and what this might mean for the future. During WWI and WWII, the United States gathered much of the world's gold supply by requiring that arms sold to allies be paid for with gold. At the conclusion of WWII, the world was largely on a gold standard but the bulk of global gold reserves were held by the US. In July 1944, 44 member countries created the Bretton Woods system to deal with this problem. All subscribing countries agreed to peg their currencies to the US dollar as long as US dollars were convertible into gold. This "gold + dollar" standard facilitated trade and currency stability in a post-war world. Early the next year, President Roosevelt had a meeting with King Ibn Saud that resulted in Saudi oil sales and reserves being priced in US dollars. Other exporters followed suit.

With gold pegged to dollars and oil priced in dollars, the US dollar became the world's reserve currency. Countries began to hold large amounts of dollar-denominated assets for reserves. By the late 1960s there were more dollars floating around worldwide than gold held by the US to back them. Gold was underpriced and the dollar overvalued, damaging growth and exports so badly that Nixon stopped policies supportive of Bretton Woods in 1971, leading to its end in 1973 along with any version of the gold standard.

While the gold-to-dollar peg was abandoned, oil remained priced in dollars. This preserved the US's status as the reserve currency to the world. All those dollars with no guaranteed conversion into gold allowed the US to continue issuing excessive amounts of debt and exercising significant influence in the global financial system. For example, the US can impose economic sanctions by blocking access to US dollars from countries that are not friendly to the Western world order. However, short of an act of war, the US cannot seize the gold bullion or oil reserves of a sovereign nation. China, Russia, and some other countries have disliked the dollar-for-oil arrangement for a long time and are working to dismantle it using other currencies as well as other commodities.

For example, Vladimir Putin announced on March 23 that "unfriendly" (hostile) countries must pay for Russian gas with Russian rubles, thereby bypassing the need for US dollars. For "friendly" countries, Russia permits them to purchase oil using their own currency. China and India have signed up. This symbiotic relationship enables the "friendlies" to issue debt more easily as they do not need dollar-denominated debt for trade. In turn, Russia can use yuan and rupees to buy products and services from China and India while over-levered allies of the US, especially Japan and European countries, find it more difficult to issue debt. In time, they too may find it increasingly tempting to engage with Russia, printing their own currencies to access petroleum instead of being forced to use US dollars.



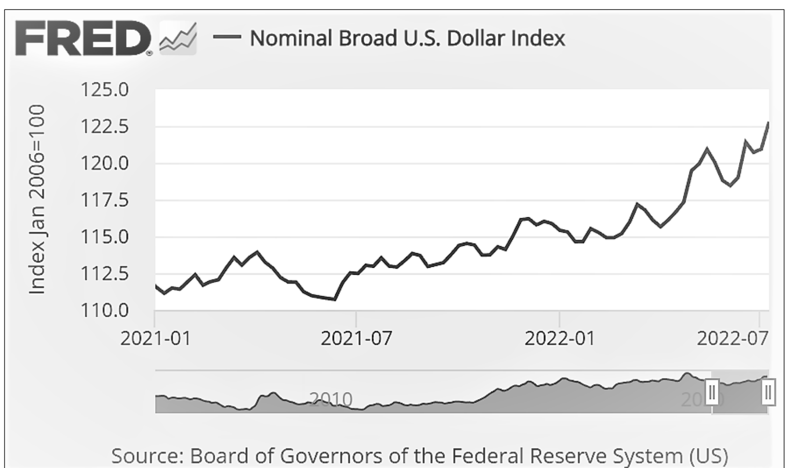
Note: Share of globally disclosed foreign exchange reserves. At current exchange rates. Data are annual and extend from 1999 through 2021. 2021 is 2021-Q1. Legend entries appear in graph order from top to bottom. Chinese renmimbi is 0 until 2015-Q2.

Source: IMF COFER.

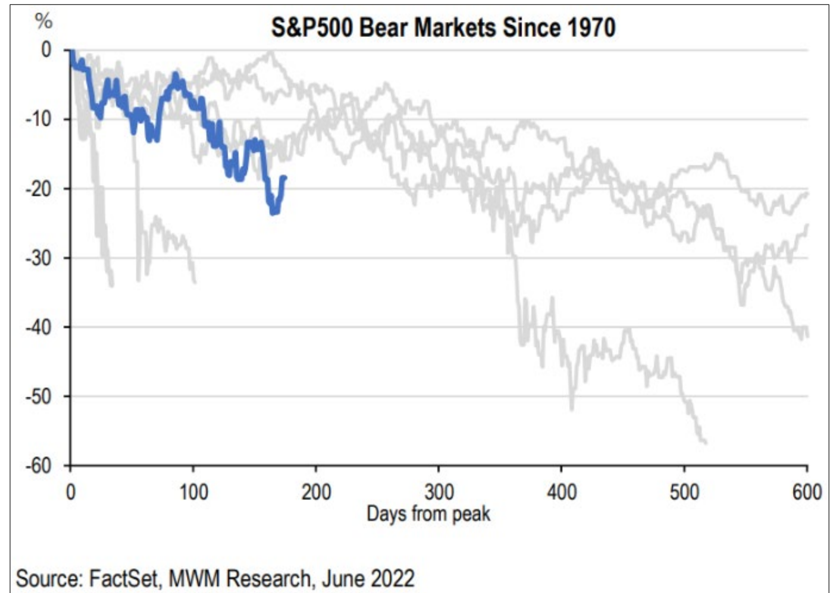
The Dismantling of Dollar-Based Oil

If its primacy continues to erode, the US dollar will eventually face significant devaluation pressures. The resulting drop in foreign demand for US government debt would further exacerbate the dollar's decline, putting more pressure on the Fed to buy the debt (leading to still more devaluation and inflation) or Congress to slow its deficit spending (bringing about a deeper recession). There is no sure way to predict whether or when the change would become remarkably large, but many increasingly relevant factors tell us to pay attention and be positioned for surprises. When debt levels become untenable, problems can emerge rapidly rather than incrementally.

For now, the tightening by our Federal Reserve is causing the dollar to become harder to find and stronger at a rapid pace. Priced against a basket of other currencies around the world, the dollar has risen an amazing 19% since May 2021. So, despite our 8% inflation, American consumers are still 11% better off relative to those holding other currencies during this time. Buying foreign goods is relatively easy for Americans and exporting is currently a challenge because of the dollar. Yet the pricing is becoming a bit extreme. If getting inflation under control means our economy slows dramatically or if international political uncertainty declines (for example, resolution to the Ukraine war), the dollar has a chance to turn down for a period of time—perhaps significantly. Our bloated debt levels may result in some unusual outcomes during the next recession.



Source: Board of Governors of the Federal Reserve System (US)



Federal Reserve chair Jerome Powell told everyone that he would produce an increased level of inflation and he did. He now says he will get inflation under control even if it means recession and a deeper bear market. We believe him. It is half of the Fed's mandate, after all. Most at the Fed talk of a soft landing but the academics at the Fed never saw US inflation coming; therefore, their ability to plan for and avoid recession is also suspect. Although the future is always uncertain, one can see that this bear market (as represented by the thick blue line at right) has been brief and not as deep as prior bear markets. It is easy to imagine there may be more to come. These uncertainties about the consequences of the increase in the money supply, rapid inflation, dollar strength, and actions/adjustments of other countries are just beginning to play out and may take many distinctive paths to a very different global economic reality.

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