News & views

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HOW LOW CAN OIL GO: IS $20 PER BARREL ON THE HORIZON?

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Newton global strategist Peter Hensman asks if technological changes could lead to oil returning to its pre-millennial norm of close to $40 per barrel and perhaps falling even lower.

History is likely to reflect on the post-millennial economic boom as a phenomenon that occurs once every several decades. The confluence of events that contributed to this period of extraordinary global growth included dramatic reforms in most of the economies that were adversely affected by the 1990s currency crises, and the entry of China into the World Trade Organisation – and the commensurate advance of globalisation. The decline in borrowing costs worldwide further advanced the development boom. Such a combination of events is unlikely to be repeated in the near term.

Set against the starting point for the commodity 'supercycle' in 1999, when *The Economist* was able to describe a world in which the US$10 oil price could decline to US$5 because "the world is awash with the stuff, and is likely to remain so",[1] expectations about the demand outlook for commodities could not have been much lower. By the end of the 1990s, many commodity prices were, in real terms, at levels that had not been witnessed since the Great Depression.[2] Not only did these low real prices help underpin demand volumes as affordability rose, they also encouraged a change in management behaviour which sought to rationalise supply growth.

Together, these contributed to the conditions necessary for the supercycle. Following this 1990s period of economic and financial turmoil, in which the emerging nations were forced to adjust to the realities of a more restrictive market backdrop, there was a prolonged, and widely unanticipated, boom in demand from the developing world. The growth in demand in emerging-markets has been such that, even in oil, non-Organisation for Economic Cooperation and Development (OECD) demand has risen from a steady 37% of total usage (which held relatively constant between 1984 and 2000) to 50% in 2013.[3]

The best cure for a high price is a high price

As some UK food retailers have discovered, demand that exists when prices are compellingly low can be diminished at higher price levels, principally because the barriers to entry that forestall new competition when prices remain low can disappear as an industry's price levels rise.

So, just as Tesco and the rest of the UK food retailers have seen sales volumes undermined by the emergence of new, low-priced discounters, the high oil price has encouraged technological advance in fuel efficiency, fuel substitution and new exploration technologies.

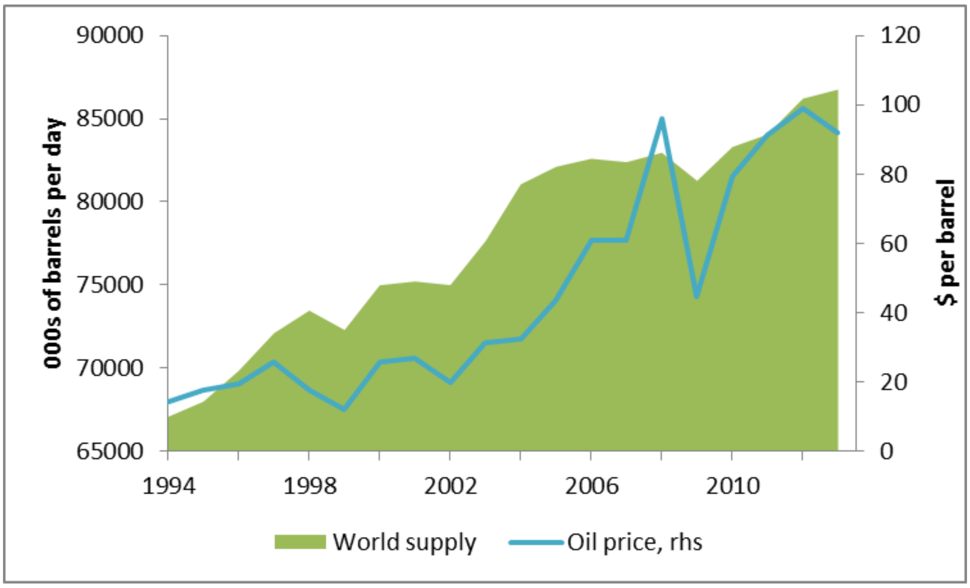
While the appetite to commit capital expenditure to these new areas was suppressed by the low price backdrop, the attractive potential return on investment created by persistently elevated prices renewed that appetite.

