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Oil Prices above $70, Big Ramifications for Currency Market

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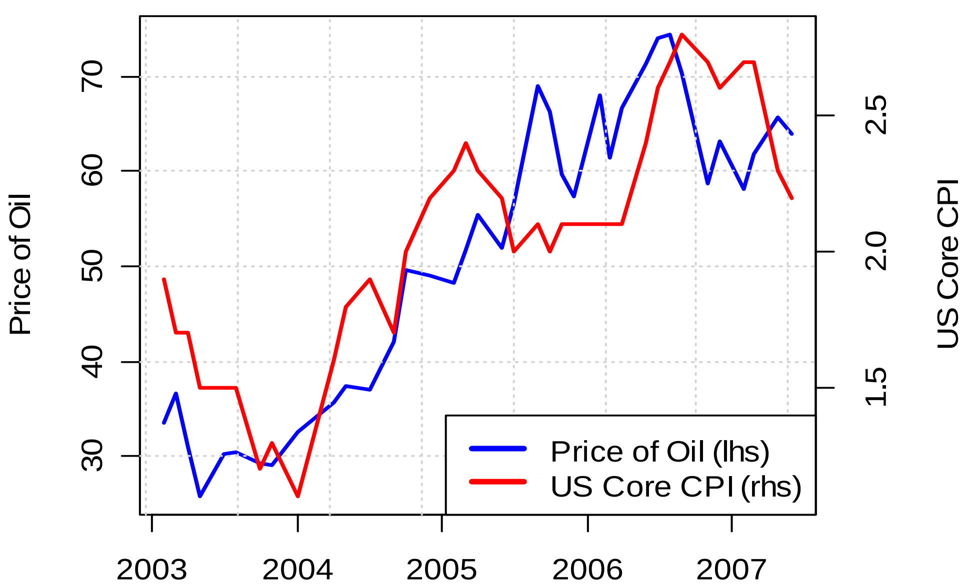
Published: July 3, 2007

If you want to know why the Federal Reserve refuses to budge from their hawkish inflation bias, all you have to do is look at the price of oil. Since the beginning of the year, crude prices have increased over 40 percent with the price per barrel now back above $70. Oil prices have a big impact on inflationary pressures both here in the US as well as globally. If crude continues to rise, it will not be long before the average price of gasoline in the US moves back above $3 a gallon. When this happens, companies around the world will begin to add fuel surcharges, which will also boost core inflation. Over the past few years, we have seen oil become the primary driver of hawkish monetary policy across the globe. The higher oil prices rise, the longer central banks will keep interest rates high, which in one word, boils down to CARRY.

High yielding currencies have already resumed their climb, with strength seen in the US, Australian and New Zealand dollars. This intimate relationship between oil prices and core US consumer prices can be clearly seen in chart below. Back in 2006, when oil prices hit their peak, annualized consumer prices in the US accelerated close to 2.8 percent, while CPI levels in the UK and the Eurozone rose solidly above their 2 percent inflation targets. As long as oil prices keep on climbing, the central banks of these respective countries have no choice but to leave interest rates at their currently lofty levels, which will keep demand for carry trades intact.

Price of Oil vs. US Core CPI through 2003-2007



Oil: $80 In Focus

With the $70 a barrel benchmark out of the way, the next stop for oil could now be $80. The significance of the level stems from the contract high of $78.36 a barrel, set back almost one year to the date. Should the price of crude rise above the psychological $80 a barrel level, it may support a flurry of speculation on last year's out-of-this-world recommendation by Goldman Sachs analysts. In a report citing the recent rush in crude speculation, experts at the US based investment bank were quoted as seeing $100 a barrel oil. Although far from plausible at the time, a push above $80 would increase the reality of such an event. However, should the psychologically important level hold in suppressing the run-up, this could set up for a considerable retracement towards support of $60 a barrel or even lower. Comparably speaking, the last time we tested just below the $80 a barrel level, the contract preceded to retrace the full move and then some until it found support at $50. With such directional implications in the short term, it's easy to see why the upcoming level may present far more importance.

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Source: Bloomberg
Testing just below $80 in 2006, crude oil preceded to retrace overall gains, falling to $50 a barrel

Summer Demand Could Keep Oil Prices High

The current directional bias in oil is clearly to the upside and this sentiment looks to continue as the recent run up has been widely attributed to summer supply concerns, disruption in the Nigerian production and no possible upgrades in OPEC production until their meeting in September. Ignoring recent calls from the International Energy Agency, OPEC leaders have remained unwavering on their current production of 30.19 million barrels per day, citing that supply continues to be robust. With plenty of speculation in the upcoming fall/winter on demand concerns, support is in favor of a move higher based on seasonality. There is also the long term support from China and India who will only increase resource demand going forward. The risk to the outlook is crude stockpile supply which is currently at comfortable levels. According to last week's figures, gasoline inventories rose 375,000 barrels as stockpiles of crude oil advanced to the highest level in more than 9 years in the week ending June 22nd. If supply continues to be plentiful, it would cap oil prices.

Trading Opportunity

Of course, the US economy's ability to weather the rise in oil prices is also important since higher oil prices act as a tax for US consumers. Therefore we are keeping a close eye on the subprime sector and the housing market as a whole because US consumers may not be able to weather the triple blow of higher mortgage payments, falling house prices and rising oil prices all at the same time. This is not a problem yet, but it could be problem in the future. The Federal Reserve has to walk a very fine line in terms of balancing growth with inflation. Other central banks in the Eurozone, Canada, Australia and New Zealand on the other hand do not have as difficult of a predicament, which means that carry trade demand against the Yen and Swiss Franc could benefit those currencies the most if oil continues to rally. If it tops out however, USD/CAD could be the biggest beneficiary because of the positive carry for short CAD long US dollar traders and because the currency pair is already attempting to base.