IeC Experience and Insight on Demand

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Oil markets risk rapid repricing as Japan stimulates

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Oil prices were historically always below $30/bbl, until they were driven above this level by repeated central bank stimulus over the past decade. But now, there is a major risk that the inevitable return of prices to below the $30/bbl level could seriously destabilise many companies.

Our previous note on oil markets (Central Banks make Downturn Worse, September 2012) highlighted how central bank liquidity programmes had led oil prices to trade at record levels, and thus destroy consumer demand. Our core argument was that **oil markets had lost their price discovery role.** Financial investors had instead used them to implement 'buy and hold' strategies aimed at creating a 'store of value' against the perceived inflation and currency risk that these programmes had created.

This argument has since been amply vindicated by events, with the IMF warning in its recent Economic Outlook that growth was again slowing globally. Oil prices have also been weakening, and were down $20/bbl at one point following the Bank of Japan's announcement in April of its own major liquidity programme (worth 1% of GDP/month for 24 months). If carried through, this will continue to weaken the yen whilst strengthening the US$.

In turn, this reduces the need for investment funds to continue to need a 'store of value'. Instead, it creates a new risk for the corporate sector, that a rapid unwinding of current positions could create a nightmare scenario of falling prices against a background of slow demand.

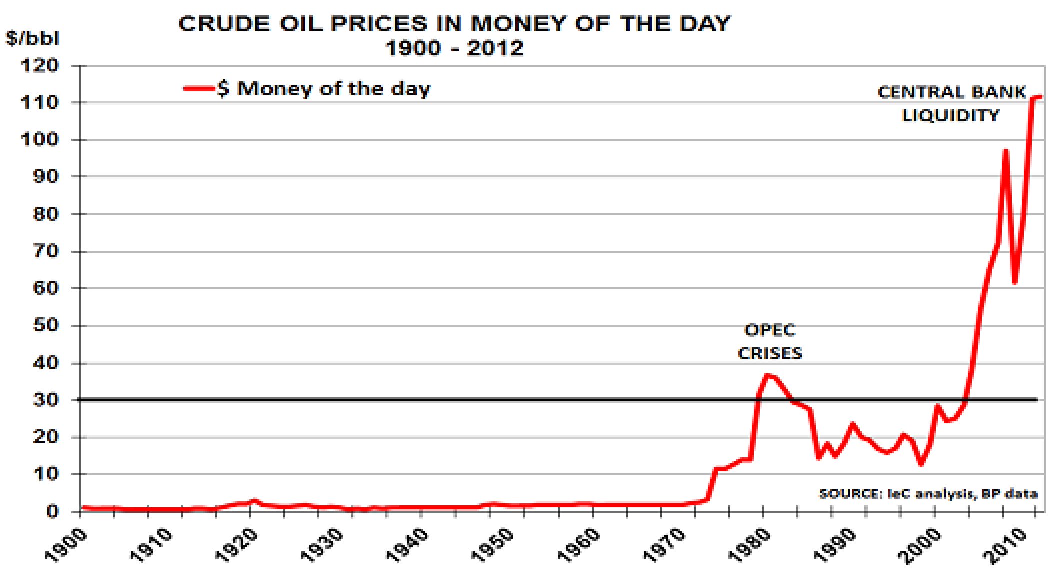


Chart 1: Oil prices have remained above their historical $30/bbl range since 2004

As Chart 1 shows, there were just 4 years between 1900 – 2003 when oil traded above $30/bbl. These were during the 1979-82 Iran crisis when OPEC operated a fixed low production ceiling. Even in real terms ($2012) oil has similarly been below this level for 78% of the period (23 years). Only since 2004 has the $30/bbl level become a floor rather than a ceiling, as policymakers:

- Firstly, held interest rates below market levels in the run-up to the financial crisis of 2008, in an effort to support growth in housing and other markets
- After 2008,initiated successive waves of stimulus and liquidity programmes in an effort to support growth in the wider economy, when the promised swift rebound failed to materialise

This period has clearly been unique in history. Yet companies and investors are now dangerously complacent about the risks they will face once reversion to historical price levels finally takes place:

- Companies have come to assume that oil prices can never fall, and so have failed to develop the necessary scenario analysis to help them survive a period of potentially extreme turbulence
- Investors have ignored evidence of slow demand and low operating rates, and have instead chosen to reward companies with higher ratings for supposedly non-cyclical performance

