

Today's Notes:

- 1. Oil: Why Energy Costs are Important**
- 2. Roubini: Is Protectionism Next?**

1. OIL

The price of oil has fallen so far, so fast that commentators actually believe it will fall forever. It has been a stunning and almost instantaneous reversal. One of the participants in the Chicago Resource Seminar last weekend suggested oil would fall to \$14.00. Last evening as I returned to New Jersey from New York City, gasoline was selling for \$1.88 per gallon just outside the Holland Tunnel. This is a far cry from the \$4+ gasoline of the summer. People should feel good about this. In fact there is something very troubling for most people. I think it has to do with the rapidity and the inability to explain the change.



The CRB has fallen 14% in just one month. Hedge funds liquidated \$97 billion in the third quarter following the now infamous “Paulson Punt” on Fannie and Freddie in July. The damage to consumers (and institutions) from housing price destruction, equity liquidation and credit contraction is massive. While there are some 9,000 funds today, Bloomberg expects another 700 hedge funds to fail. What began as a reluctant Washington defending the US dollar and an attempt to inspire confidence in the US banking system (to allow it to recapitalize), has morphed into global asset liquidation. The Paulson Treasury has failed on both issues (realigning the dollar and restoring faith in the banking system) and at the same time has tipped the world dangerously closer to a deflationary spiral. Yesterday the PPI inflation fell 2.8%. This was the largest decline since the end of WW II. It reversed a three year upward move in producer prices.

Month	Finished goods					Intermediate goods	Crude goods
	Total	Foods	Energy	Except foods and energy	Change in finished goods from 12 months		
2007							
Oct.	0.5	1.3	1.1	0.1	6.1	0.6	4
Nov.	2.6	-0.2	11.7	0.3	7.3	2.9	6.8
Dec.	-0.5	1.3	-3.5	0.1	6.2	0.2	1.8
2008							
Jan.	1.2	1.7	2.2	0.6	7.4	1.2	2.9
Feb.	0.3	-0.6	1	0.4	6.5	0.9	3.9
Mar.	0.9	1.4	2.5	0.1	6.7	2.4	6.7
Apr.	0.3	0	-0.1	0.5	6.4	1	4.7
May	1.4	0.6	5.3	0.2	7.3	2.7	6.1
June(1)	1.7	1.5	5.6	0.2	9.1	2.2	2.8
July(1)	1.2	0.3	2.9	0.8	9.8	2.5	5.5
Aug.	-0.9	0.3	-4.6	0.2	9.6	-1	-11.9
Sept.	-0.4	0.2	-2.9	0.4	8.7	-1.2	-7.9
Oct.	-2.8	-0.2	-12.8	0.4	5.2	-3.9	-18.6
Footnotes							
(1) Some of the figures shown above and elsewhere in this release may differ from those previously reported because data for June 2008 have been revised to reflect the availability of late reports and corrections by respondents.							

Today we shall receive October's CPI (consumer inflation) numbers. They are expected to fall in similarly stunning fashion. The US cost of living will likely fall more than in the past 6 decades. It is truly becoming a perfect deflationary storm.

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But all storms end. There will be damage and pain but we will clean up. Savings rates are already turning up – albeit frustratingly slowly – in the US. This will be a necessity and take a very long time to restore levels to those that can once again propel the US economy forward.

For three years we have maintained that the real battle is that of inflation versus deflation. Historically the Federal Reserve has been unable to walk the line and balance growth and inflation perfectly. For the past 25 years, the Fed has reduced target interest rates and debased the \$ in an effort to stimulate the economy. That process seems to be at an end today. Dr. Bernanke wrote his thesis and a book that detailed how he would avoid the mistakes of the Great Depression. But the big mistakes have already been made and not

necessarily by the Fed. It is becoming evident that the Fed is “out of bullets.” By my reckoning over \$4 trillion has been committed one way or another in the battle against the crisis (AKA monetary deflation). At present expenditures or guarantees of \$4.2 trillion have had little positive effect.

Federal Reserve	
(TAF) Term Auction Facility	\$ 900.00
Discount Window Lending	
Commercial Banks	\$ 99.20
Investment Banks	\$ 56.70
Loans to buy ABCP	\$ 76.50
AIG	\$ 112.50
Bear Stearns	\$ 29.50
(TSLF) Term Securities Lending Facility	\$ 225.00
Swap Lines	\$ 613.00
(MMIFF) Money Market Investor Funding Facility	\$ 540.00
Commercial Paper Funding Facility	\$ 257.00
(TARP) Treasury Asset Relief Program	\$ 700.00
Other:	
Automakers	\$ 25.00
(FHA) Federal Housing Administration	\$ 300.00
Fannie Mae/Freddie Mac	\$ 350.00
Total	\$ 4,284.50

These numbers (Billions of \$) are through October 31, 2008. They were compiled by CNBC.

