Real Yields Affect on Oil
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On July 7th 2008, oil peaked at $145.29. By December of that year (just 172 days later) oil hit a low just under $30 a barrel. Fast forward to 2011 and oil is back up and trading for over $100 a barrel. When you think about it, oil has had quite a remarkable journey.

Whilst its ascent is inspiring it is also quite unsettling. Deutsche bank estimates that for every 1cent ($0.01) increase in retail gasoline prices consumers spend approx. $1-1.5B less on non-energy consumption in the US. This inextricably links oil prices to the recovery and several prominent economists believe oil above $130 will materially destroy demand.

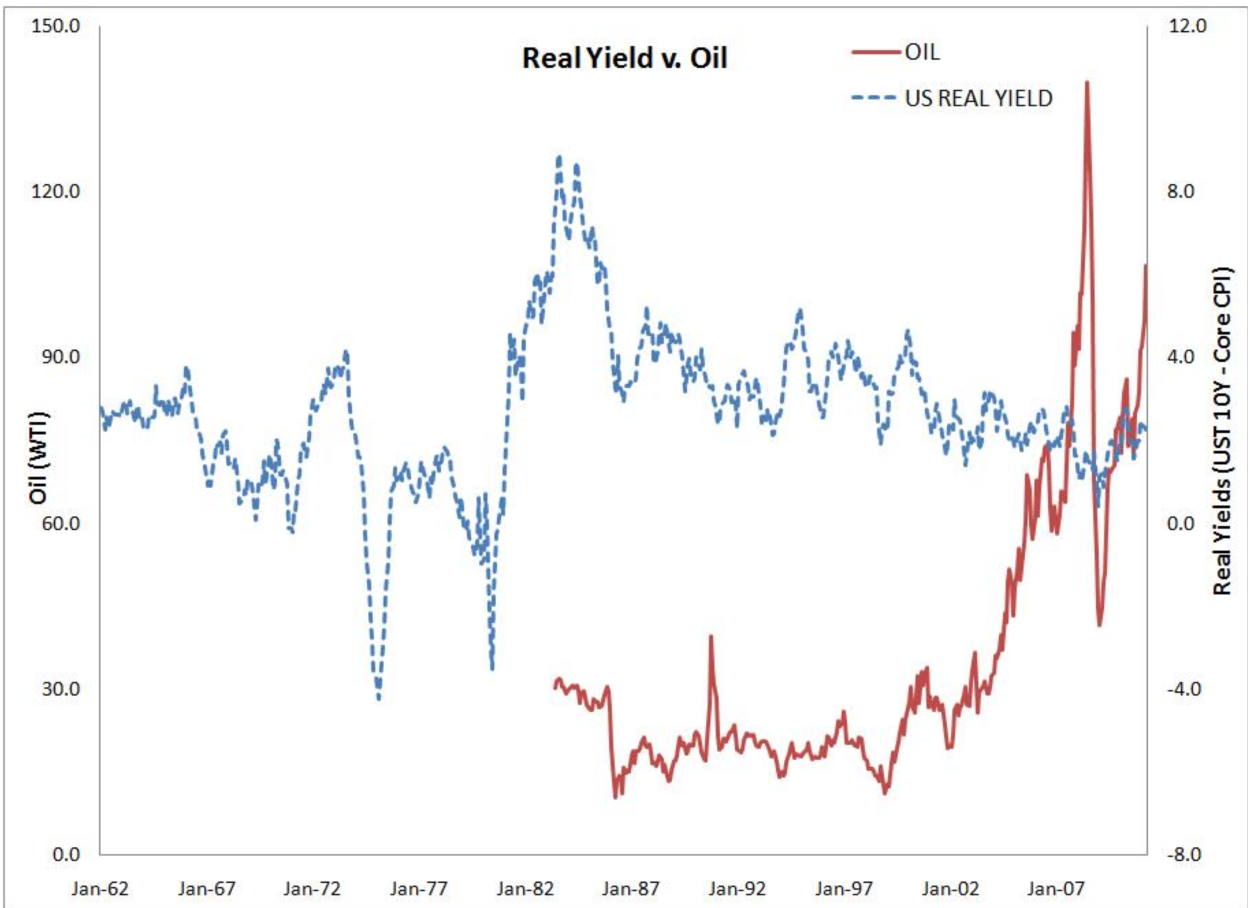
Naturally, the resurgence will also recapture the attention of legislators in Washington, who are unable to come to terms with fact that price is dictated by basic supply and demand dynamics. Before long we will have more hearings, more accusations and more calls for a windfall tax. Ironically or perhaps conveniently we gloss over the fact that contemporary monetary theory has created one of the biggest dislocations in the supply/demand equation, a problem that I will elaborate on momentarily.

