



Hurricane Watch: How Has Katrina Changed the Investment Outlook?

Our thoughts are with the hundreds of thousands of people who are suffering from the devastation that Hurricane Katrina brought to the southeastern United States. Unfortunately, a disaster of this magnitude may well have far-reaching economic and financial consequences as well. We are obliged to consider

those impacts on the behalf of our clients and hope we can provide some useful economic perspective, without losing sight of the appalling human dimensions of this catastrophe.

We have organized our thoughts into a question and answer framework, intended to address investors' key questions about the potential economic and market effects of Katrina.

Q: Historically, most natural disasters have had fairly limited macroeconomic and market effects. Is Katrina's impact likely to be any different?

A: Information about Katrina's economic toll remains incomplete at the time of writing, but the magnitude of the damage and its impact on a large fraction of the U.S. energy-related infrastructure already put it in a class by itself in terms of modern natural disasters affecting the U.S. With storm damage spread over an area roughly the size of the U.K., and with more than 90% of energy extraction and refinery capacity in the affected region temporarily shut down, the economic impact of Katrina seems likely to be both larger and longer-lived than any other U.S. natural disaster in recent times.

Preliminary estimates from risk management experts suggest that total losses from Katrina could come in at close to \$100 billion US, with insured losses ranging as high as \$35 billion. As a result, Katrina may well cost the insurance industry more than any other natural disaster in the modern era, eclipsing Hurricane Andrew in 1992, which cost the industry \$21 billion in 2004 dollars.

The fact that Katrina has rendered the largest port city in the United States, New Orleans, virtually uninhabitable for many

months to come also puts the calamity in a class by itself. However, the most worrisome risk to the U.S. economy comes from the disruption in energy supply, which happens to have coincided with extremely tight market conditions that had pushed the price of crude oil up quite dramatically even before the storm.

Q: Despite the scale of Katrina's damage, isn't it true that the devastated area represents only a small fraction of the U.S. economy?

A: Yes, and that is one reason that financial markets have responded to the news in a relatively calm manner. To put the direct impact of Katrina into perspective, the metropolitan area of New Orleans accounts for only 0.4% of U.S. personal income and its 617,000 residents account for only 0.5% of total employment. In fact, the combined GDP of Louisiana, Mississippi and Alabama account for only 3% of national GDP. While that area's GDP may fall sharply for a month or two as business activity is interrupted, paradoxically it is likely to grow rapidly in following months as reconstruction activity gets underway.

Q: But how severe is the energy supply shock associated with Katrina?

A: The honest answer is that no one knows for sure yet, until damage assessments are more complete. However, consider the following assessment from the well-known energy economist Daniel Yergin, Chairman of Cambridge Energy Research Associates: "If the next weeks reveal that the losses are as large as some fear, this would constitute one of the biggest energy shocks since the 1970s, perhaps even the biggest. Unlike the crises of the 70s or the Gulf Crisis of 1990-91, this does not involve just crude oil: It includes natural gas,

refineries, and electricity. The 1.5 million barrels of oil production capacity that has been 'shut in' – closed down – is much less than was lost in the market when Saddam invaded Kuwait. But although it has received less attention, 16% of U.S. natural gas production is also shut in; and 10% of refining capacity is under water at a time when there is no slack at all in the world's refining system."

Mr. Yergin's immediate concern focuses on the integrated nature of the current supply crisis since the entire supply system in the region has been disabled, and the various parts depend on each other for recovery. Refineries cannot operate without energy and people, and boats cannot get out to platforms in the Gulf without diesel fuel.

The most visible impact of Katrina away from the disaster zone has been a sharp spike in the price of gasoline, which rose above \$3.00 a gallon in many parts of the U.S. from about \$2.60 before the storm. As shown in Chart 1, the so-called "crack spread" – the difference between the futures price of gasoline and crude oil – soared after the hurricane, reflecting the loss of refinery capacity. That implies a double whammy for consumers, who not only suffer from the high price of crude oil but are now also suffering from a new shock in the cost of converting crude oil into gasoline.

Q: So how will this new energy reality affect the economic outlook?

**Will Katrina Crack the Consumer?
The Crack Spread: Difference Between Price of Gasoline
and Crude Oil Futures**



Source: Bloomberg and Trilogy Global Advisors

Chart 1: Katrina's severe impact on U.S. oil refineries has resulted in a sharp rise in gasoline prices far beyond what is implied by the recent rise in oil prices.

