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THE HIGH PRICE OF ENERGY: <u>ROBBING FROM PETER IN ORDER TO PAY PAUL</u>

Persistently high oil prices will, eventually, take their toll of the profits of companies, those public and those private.

It is all a matter of time.

Higher interest rates will, at first, give a fillip to some companies, but things that go around come around.

It, too, is all a matter of time.

Last Thursday, The US Labour Department remarked that high energy costs had been responsible, in part at least, for a slower growth rate in the fourth quarter of 2004.

The exact wording of this release, *'Productivity and Costs'*, disseminated last Thursday at 8:30 am included, inter alia:

'PRODUCTIVITY AND COSTS

First Quarter 2005, preliminary

'The seasonally adjusted annual rates of productivity change in the first quarter were:

2.1 percent in the business sector and
2.6 percent in the nonfarm business sector.

'Productivity in the business sector grew more slowly than in the fourth quarter of 2004, when it increased 3.7 percent. In the nonfarm business sector, however, productivity increased more in the first quarter than it had in the previous quarter. Nonfarm business labor productivity increased 2.1 percent in the fourth quarter of 2004.

' In manufacturing, productivity changes in the first quarter were:

3.9 percent in manufacturing,

6.3 percent in durable goods manufacturing, and

1.3 percent in nondurable goods manufacturing.

'Productivity growth in manufacturing in the first quarter of 2005 reflected a 3.3-percent increase in output and a drop of 0.7 percent in hours worked in the sector. Output and hours in manufacturing, which includes about 13 percent of U.S. business sector employment, tend to vary more from quarter to quarter than data for the aggregate business and nonfarm business sectors …

'Business

'Productivity in the business sector rose 2.1 percent in the first quarter 2005, as output grew 3.6 percent and hours of all persons engaged in the sector increased 1.5 percent (seasonally adjusted annual rates). Revised data for the fourth quarter of 2004 show that output per hour increased 3.7 percent, reflecting a 4.3-percent rise in output and a 0.6-percent increase in hours at work…

'Hourly compensation increased 4.8 percent in the first quarter of 2005, more rapidly than in the fourth quarter, when it grew 3.8 percent. When the rise in consumer prices was taken into account, real hourly compensation rose 2.4 percent in the first quarter, up from 0.2 percent in the fourth quarter of 2004.

'Unit labor costs grew 2.2 percent in the first quarter of 2005, more rapidly than the 1.7-percent rise of the previous quarter. The implicit price deflator for nonfarm business output rose 2.9 percent in the first quarter and 2.5 percent one quarter earlier.

'Manufacturing

'... The first quarter increase in labor productivity was the smallest in nondurable goods manufacturing since a 4.5-percent drop in the fourth quarter of 2002. Hours in that sector have declined in every quarter since the second quarter of 1999, when they increased 1.2 percent…'.

Aside from putting a damper on profits of many a company, high energy costs, especially when crude oil prices are higher than $US50 per barrel, lends to general uncertainty in equity markets.

And uncertainty is one thing that equity markets abhor.

High demand for crude oil, internationally, is the major contributory factor to the present situation.

The situation could have been ameliorated, more than one year ago, had The **O**rganisation of **P**etroleum **E**xporting **C**ountries (OPEC) determined to open the oil taps another turn or so.

OPEC, as with any capitalistic enterprise, however, likes the idea of making more profits.

The knock-on effect of the actions – or, should that read, *'non-actions'* – of OPEC will, in due course, come back to haunt this cartel, which controls about 30 percent of the world's exports of crude oil.

It is all a matter of time, too.

Since it is highly unlikely that countries, such as the People's Republic of China (PRC), will cut back on imports of oil, especially since the economy of the world's most-populous nation is expanding at close to 10 percent per annum, it follows that an international decline in economic growth for most of the largest economies of the world, due to the relatively high prices, being demanded for crude oil, is highly unlikely**,** too.

At least, that would appear to be the case at this time.

At the same time, however, a real and persistent danger is that consumers may well cut back on spending because the high cost of energy tends, in terms of household expenditure, to rob from Peter in order to pay Paul.

