Standard Life Investments

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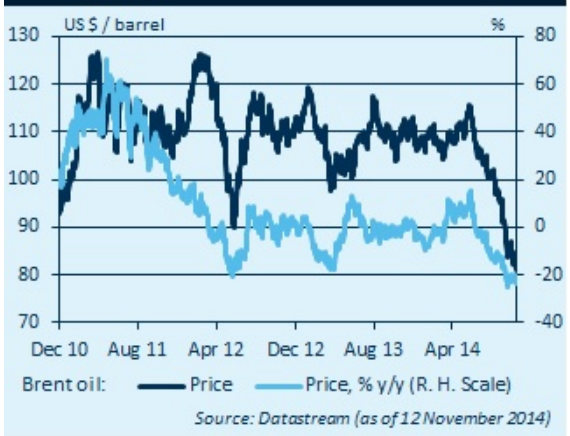
Global Spotlight

Lubricating the wheels of growth

24 November 2014

Oil has a nasty habit of holding economic growth to ransom, with 10 of the last 11 US recessions preceded by an oil price spike. Not surprisingly, investors have become used to keeping a watchful eye on oil trends. Having enjoyed a relatively stable period since 2011, with Brent oil prices largely traded in a tight range of $100-120 per barrel (pb), there are signs that oil is entering a new trading range. The good news for growth is that the price pressures are downward, with West Texas Intermediate (WTI) and Brent falling 25-30% from June highs (See Chart 1). If this is sustained, a key assumption, it may also have repercussions for inflation and monetary policy decisions, corporate earnings and emerging market winners and losers.

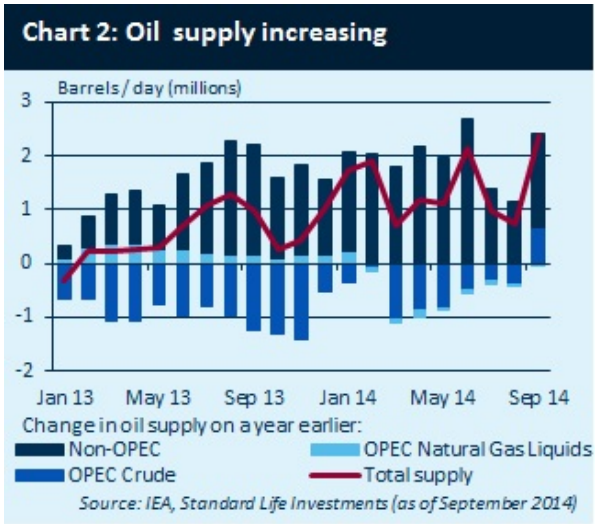
Chart 1: Oil exiting its price range



Source: Datastream (as of 12 November 2014)

Of course, to assess the magnitude of any knock-on effects of a decline in oil prices it is important to understand why oil prices have been behaving the way they have. The obvious place to begin is demand and supply trends for the commodity. An examination of Nymex/ICE futures and options contracts suggests there has been a significant reduction in the demand for oil, with these financial instruments down from 500,000 to 300,000 million barrels. In addition, we have also seen some weakness in economic data in the third quarter, particularly in the Euro-zone, that might also point to lower oil needs. However, not all evidence corroborates such a demand slowdown, with oil tanker rates far from indicating a break in demand pattern in recent weeks.

On the supply side, the picture is less ambiguous. A ramping up of oil output from major marginal suppliers, such as US shale, Libya and Iraq, has coincided with a remarkable unwillingness to curtail supply (See Chart 2). In particular, the Organisation of Petroleum Exporting Countries (OPEC) members have failed to react to lower prices by cutting output. This is partly because key producer Saudi Arabia has so far proven reluctant to interfere with the market pricing mechanism, despite the challenge lower prices pose to balancing its own national budget. Speculation regarding its motives has intensified in recent weeks with the most plausible explanations including a need to dissuade more shale supplies in the US/Europe and/or to put extra pressure on regional rivals in the Middle East. Given the uncertainty on Saudi plans other oil producers have focused on producing as much oil as possible with political and financial troubles adding to the pressure to boost exports.



The key question is whether the confluence of factors weighing on oil prices are here to stay? We think there are a number of reasons not to get too comfortable with the idea of lower energy costs. One trigger for a major change in oil prices, i.e. back towards $100 pb, would be a significant reduction in oil production by OPEC at the forthcoming meeting on 27 November. Another date to watch will be 24 November and any agreement with Iran on sanctions. Further ahead, a trigger would be a degree of pull back by US shale producers in 2015-16. $70-75 is generally seen as the level to alter new production, albeit more in 2016 than 2015. Although not our central view, another medium term risk would be a substantial rebound in commodity demand from the US, China or the Eurozone into 2015 as growth reignites. Lastly, manifestations of serious geopolitical risk in Iraq or Ukraine could obviously cause prices to rebound.

Of course, these risks remain just that for now, and if these scenarios are avoided then a more sustained period of low oil price could be upon us. So what does this mean for investors? The most obvious implications relate to global inflationary pressures. Some observers forecast that US headline inflation will fall well below 1% by spring next year due to the drag from energy prices. This could complicate the task facing the Fed as it seeks to explain the need to raise interest rates. Conversely, there is already talk of the Reserve Bank of India being able to cut rates in spring 2015 as the burden of oil imports eases. The pressure on the ECB to deliver a more robust weapon against deflationary forces is also likely to intensify with Eurozone inflation already running at 0.4% pa.

The impact of oil prices in other areas is more ambivalent. In terms of corporate profits, lower earnings in the energy sector are likely to bring down market averages, although lower oil costs for non-energy sectors may offset some of this decline. Lower energy costs may also hinder structural reform programmes, particularly in oil-importing emerging market nations such as Indonesia as pressures on inflation and fiscal accounts ease. The benefit for the global consumer should be more

discernible, with real income growth likely to support household spending. This may have a knock-on effect on growth trends, with a reinvigorated consumer likely to generate a larger share of GDP into 2015. The impact on business investment may be more mixed, with energy sector capex likely to take a hit while consumer facing and energy intensive industries may be encouraged to increase investment.

In conclusion, the repercussions of the recent decline in oil to a four year low are beginning to seep through to the global economy and financial markets. The immediate beneficiaries are likely to be oil importers and the global consumer but the implications elsewhere will be more mixed. As a result, investors fixation with oil prices are likely to continue although compared to the scare stories of the past the endeavour may become increasingly enjoyable viewing.