Weekly Commentary by Professor Jeremy J. Siegel

Rising Oil Threatens Recovery

2:45 p.m. EDT, 4/8/2011, Philadelphia PA

I voiced concern about oil prices in my last commentary and recent events have only increased my worry. Brent oil today soared past $126, U.S. gasoline prices rose to $3.74 and the future price of gas is now pointing well above $3.80 a gallon. If these prices were to stop rising, then everything would be fine, but there is no indication that this is the end. Other commodity pressures continue to build, and gold is up $16 today to $1,474. Furthermore, the dollar is down sharply against the euro today – I thought that the euro would weaken after Trichet's expected bump up in the ECB policy rate, but the euro has continued to rise. Although the Japanese yen has been weak, the dollar index against developed countries has dropped to a yearly low.

All this puts pressure on the Fed to tighten. The March 2012 Federal Funds future has been bouncing around 50 bps for the last several weeks, but has shown no clear sign that the Fed is going to begin tightening soon. The minutes of the March 15 FOMC meeting indicate that there was a lively debate on when the exit strategy from the monetary accommodation will start, but also agreement that the QE2 program will continue through June, as originally planned. Next Thursday and Friday we will see the March PPI and CPI indexes. Again, there is expected to be big bumps in overall rates (+1.0%, +0.5%), but the core rates are expected to be modest (both at +0.2%). However, it is only a matter of time before rising energy and food prices – as well as a falling dollar – will have a broader impact.

The GDP growth for the first quarter, to be announced April 28 (the day after the next FOMC meeting) is likely to show an anemic growth rate of between 2% and 2.5%, and possibly lower. Although most forecasters are projecting the second quarter growth at 3.5%, this also will be reduced if oil prices continue to rise.

I don't want to over-emphasize my concern with oil prices. The U.S. is in much better shape to withstand steep increases now than it was in the 1970s. The energy intensity of our economy (the amount of energy needed to produce $1 of GDP) is half of what it was in the 1970s. Nevertheless a slowdown is inevitable if prices continue to rise and a recession not out of the question if oil rises radically.
