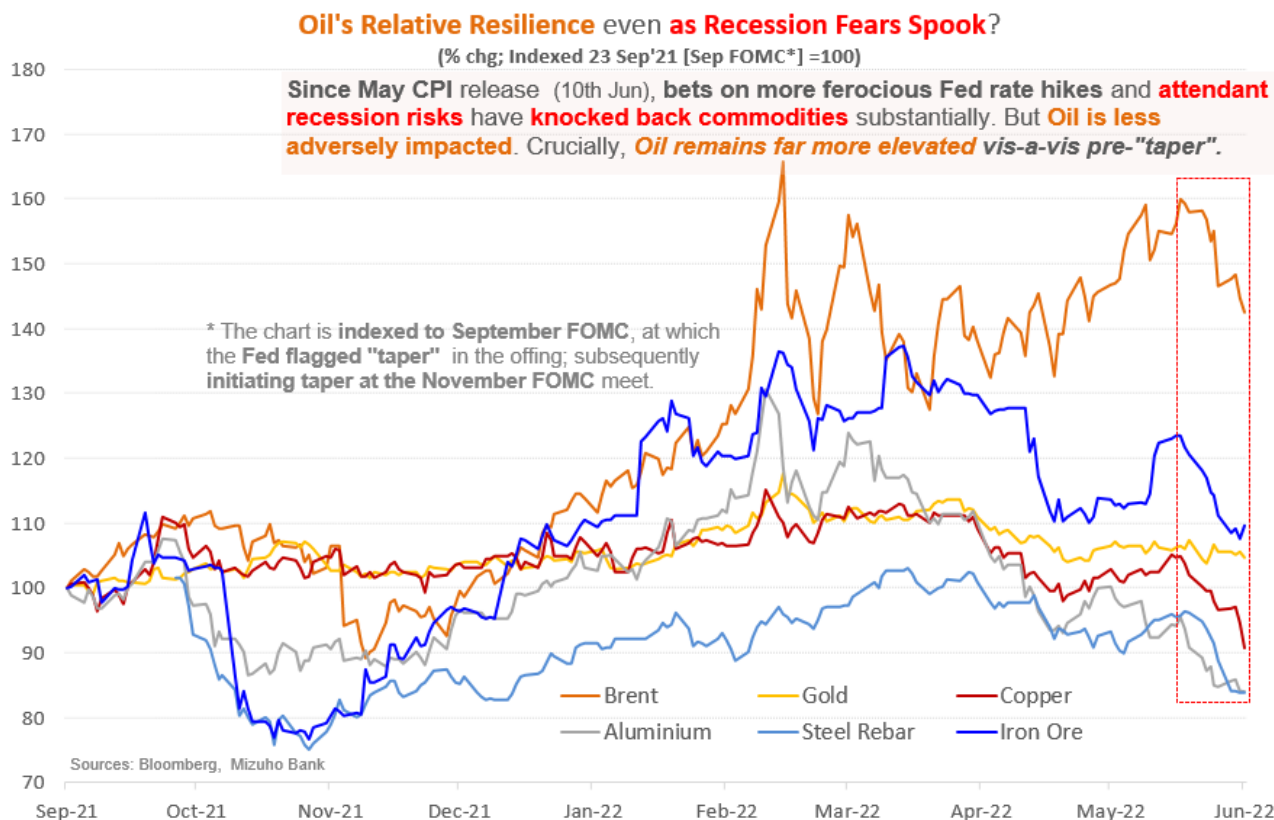


## Why Oil is a Binary Risk



“To be a Jedi is to face the truth and choose. Give off light or darkness, Padawan” - Master Yoda

**Binary Risk: Oil** is by and large turning out to be a **binary risk**. That’s to say;

- Either elevated and “sticky” oil** prices *due to exceptional supply-side uncertainty imposed by the war* in Ukraine **results in more profound and prolonged inflation** that **compels far more aggressive Fed tightening** (and consequent risks) on one hand.
- Or** on the other, **sharp plunge in Oil prices amid recession fears** (induced by brutal Fed tightening) **exacerbates the downturn**, ultimately **forcing the hawkish Fed to suspend tightening, if not make a violent, bearish swerve**; potentially too late **to avert a hard-landing**.

**Dog or Tail?:** To this end, determining **whether Oil is the “dog” or the “tail”** is **critical to discern** at a time **when the Fed has “unconditionally” committed to fight inflation**; and is consequently undertaking **tightening** (rate hikes and QT) **with unprecedented ferocity**, thereby **risking an inadvertent recession**.

Specifically, the question of interest is whether **oil is the “dog” wagging the inflation “tail”**, consequently is setting Fed up for an aggressive tightening path, **or the “tail” wagged sharply lower by recession fear dog**, which inevitably accompanies the Fed’s Volcker-esque response to inflation shocks.

