

## The oil crisis and the investment outlook



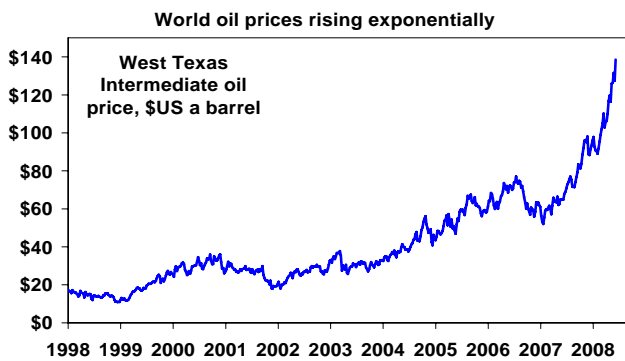
### Oliver's insights

#### Key points

- While the credit crunch has not led to global recession there is a high risk that the surging oil price will.
- The long term trend in the oil price will remain up with \$US200 a barrel likely some time in the next few years.
- However, current prices are not justified by oil supply & demand and are likely to fall back - probably to around \$US100 a barrel - sometime in the next six months.

#### Oil price going parabolic

In the last few days oil prices have spiked to a new record of nearly \$US139 a barrel. This is roughly double year-ago levels and nearly thirteen times above their 1998 low point.



Source: Thomson Financial, AMP Capital Investors

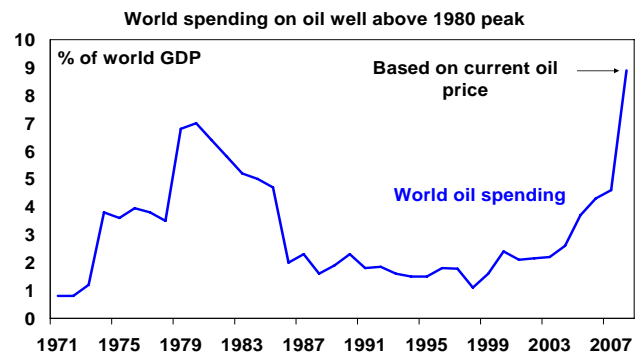
#### Growing risks for the global and Australian economies

The ever rising world oil price is now posing a major threat to the economic outlook. The threat to inflation is already apparent and inflation rates in most countries are now running well above year-ago levels. It is also leading to higher interest rates than would otherwise be the case in the face of slowing economic growth. The continuing surge in oil prices will complicate the setting of interest rates in Australia because it's quite conceivable that the latest spurt in oil and petrol prices will push headline inflation up to 5%.

But more importantly at a time of weak economic conditions is the "tax" on consumer spending that higher oil prices are resulting in and likely pressure on corporate profit margins as weakening consumer spending will make it hard for companies to pass on oil related cost increases.

**While the US credit crunch and housing slump have not been enough to bring on a global recession, it seems as if the oil market is determined to do so. At current oil prices, world oil spending expressed relative to global GDP is well above the levels that**

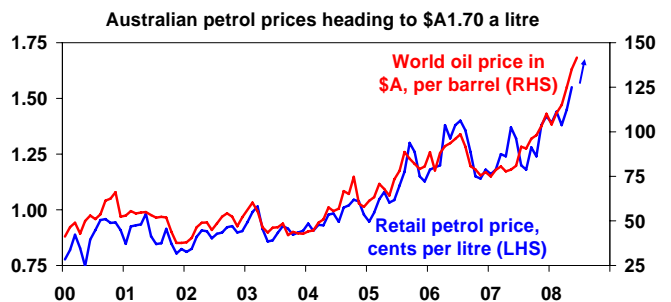
**created problems for global growth in the early 1980s.** And it is increasing faster than occurred in the 1970s, having almost doubled in the last year. See chart below.



Source: AMP Capital Investors

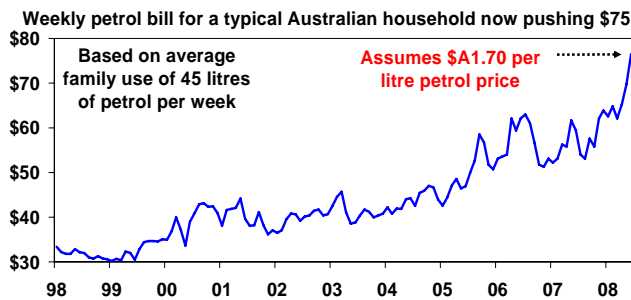
Coming at a time when global growth is already slowing rapidly and consumers & businesses are already struggling, the latest surge in the oil price is significantly increasing the risk of global recession (defined as global growth below 3% pa), the probability of which we would put at about 40%.

For Australia the rise in oil prices is not as bad as in many other countries because it has been accompanied by a rise in commodity prices and this has boosted Australia's national income. However, for most Australians this boost (reflected in higher returns from resources shares, income tax cuts and lower import prices from the strong \$A) is being more than offset by higher interest rates and, more significantly, higher petrol prices. The latest surge in oil prices if sustained will see Australian petrol prices rising above \$1.70 a litre over the next week or so.