While, thus far, there have only been veiled hints of this materialising, to any great degree, at least, as with the outset of chicken pox, eventually, the red spots will become only too evident.

Last week, the US Federal Reserve, at its Open Market Committee Meeting, determined to raise interest rates by another 25 basis points to 3 percent.

The Fed's action was well expected and the announcement was of no great shakes.

This is part of that which The Fed said at the conclusion of its Open Market Committee Meeting, last Tuesday (TARGET has highlighted those sentences which this medium determines to be of some concern for the near term):

> *'The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 3 percent.*
>
> *'The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity**. Recent data suggest that the solid pace of spending growth has slowed somewhat, partly in response to the earlier increases in energy prices.** Labor market conditions, however, apparently continue to improve gradually**. Pressures on inflation have picked up in recent months and pricing power is more evident.** Longer-term inflation expectations remain well contained.*
>
> *'The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability… '.*

It was the eighth consecutive Open Market Committee Meeting that Dr Alan Greenspan and his merry men of The Fed had decided that they had to keep the thumbscrews on the US economy.

The effect of The Fed's actions will, eventually, result in the prices of flats and houses to start to decline because mortgage rates must reflect the higher cost of money.

That will come to mean higher debt service for consumers.

Again, this will have a knock-on effect, as US consumers will, without question, tighten their purse strings.

Savings will rise and spending will be curbed because the fear factor will become manifest.

In the past few years, the higher prices of housing in the US have come to mean that quite a number of people have made material sums of money, helped, to a great extent, by interest rates which hit, at one point, a 40-year low.

Those days are gone, at least for the time being.

In the month of April, one noted that US consumers appeared to be less willing to spend.

That phenomenon was coupled with fewer building projects, having been realised.

It all makes sense that these events should materialise and few economists and right-minded businessmen would have expected otherwise.

The economic growth rate of the US is, still, expected to be about 3 percent for 2005, but one should not expect much more than this.

The reason that economic growth in the US is unlikely to be greater than 3 percent, this year, is not because *'USA Incorporated'* does not have sufficient money to fund expansion and/or *'USA Incorporated'* does not have sufficient money to be utilised for additional investments, but, simply put, *'USA Incorporated'* can't see its way clear to employ its available funds for capital expansion/additional investments in a period of such uncertainty as the world is, presently, facing.

Capital spending in the US has been seen of late to be extremely sluggish, all factors considered, and even capital replacement spending is not very much in evidence.

Then, one has a rather unusual scenario, one that consumers will not appreciate, at all: Due to The Fed, having raised interest rates to the 3-percent level, companies will consider, no doubt, passing on their increased additional manufacturing/operational costs to the consumer in order to offset the higher cost of money and the persistently high cost of energy.

To the housewife consumer, she will feel the effects of this in the High Street when she goes to buy her groceries, replace a balding tyre for the family motor car, replace an old television set, look around for clothes for the children, etc.

The high cost of energy and the higher cost of money will enable many managements of many a company to earn a little more money, using the excuse that they have no alternative but to pass on some, if not all, of their increased costs of production/operations to the consumer.

In the past year or so, it was not possible to pass on many of the increased additional costs of production because it was reasoned that consumers would rebel: Consumer loyalty does not mean much in times of adversity or when disposable income is drying up.

Now, the situation has changed, appreciably.

If, however, inflation gathers momentum (and this seems quite likely), the scenario is going to change again since, then, an additional increase in interest rates will have a very negative and detrimental effect on the Bottom Lines of many, if not most, companies.

And companies cannot pass on higher production/operational costs to consumers, ad infinitum.

US consumers, especially, those who decided, a couple of short years ago, to raise their debt loads, will start to feel the pinch of higher interest rates.

Again, they will seek to rob Peter in order to pay Paul.

Disposable income will wane, once again.

Conclusion: Investments in equities in Asia continue to be more attractive, today, than investments in equities in North America and Europe due in large part to the work ethic of Asia and the lower levels of debt.

-- END --

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