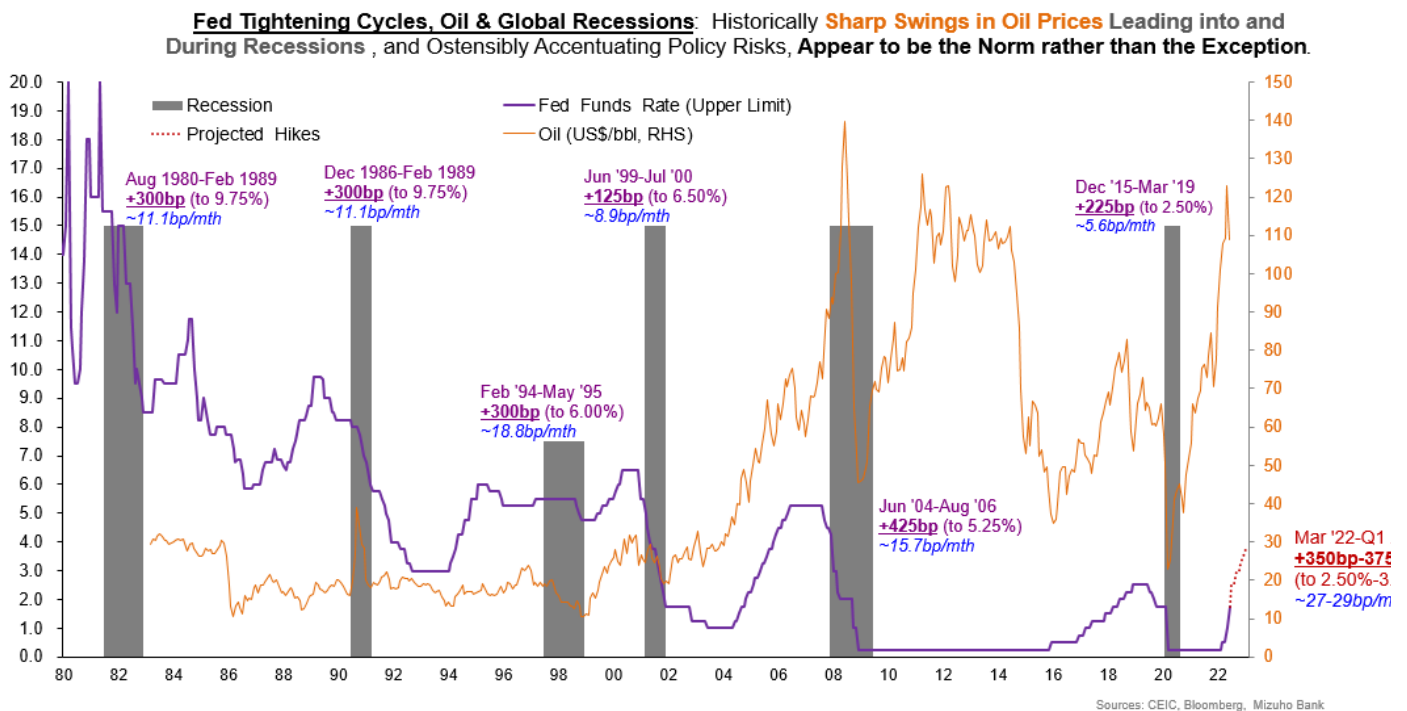
**Sticky Oil & Inflation:** *For now, it appears that Oil is the dog* given perceptibly, if not **significantly**, **“stickier” Oil prices** (vis-à-vis industrial metals) **on the way down amid recession fears** (See Chart above). This “stickiness” arguably **reflects war**, and attendant **uncertainty, premium**.

Fact is, **despite recent price declines** in response to recession risks, taking directional cues from other commodities, **oil prices are unequivocally and unusually elevated** (up ~42% YTD as well as since the Sep FOMC); **consistent with inflation risk risks** that feed into **vehemently hawkish Fed response**.

**Tipping Tendencies on a Narrow Path:** Crucially, **“tipping tendencies” in Oil**, whereby **sticky Oil prices suddenly collapse** with short notice **renders Oil a binary risk**; liable to lurching from one extreme to another.

Admittedly, there may be an argument for adjustments in Oil feeding back to inflation and policy response that helps achieve a highly desirable “soft-landing”. But **neither historical precedent** (See Chart below) **nor the “reflexive” nature of oil dynamics**, exaggerated in a pro-cyclical manner by financial channels/contagion risks, provide favourable odds for such an ideal outcome.

Instead, **tipping tendencies are consistent with binary risks in Oil** that **simultaneously feed off and into a narrowing path for a soft-landing**. *Echoes of Master Yoda’s allusions to the Jedi’s choice between two extremes resonate with Oil’s binary risks.*



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