A: As recently as six weeks ago, when crude oil prices were trading at close to \$55 a barrel and economic data was generally delivering positive surprises, many economists were penciling in relatively robust consumer spending growth of 3% to 4% for the second half of 2005. Even had Katrina not occurred, the \$10 plus increase in the price of oil in recent weeks was likely to have triggered downward revisions to the consumption outlook of one-half to one percentage point.

In coming weeks, the outlook for both consumer and business spending will increasingly be hostage to crude oil and gasoline prices. The fact that both the U.S. government and the International Energy Agency have now decided to release significant strategic oil reserves should be a plus in preventing a further parabolic move in prices from this point. However, the reserves will have to be replenished through official purchases in coming quarters, which may keep prices elevated for a longer period.

If for any reason, energy prices continue to rise from here, even more substantial downward revisions to the economic growth outlook are likely to follow. Analysts at Credit Suisse First Boston calculate that if a national average gasoline price of \$3.25 is maintained for the full month of September, the monthly gas and fuel oil bill in personal consumption could rise by a staggering \$100 billion in the third quarter, bringing the headline CPI inflation rate above 5% on a year-on-year basis.

That would create the largest reduction in purchasing power from energy since 1979 and could quickly lead to forecasts of anemic growth. However, we are inclined to view the most recent increases in energy prices as temporary and thus expect the shock to consumer spending to be relatively short lived.

Q: What will this new uncertainty about the outlook mean for the Federal Reserve and interest rates?

A: The markets have rapidly, and probably rightly, come to the conclusion that the Fed will need to pause soon in its policy of tightening monetary policy as it takes stock of the post-Katrina economic outlook. Evidence of this change in view can be seen in Chart 2, which shows a huge drop in the yield on two-year U.S. Treasury notes in the days following the storm, with similar dramatic moves being seen in Fed funds futures markets. While the Fed may still decide to move rates up by 25 basis points to 3.75% on

**Katrina Triggers Major Drop in Bond Yields:
U.S. Government 2 - Year Note Yield (%)**



Source: Bloomberg and Trilogy Global Advisors

Chart 2: Given the uncertainty Katrina has created about the economic outlook, market participants have begun to conclude that the Fed may soon pause in raising rates.

September 20, many bond market analysts are using the catch phrase “one and done” to describe the new outlook.

This view appears to have supported equity markets as well. Many market participants had become concerned that the Fed had painted itself into a corner, with an apparent commitment to raise rates at virtually every meeting. That pace of tightening could well have led to an inverted yield curve and quite reasonable fears of a 2006 recession. From that point of view, Katrina could prove to be a catalyst for the Fed to move into a wait-and-see, data-driven mode that would actually ease fears of a material slowdown or recession in 2006.

The fact that the yield curve in the U.S. has steepened sharply in late August and early September is also consistent with expectations that a pause by the Fed now could lead to stronger economic activity in 2006. The weakening of the U.S. dollar on foreign exchange markets since Katrina likewise reflects changing perceptions about the Fed’s probable course of action in coming weeks and months. Since the U.S. needs either high interest rates or a lower currency to attract foreign funds to finance its enormous current account deficit, our view is that a pause by the Fed raises the risk of further dollar weakness.

Q: Should the post-Katrina energy environment prompt any major changes in asset allocation?

A: Perhaps surprisingly, our quantitative asset allocation models have become more constructive on equities versus fixed income following Katrina, primarily due to the drop in bond yields. Despite the new uncertainties in the energy outlook, prospects for the Fed to pause in raising rates come at a time when equities remain attractively priced relative to fixed income, with the P/E ratio of the MSCI World Index trading at around 15 times forward earnings.

Accordingly, we are maintaining our pro-equity tilt in CI International Balanced Fund despite our concerns that the near-term growth outlook has deteriorated due to the energy shock. We are also comfortable that our portfolio tilts away from the U.S. market and the U.S. dollar will serve us well in this environment, as will our tilts away from U.S. retail and financial stocks.

We do not recommend adding to energy exposure at this point, since the chance for a material correction in energy prices – and a rise in stock prices in other sectors – will rise as capacity comes back on stream.

To be sure, Katrina has been a cruel blow to millions of people in the southeastern U.S. History makes it clear, however, that even severe natural disasters need not lead to recessions or bear markets if policymakers respond appropriately. And despite the unique challenges posed by this calamity, we expect the resilience of the U.S. and global economy and financial system to be demonstrated once again.

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