Crude Above $100 Leaves Fed Facing an Unwelcome Tradeoff

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Global oil prices climbed back above $100 per barrel this morning as the conflict in the Middle East continues to broaden across the Gulf region. Iran-backed Houthi rebels bombed oil facilities in Saudi Arabia yesterday, while Iran attacked an American warship and the U.S. reported destroying five Iranian oil tankers. Very few vessels are passing through the Strait of Hormuz and although some crude oil is finding alternate passage out of the region, sources vary wildly on the amount. What seems indisputable is that global supply of both crude oil and liquefied natural gas is severely strained, while prospects for a near-term increase in production have faded.

As of this morning, Brent Crude was trading around $101 per barrel while WTI is above $96, up nearly $20 over the past month. AAA reported the nationwide average gasoline price rose to $4.22 per gallon this morning, while the price of diesel reached a new record high of $5.94. Surging diesel prices increase transportation and shipping costs, which will affect entire supply chains. This implies core inflation may be impacted to a greater degree.

From the Fed's perspective, *there are no good policy choices available*. The brief summer downturn in inflation has ended, and the financial markets are anticipating the FOMC will address the recent increase in prices as soon as next week. However, the problem is *on the supply side* while monetary policy can only influence demand. Committee members will decide next Wednesday whether to hike the overnight target rate, thereby increasing borrowing costs, slowing consumer spending and by extension, economic growth.

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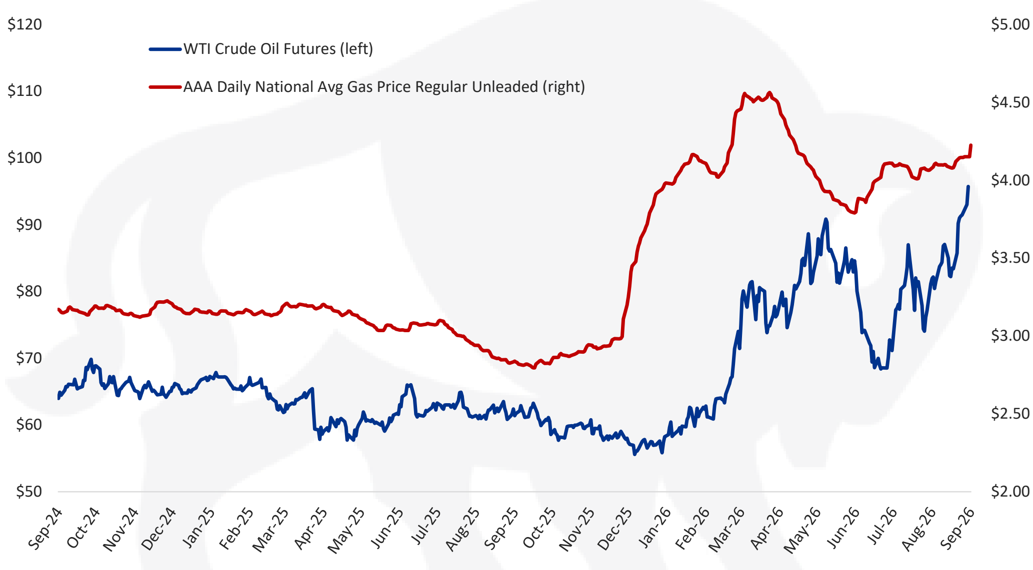
Gas & Oil



Source: New York Mercantile Exchange / AAA / Bloomberg

Although an argument can be made for the Fed to maintain monetary policy until there's more clarity, investors have concluded that energy prices will remain elevated for the foreseeable future which suggests the inflation picture will only worsen. Fed officials may gain credibility by conceding a rate hike next week, but risk making a perceived policy error if the downturn proves more severe.

Remarkably, today's 3-year yield is more than 100 basis points above where it traded before the FOMC began its rate-cutting campaign two years ago that ultimately drove the overnight funds rate down 175 basis points.

The August Producer Price Index (PPI) is scheduled for release tomorrow with the more important Consumer Price Index (CPI) on tap for Friday. Headline CPI, driven by a known rise in energy prices last month, will certainly be higher, while core CPI, driven by a continued ease in shelter costs, is expected to be slightly lower. Hotter-than-expected core inflation may force the Fed's hand.

Bond yields are (once again) higher with the 10-year Treasury note reaching 4.85% this morning, the highest since 2007, while the three-year Treasury climbed above 4.50%, up from 3.38% in late February. Remarkably, today's 3-year yield is more than 100 basis points *above* where it traded *before* the FOMC began its rate-cutting campaign two years ago that ultimately drove the overnight funds rate down 175 basis points.

Market Indications as of 12:55 P.M. Central Time

DOW	Down -291 to 52,495 (HIGH: 54,349)
NASDAQ	Down -136 to 26,285 (HIGH: 27,094)
S&P 500	Down -33 to 7,641 (HIGH: 7,799)
1-Yr T-bill	current yield 4.15%; opening yield 4.13%
2-Yr T-note	current yield 4.42%; opening yield 4.39%
3-Yr T-note	current yield 4.51%; opening yield 4.47%
5-Yr T-note	current yield 4.60%; opening yield 4.56%
10-Yr T-note	current yield 4.83%; opening yield 4.79%
30-Yr T-bond	current yield 5.28%; opening yield 5.25%