Investment/ hedge funds dominate oil markets

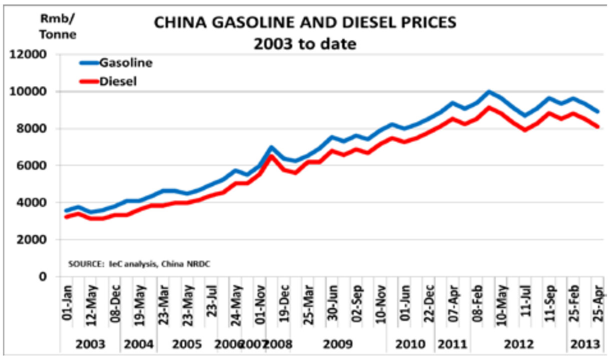
Central banks' systematic intervention to support higher asset values can be traced back to 2004, when they focused on stimulating western housing markets via the continuation of the low interest rates seen after the dot-com downturn and the 9/11 tragedy. As former Bank of England governor Lord George told Parliament in March 2007 about the consumer spending boom of recent years:

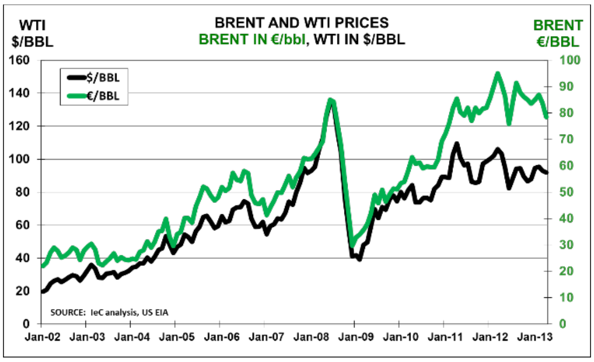
"We knew we had pushed it up to levels that could not possibly be sustained in the medium and longer term.... That pushed up house prices and increased household debt. That problem has been a legacy to my successors; they have to sort it out"[1]

The adoption of 'easy money' between 2004-8 led to an increasing imbalance between supply and demand for many commodities. Supply was simply unable to respond quickly enough to the sudden and unexpected surge in demand. In turn, this created a series of asset bubbles which had their unpleasant end in the financial crisis of 2007-8. Following this, investment funds were then extremely alert from 2009 onwards to the prospect of further asset bubbles and rising inflation, particularly as they believed part of the US Federal Reserve's aim was to stimulate exports by devaluing the US$. They were therefore quick to invest in oil and other commodities as potential 'stores of value' when policymakers began a second round of stimulus from 2009 onwards.

Hedge funds followed them very quickly, having correctly recognised that the funds' arrival would create a potentially very profitable momentum play. Critically from the viewpoint of supply/demand fundamentals, both have primarily been 'buy and hold' investors, routinely rolling forward their futures contracts and only reducing investment when it seemed liquidity programmes might end. The end result has been that the oil market has lost its price discovery role.

[1] Hansard, Treasury Committee evidence, 20 March 2007





Charts 2,3: China has seen record gasoline/diesel prices, whilst Europe has suffered record oil prices

Charts 2 and 3 show how this has not only led to record annual prices for crude oil in US$ terms between 2011-12, but has also taken prices in Europe and China to all-time record levels:

- China's prices for gasoline and diesel have been 35% above 2008 peaks, as the government had previously capped them during the 2008 Beijing Olympics to avoid social unrest.
- European prices have been at all-time record levels, due to the euro's weakness versus the US$

Overall, the total cost of oil is now at 5% of global GDP – a level which has always led to recession in the past, even when these prices were only sustained for a few months rather than today's years.

Yet since 2009, there have been **no shortages of oil or oil products, inventories have been at high or record levels in all major regions, global demand growth has been slow, and supply has been increasing rapidly**. US production has now reached 7mbd, a 20-year high, and is still increasing. Equally none of the specific arguments put forward for higher prices– supposedly major growth in China's demand; massive supply disruption due to the Arab Spring etc – have proved to be valid.