Actual Fed Funds rates are already near zero percent (17 basis points) in the market. Interest rate spreads are rising yet short and intermediate term Treasury yields are falling. This has resulted in the steepest Treasury yield curve in 5 years. Business activity, inflation and Treasury yields are clearly falling. It is not just the equity market trying to find a bottom. It is now the global economy. This implies a recession that will be deep and last longer than usual. Nouriel Roubini expects 9% unemployment which is on the cusp of disaster for the US economy. Remember, however, before you decide to jump off the Golden Gate that unemployment in the Great Depression reached 26%. It took the great demands stimulus of WW II to break the shackles of that deflation and that occurred only after a decade of misery. This should not become another Depression.

Back To Oil. There is both a silver and a lead lining here. A country must have access to cheap energy to increase its quality of life. On one hand the reduction in the price of oil eases inflationary pressures on the economy and does provide cheaper energy. It also takes some of the geopolitical pressure off the world. Russia, Iran and Venezuela must now begin to behave. Their energy prowess is lessened. As you see in the Dept of Labor’s PPI Table energy prices

fell 12.8% in October alone. **This is unprecedented.** On the other hand markets always move to extremes. Whatever happens to energy prices in the next 15 to 18 months, we are most definitely running out of cheap oil. This presents a discovery opportunity.

The lead lining? A decline in energy prices, while positive for the economy, will derail many of the alternative energy initiatives in our economy. In the long run lower oil prices will force us to remain on the oil largesse of the Middle East. Here's the real problem. The IEA has suggested that in spite of a surplus of oil in today's market, production from the 800 oil fields it recently surveyed will decline at 9% per year without additional investment. Even with significant investment, annual decline rates will average 8.6% (IEA). There is absolute and clear evidence that Ghawar, the world's largest oil field is now declining as its water floods are less productive. What will we use for fuel if we have not developed nuclear energy, solar, wind and domestic oil and gas? That is why I am still convinced that Discovery is critical. It is true that many of these companies have been smashed. But they are going to be critical to our future in so many respects.

2. ROUBINI: THE WORST IS NOT BEHIND US

"To be forewarned is to be forearmed"

Perhaps he is an alarmist. Professor Nouriel Roubini suggested this AM that this is only the end of the beginning. He said on Bloomberg this AM,

"This is really severe ..., the worst in 50 years ... Whatever the Fed does doesn't matter for market rates because of the credit crunch ... commercial real estate is next ... Housing must fall another 40%. Housing starts are falling ... it is a vicious cycle and there is no bottom to it."

To date people around the world are still seeking US dollars. Take a look at today's currency crosses. The US Dollar is stronger again against most and the Yen stronger again against all. The gigantic debt binge that we all sanctioned either intentionally or through ignorance is still unwinding. That means liquidation is still in force everywhere and in everything. The fine professor sees *"Global recession this year and next year ... unemployment around 9%."*

Perhaps the most important reform issue as outcome from all this volatility will be a global currency system that works. However, what is more likely, judging from Congressional hearings on GM today and yesterday with Secretaries Paulson and Bair, and Chairman Bernanke, protectionism is likely to revive itself. This will be not only in trade but more importantly in the financial sector. Not only will all countries race to the bottom in their interest rate policies but they will eventually seek to protect their own banking systems. The plight of the Euro is at stake.

Currency	Chg% <u>X=1\$USD</u>	NY Time	X= 1\$USD	X\$USD =1	Gold Price/oz	Gold Chg	Gold Chg%
US Dollar	--	11/19-07:45	--	--	737.00	-0.70 ▼	-0.09%
Australian Dollar	-0.52%	11/19-07:40	1.5436	0.6478	1137.63	+4.86 ▲	+0.43%
Brazilian Real	-0.70%	11/19-07:44	2.3456	0.4263	1728.71	+10.38 ▲	+0.60%
British Pound	+0.61%	11/19-07:43	0.6636	1.5070	489.04	-3.49 ▼	-0.71%

Canadian Dollar	-0.01%	11/19-07:40	1.2318	0.8119	907.80	-0.75 ▼	-0.08%
Chinese Yuan	-0.08%	11/19-05:07	6.8255	0.1465	5030.39	-0.65 ▼	-0.01%
Euro	+0.21%	11/19-07:30	0.7906	1.2649	582.64	-1.81 ▼	-0.31%
Hong Kong Dollar	+0.01%	11/19-07:44	7.7454	0.1291	5708.36	-5.79 ▼	-0.10%
Indian Rupee	-0.94%	11/19-06:38	50.0000	0.0200	36850.00	+308.03 ▲	+0.84%
Japanese Yen	+0.32%	11/19-07:44	96.8100	0.0103	71348.97	-296.45 ▼	-0.41%
Mexican Pesos	-0.53%	11/19-07:44	13.1755	0.0759	9710.34	+41.68 ▲	+0.43%
Russian Ruble	+0.11%	11/19-07:30	27.4374	0.0364	20221.36	-41.63 ▼	-0.21%
S.African Rand	-1.55%	11/19-07:44	10.3765	0.0964	7647.48	+109.66 ▲	+1.45%
Swiss Franc	-0.25%	11/19-07:44	1.2056	0.8295	888.49	+1.41 ▲	+0.16%

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