Economic and Social Outlook: *July 2008*

If oil prices stay at current levels or, worse yet, rise further from here, recession is indeed a risk in '09. Falling energy prices would provide welcome relief for both economic prospects and the stock market.

Market Overview

Back in April the skies were clearing over the stock market. The Fed had been decisive and creative in dealing with the financial crisis on Wall Street. The problems in the housing and financial service sectors, while far from over, seemed set on a path to resolution. Many sectors of the economy outside of housing and financial services, particularly exports, were doing fine. It looked like recession had been averted.

The stock market shared this outlook, staging a sharp rally from mid-March to mid-May that added 12% to the S&P 500. And, indeed, we believe the prospect of a recession in 2008 remains unlikely. First quarter real GDP growth came in at a slow but positive 1% and the second quarter appears on track for a similarly tepid but positive result. With tax rebate checks goosing consumer spending and the lagged effects of Fed interest rate cuts starting to register, the back half of the year should see the economy continuing to limp along.

2009, on the other hand, was supposed to be the year of recovery. Now that's in question. This is why the market has fallen back to its lows for the year—back to levels reached at the bottom of the decline in March. This puts the S&P 500 down 12% so far in 2008. The reason for this sudden souring of animal spirits is, in a word: oil.

The Stagflation Narrative

For reasons hotly debated by politicians and financial analysts the world over, the price of oil began to skyrocket in April, moving from $100 a barrel to $145 -- a 45% rise in a couple months. The bearish story for stocks, based on spiraling oil prices, goes like this:

Oil price spikes threaten to depress economic growth and rekindle inflation. The word for this unwelcome prospect, first coined in the 1970s, is "stagflation," i.e., a stagnant economy with rising inflation. Such a scenario is doubly bad for stocks. First, a stalled economy spells stagnant or declining corporate earnings, which often bring lower share prices in tow. Second, rising inflation could spur the Fed to raise interest rates. This would raise the costs of borrowing, consuming and doing business, further depressing the economy, earnings and share prices.

Our Take

To have a view on the US economy and stock market today, you have to have a view on oil. If oil prices stay at current levels or, worse yet, rise further from here, recession is indeed a risk in '09. If that happens, stocks have further to go on the downside. With current share valuations modest, we don't see downside risk anything like that of the bear market of 2000-2002. But there could be further declines nonetheless.

We think the odds are 50/50 that we avoid a recession in '09. The case for continued economic expansion turns on the prospect of oil prices declining in the near term. The reasons to expect a decline in oil prices are quite simple. Global demand for oil should slow—or, more precisely, the rate of growth in demand for oil should slow—and supply should increase. Slowing demand with rising supply is a textbook formula for declining prices.

China and the Global Picture for Oil

The Chinese economy accounted for 80% of the increase in global oil demand in 2007.

continues on reverse

Major Market Performance through June 30, 2008

	2nd Quarter 2008 % chg.	1st Half 2008 % chg.
DJIA	-6.84	-13.29
S&P 500 (large cap)	-2.73	-11.91
S&P 1000 (small/mid cap)	3.82	-4.91
S&P 1500 (all cap)	-1.97	-11.12
NASDAQ	0.61	-13.55
Lehman State G.O. Muni Bond	0.62	0.97
Lehman Gov/Credit Interm. Bond	-1.53	1.43

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So to know what oil prices will do, you need to know what the Chinese economy's going to do. We think it's going to slow because the Chinese government wants it to. They see current levels of inflation as a threat to social stability and to the government's hold on power. The People's Bank of China accordingly has sharply tightened monetary policy recently in an effort to slow China's torrid pace of growth and cool inflation.

Perhaps the best sign of a future slowdown in China is the Chinese stock market's 55% decline over the past eight months. Stock markets anticipate economies and China is no different in this regard. A coming slowdown in China means slowing demand for oil.

In all these regards, China is the bell cow for emerging economies in general, which in aggregate now account for a greater share of the global economy than the US. What's happening in China is happening throughout the developing world. So you have emerging economies generally facing a slowdown ahead, which should slow demand for oil. Throw in a tepid US economy and fading growth in Europe and the picture for global oil demand seems clear: It should slow. Without an offsetting decline in the supply of oil, prices should ease going forward.

While saber rattling between Israel and Iran and civil strife in Nigeria pose short-term threats to oil supplies, the big news on the supply side is Saudi Arabia. The Saudis, who produce more oil than any other country, have stated flatly that they will *increase* oil production in coming months. Their goal: moderating oil prices. The Saudis know well that when oil prices reach levels that threaten global economic growth, demand for oil can plummet and with it the price of oil. Global recessions are bad for the Saudis. So, we think supply increases and prices ease.

Oil Prices and the Credit Crunch

If oil prices fall back to their March levels of $100 a barrel (or lower), the odds of a US economic recovery in 2009 go back up. The rising tide of a recovering economy would certainly help the Federal Reserve and the US Treasury in their efforts to keep the financial system liquid and providing credit to home buyers and businesses.

Recent headlines about the Fed's efforts to support mortgage providers Fannie Mae and Freddie Mac have put the weakness in the housing and mortgage markets back on investors' minds. While we're not out of the woods on either front, it appears the worst of the housing bust is behind us. The supply of unsold homes has begun to decline and housing prices have returned to long-term averages of affordability. That said, credit remains tight as lenders of all stripes cinch in their belts. Tighter credit will be a headwind for the overall economy through 2009.

Which brings us back to oil. If oil prices remain high or rise further, that in tandem with tight credit will likely tip the US economy into recession in 2009. If oil prices fall, as we think a slowing global economy suggests, that headwind will abate and allow the US economy to continue to expand.

Irrational Exuberance v3.0

While we think there's a good case to be made for declining oil prices, there's also an element of irrationality in oil pricing today that throws a wild card into any prediction. The price spike we've seen lately looks a lot like "irrational exuberance" among herd-like investors stampeding into an appreciating asset class. We saw this in technology stocks in the late 1990s and real estate in the early 2000s. In both cases exuberance lasted longer than fundamentals warranted. But as both cases illustrate, eventually the fundamentals win out and when they do the inflated asset class declines sharply.

What We're Doing

With those prior lessons in mind, one thing we're NOT doing is chasing the energy sector. We remain slightly underweight oil-patch firms despite the sector's strong returns. We see the fundamentals pointing to lower oil prices near term but don't know when those fundamentals will overtake investor exuberance. What we do know is when sentiment turns oil prices and oil company stocks could fall sharply.

Given this element of unpredictability in oil prices and continuing stress in the credit markets we're maintaining our neutral posture toward stocks. We see both upside and downside "risk" in the market based on the 50/50 odds of recession in '09. If we get a recession, stocks could have further to go on the downside. If we don't, stocks have significant upside potential from here. Retaining a neutral weighting for equities in portfolios is our way of hedging those two possible outcomes.

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Social Advocacy

This spring 28% of ConocoPhillips shares were voted in support of our resolution calling for greater disclosure on the environmental impact of the company's oil sands development in Alberta, Canada. This was the first-ever resolution to address oil sands extraction. Oil sands can hold a massive amount of crude oil but require an equally massive amount of energy and water to extract, resulting in tremendous environmental damage along the way. For a quick primer on oil sands, tune into an interview I did with Corporate Watchdog Radio, at http://corporatewatchdogmedia.blogspot.com/2008/06/tar-sands-perpetuate-petro-addiction.html.

Shelley Alpern

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