Just as the oil price boom in the 1970s encouraged new innovation – North Sea oil exploration was at the cutting edge of deep-sea discovery for the time – the high oil prices of recent years have helped unlock the technological advances that have boosted US oil output above 10 million barrels per day for the first time since

[1] The Economist, *Drowning in oil*, 4 March 1999
[2] Thomson Reuters Datastream, January 2015
[3] *BP statistical review of world energy 2014*, and Newton, October 2014

1986. Firms in the US have been able to start extracting oil from shale formations previously considered unviable.

In addition, unlike the pre-crisis period, if the data are to be believed, the Organisation of the Petroleum Exporting Countries (OPEC) is operating with a degree of spare capacity that was unimaginable as the oil price headed to US$147 in 2008.



Source: BP Statistical Review of World Energy 2014, Thomson Reuters Data Stream and Newton, October 2014

Developing world demand

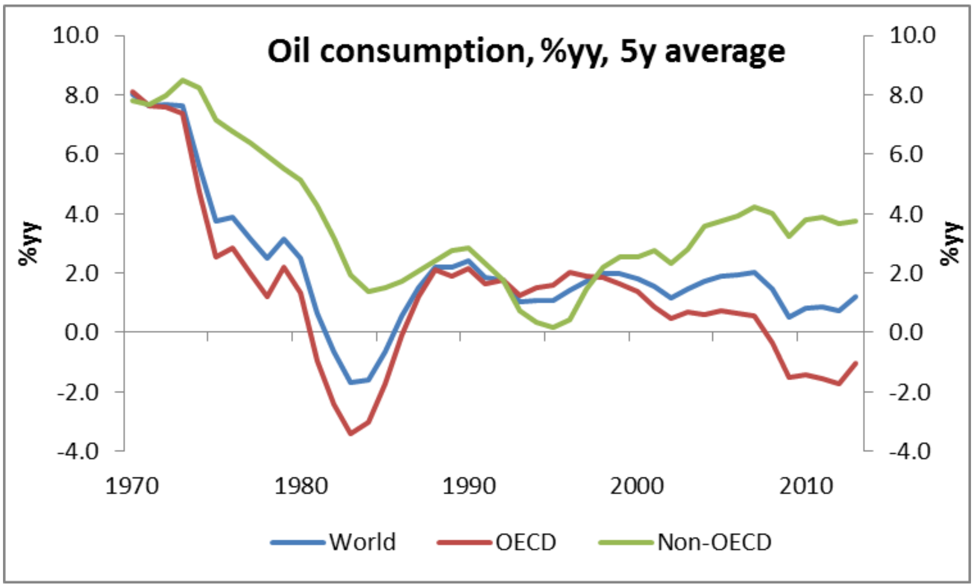
What of demand from the developing world? After all, we calculate that it is this that has contributed more than 100% of the increase in demand for oil since 2002. Even here there is reason to expect softness.

Not only do the one-off factors behind the supercycle boom suggest a period of more moderate demand growth is likely, the fact that activity in these countries has become increasingly reliant on credit adds greater reason for future demand to undershoot expectations. This softer demand prospect may be exacerbated further by weakening exchange rates which increase the local-currency costs of commodities.

Could the combination of these effects – the impact of technology in reducing demand and raising supply, a collapse of OPEC cohesion, and the end of the conditions that supercharged emerging- market demand – contribute to a period in which the oil price declines further still? Could the adjustment be such that the oil price reverts to US$40 per barrel (or even US$20 per barrel), which would be in line – in 2014-dollar terms – with the experience from 1986 to 2002?

A wide range of factors will of course impact oil prices over a specific period. Future geopolitical events, such as a war in the Middle East or instability in Russia, still have the potential to shock the market. However, the series of events that came together to create the commodity supercycle and a soaring oil price are unlikely to be repeated in the foreseeable future.

We think the prospective combination of demand that continues to undershoot expectations and a lack of restraint on oil production probably means that the oil price will fall further before it begins to reverse the demand-squeezing, supply-encouraging effects of recent high prices.



Source: BP Statistical Review of World Energy, and Newton, October 2014