Meeting trend growth (and keeping unemployment low), has become increasingly difficult. To stimulate the economy central bankers around the world have systematically lowered the level of interest rates over the last twenty years. (Low interest rates can weave that special kind of magic that takes 1% growth and makes it 3%).

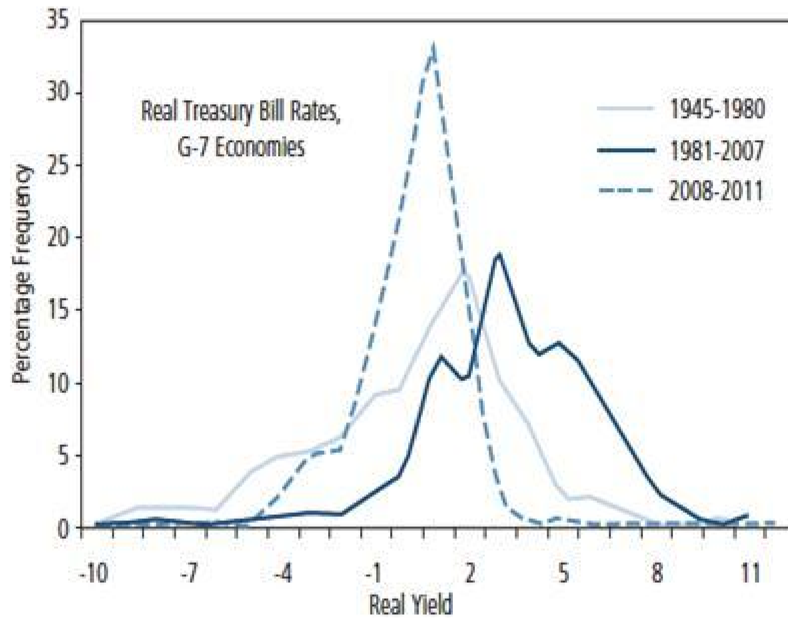
As a politician or Reserve banker, it's an easy sell, but for investors the policy decisions set by the central bank have a meaningful impact on the investment world. We've put our pension funds, insurance companies, and oil producing countries in a precarious situation: where do they park their capital when market yields are low and sometimes negative in real terms? PIMCO's Bill Gross has, under great publicity, completely exited the US Treasury market for preciously this reason. A copy of his thesis is available here.

Yet unlike pension funds or insurance companies oil rich countries have the luxury of leaving their spare capacity in the ground. We must give them a compelling reason to monetize their oil reserves, and we simply haven't. This has kept true capacity on the side lines which in turn forces oil prices upward. In essence oil producers are demanding a higher price to subsidize the low yields they will earn on their bond equivalent oil reserves.

Looking at the below chart you will notice real yields (Right hand side) have been trending downward while the price of oil (Left hand side) has steadily increased.



Source: Bloomberg



Source: Reinhart and Sbrancia (2011), International Financial Statistics, PIMCO

Many argue that low yields are a positive for growth, a high-octane shot in the arm sort of speak. Yet we walk a thin line between stimulating short term growth and over the long term destroying it. Especially

today, the Fed is so focused on getting the economy back on track that they've ignored the indirect effects low yields have on oil. It seems as if we cannot have our cake and eat it too.