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In my view, the seemingly unstoppable rise in energy prices is the biggest problem confronting the U.S. economy and financial markets. Compared to 1999 when oil prices were low, we are now spending an additional $250 billion per year on imported crude oil. U.S. households bear the brunt of the burden where total energy price increases (petroleum products, gas, electricity, etc.) have added nearly $400 billion in additional annual consumer costs compared to 1999. Given that consumer spending, in a good year, increases about $500 billion, this added energy burden is very significant and is slowing real consumer spending sharply. On the other hand, personal income did rise $681 billion last year.

So far, as I expected, we have avoided recession and a big rise in inflation. Certainly there have been serious problems in the housing and financial sectors, but the rest of the economy has held up fairly well. Today, first quarter real GDP growth was revised up to 0.9% (2.1% excluding housing). And the annual total GDP inflation rate is a low 2.2%. I think we have so far avoided recession and higher inflation because businesses and labor have been working very hard to control costs, keep productivity rising and stay competitive in global markets. I would hate to see all that effort lost due to spiraling energy prices.

It is not clear that real market demand and supply factors are the principal factors driving this price spiral. U.S. crude oil imports peaked in June of 2005 and are now down about 10%. Total industrialized nation demand is down, but emerging nation demand (China, India, etc.) is still rising. All in all, growth in total world oil demand – while still positive – is tapering off. Meanwhile, the OPEC (Organization of Petroleum Exporting Countries) cartel has cut production while the non-OPEC oil supply is rising. I think this fall in oil demand and rise in non-OPEC oil supply will likely continue, driven by these extraordinarily high prices. If so, then hopefully oil prices will fall before serious damage is done to the economy.

So, why are prices so high? Some argue that major increases in speculation in futures markets are the culprit. Others blame OPEC. I agree with both assessments. With energy demand and supply relatively fixed over the short-run, speculators may be able to push prices around, but after a while, folks start to make adjustments – cutting back on driving, taking public transportation, converting heating systems. And oil and alternative energy supply begins to expand. Sometimes you see the underlying reality in the small things. I read last week that a farmer in Indiana had spent $100,000 drilling an oil well and putting in a pump and storage tank. He is lifting three barrels a day. At first that sounded silly to me, but after doing the math, I see that if he nets $100 per barrel, he will bring in $109,500 in the first year. Using our jargon, that's a very good ROI (Return on Investment)!

We do have a strong and resilient economy and financial system that is faring remarkably well under tough circumstances. I continue to believe that we will see a significant drop in energy prices, and I hope and expect that drop will come before it triggers a recession. Consequently, I am not recommending a "bunker mentality" at this time. But that day may come if energy prices do not come down. As always, please call me with any questions or concerns.

Sincerely,

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