Source: Thomson Financial, AMP Capital Investors

This will see the weekly petrol bill for a typical Australian family reach about \$75, \$20 a week up on a year ago. This is an extra \$1000 a year which is on top of higher mortgage payments, which means less spending on other things.



Source: AMP Capital Investors

While the risk of recession in Australia is below that in the US, Europe and Japan, the risk is now significant thanks to high interest rates and surging petrol costs. There is also a growing risk that the rise in oil prices both indirectly (via slower rich country growth) and directly starts to drag down growth in China and the rest of Asia which will have an adverse impact on demand for Australian exports. The risk of recession in Australia is now probably around 30-35%, and our assessment is that the RBA should and will give more weight to this as opposed to the short term inflation threat flowing from higher oil prices and hence leave interest rates on hold.

### Demand and supply fundamentals support high oil prices, but not this high

Our assessment has been and remains that with global demand likely to continue trending up as countries like China and India industrialise and in the process use up more energy, oil supply will struggle to keep up in the absence of higher prices. So the long term trend in the oil price will remain up and it's likely we will see \$US200 at some point in the next few years.<sup>1</sup> However, the surge in oil prices this year is being driven by a range of factors over & above normal supply and demand influences, including:

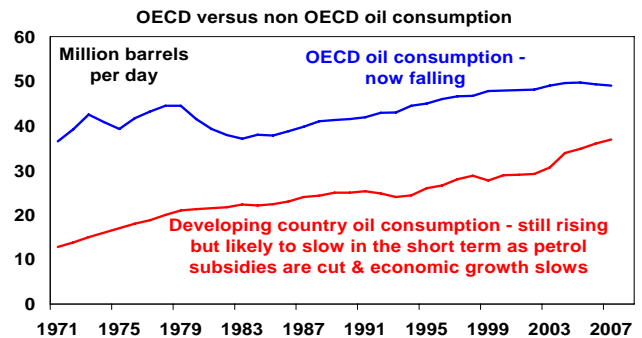
- increased global pension fund demand for commodities, including energy, as another asset class. This has been fuelled by the low correlation of commodities to other investments, and has been given a boost by strong gains in commodity prices as shares, credit and property have been struggling;
- the slide in the \$US which has pushed up the value of commodities, such as oil, which are priced in \$US and raised their demand as a hedge against a falling \$US; &
- in the last few days a premium for geopolitical risk has been built back into the oil price on concerns Israel may bomb Iranian nuclear facilities.

It's doubtful these factors adequately explain the 40% plus surge in oil prices so far this year. **It's looking increasingly likely the rise in the oil price has departed from fundamental supply and demand considerations – which would be consistent with an oil price around \$US90 a barrel - and has become a classic speculative bandwagon** with investors piling in with the hope of more gains ahead. The supply/demand balance for oil has not changed over the last year so much that it would justify a doubling in the oil price. In fact there is increasing evidence that global demand for oil is starting to slow and this will likely become more apparent as global growth slows.

- Demand for oil in developed countries is now falling. See the next chart. US oil demand year to date is

<sup>1</sup> The long term trend was discussed in more detail in "Oil prices and the economic outlook", *Oliver's Insights*, April 2008

running 2.8% below year ago levels, UK petrol consumption is down 7% on a year ago and Australian unleaded petrol sales fell 4.4% in the March quarter



Source: AMP Capital Investors

- While subsidies and price caps have kept petrol prices down in developing countries this may be starting to change with India, Malaysia and Indonesia recently increasing their petrol prices. As this flows through along with slowing growth in emerging countries generally it is likely to lead to a short term slowdown in emerging market oil demand.

With speculators now playing a big role in the oil price, the very short term outlook is hard to predict. It could spike to \$US160 a barrel plus or just as easily fall back. The bottom line though is that barring a threatened or actual disruption to oil supplies, at some point over the next six months the oil price is likely to fall sharply, probably to around \$US100 a barrel, in response to weaker oil demand, due partly to the rise in the oil price itself, and as speculative positions are unwound.

### Implications for shares

The surge in oil prices is great news for energy shares. Each \$US10 rise in the oil price leads to Australian energy shares outperforming the broader Australian share market by 15%. But it is bad news for the rest of the market given the impact on profit margins, interest rates and consumer demand. Transports and consumer discretionary stocks are the most vulnerable. Our view remains that shares are likely to find the going tough over the next few months with further falls likely and the latest spike in the oil price only adds to that view. Asian countries and share markets are particularly vulnerable given their greater reliance on imported fuel and greater energy intensity of GDP. Later this year though if the oil price falls back as expected that should help shares rally into year end.

### Concluding comments

The surging world oil price is now a major threat to global and Australian economic growth. Slowing world growth should contribute to a fall back in the oil price over the next six months, but it could do a lot of damage in the interim if it continues to surge higher. Finally, while it's tempting to point the finger in relation to rising oil prices, it's worth noting that oil is a scarce resource getting scarcer. It's hard to blame OPEC – its spare capacity is half what it was a few years ago. Or China - its per capita oil usage is 2 barrels a year. We in Australia use up 15.5 barrels per person a year!

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