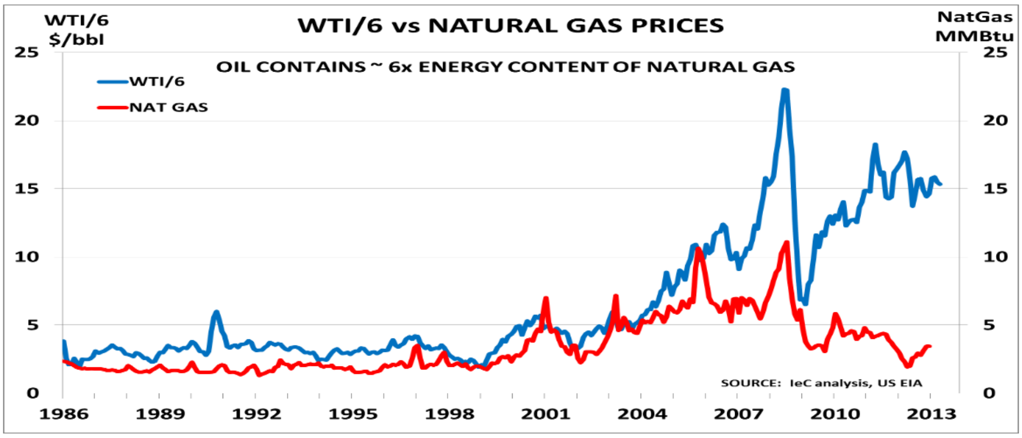


Chart 4: Oil prices are a long way from their traditional relationship with natural gas

Oil and product prices have now returned to levels which have always caused demand destruction in the past. But worse may well be to come. 'Reversion to the mean' is one of the most successful investment strategies, and so a return to oil price levels of below $30/bbl is entirely possible. As Chart 4 shows, oil has 6 times the energy content of natural gas, and has traditionally traded at around 10 times natural gas prices, due to its greater flexibility as a supply source. Today's natural gas level thus implies oil prices should be at $30/bbl or less, rather than closer to $100/bbl.

Japan is the potential catalyst for repricing

The key issue, of course, is the potential catalyst for such a reversion. Since 2009, after all, the combined weight of investment and hedge fund investment has meant that any traditional 'value player' operating on the basis of the fundamentals of supply and demand has quickly lost their money. Today, however, Japan's decision to reverse the yen's appreciation versus the US$, and to develop its own stimulus policy could well provide the essential catalyst for repricing to take place.

The $: ¥ rate has already recovered to the $1: ¥100 level from the $1: ¥77 peak last October. In turn, this has reduced the need for US investment funds to worry about currency and inflation risk. And it has already led to simultaneous 10%+ price falls in key 'store of value' markets such as oil, gold and copper. Equally, these falls have prompted some analysts to reverse previous supercycle assumptions about the inevitability of sustained demand growth. As Citibank have recently argued:

"This drop in oil demand is partly the result of natural gas getting substituted for oil in a variety of sectors. This development is taking root in the US due to the large gap between natural gas prices and oil product prices, but it should transfer across the globe, as in many countries the spread between oil and gas is still substantial, if not a bit smaller than the US. Even in.... China environmental concerns are bolstering the shift from oil to gas."[2]

This potential unwinding of investment positions is clearly good news for demand in the longer-term. But it could easily create major disruption in the corporate sector if it occurs quickly:

- Demand is currently extremely slow (even though we are in the seasonally peak period), as consumers have little discretionary cash after paying to heat their homes and fuel their vehicles
- It would therefore be extremely difficult to quickly reduce current inventories (all now valued at $100/bbl oil equivalent), particularly as we head into the quieter summer months

Buyers down the value chain are already trying to avoid making excessive forward commitments on volume. And any sign of tumbling oil and product prices is likely to make them even more nervous. In addition, lenders are increasingly concerned that the collateral value of their loan is reducing.

The sad fact is that company managements and investors have both been lulled into a dangerous state of complacency by constant policymaker reassurance over the inevitability of a quick return to growth. This has led them to accept the seemingly inexorable rise of oil prices as being a new paradigm based on the potential for a sustained commodity supercycle. Only now are they starting to recognise it was instead the inevitable and unhelpful side-effect of repeated central bank liquidity injections and policymaker stimulus. Similarly, the assumption that growth is inevitable due to the shift of interest rate decisions from politicians to central banks is starting to be questioned.

Bursting asset bubbles have the potential to cause great harm to today's already fragile economies. But forewarned is at least forearmed. Companies and investors need to urgently prepare their plans for this to happen in crude oil markets during 2013.

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[2] Citigroup, 'The End is Nigh', 26 March 2013

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