

## Oil and shares – this year's Factor X

### Oliver's insights



#### Key points

- The oil price is now critical to the outlook for shares.
- While the long term trend in the oil price will likely remain up, current prices are not justified by oil supply and demand and are likely to fall back - probably to around \$US100 a barrel - in the next 6 months.
- But if the oil price continues to surge shares will remain under pressure. Iran and hurricanes are the wildcards.

#### Oil is the key

The big slump in shares from their highs in October/November last year to their lows in March this year was driven primarily by the credit crunch. But the continued surge in the oil price has played a major role in the slump in shares since mid-May which has now taken them below their March lows. The dramatic rise in oil prices is now a major threat to economic growth. It has also made the credit crunch worse by pushing up inflation and hence market interest rates which has offset the US Federal Reserve's interest rate cuts, made global central banks more hawkish, and increased the risk of debt defaults. While US Treasury moves to support Fannie Mae and Freddie Mac should help provide a bounce for shares, if the oil price doesn't turn around soon a global recession will become a certainty and shares will fall further. But if the oil price does manage to stabilise and start heading back to earth then shares will likely be given a huge boost.

#### Fundamentals support a rising trend in oil price

For many years our view has been that the rise in oil prices has been justified by fundamental supply and demand considerations. As countries like China & India industrialise (and in the process use up more energy) the supply of oil is struggling to keep up. For China and India, their per capita oil usage has been rapidly rising, but even though this has been occurring from a low base the huge population of both countries has meant a massive rise in oil demand, with China now accounting for around 70% of the annual increase in global oil demand. And this is set to continue. Eg, if per capita oil consumption in China and India were to rise to just half of Australian levels it would imply an extra 40 million barrels per day in global oil demand (which is currently 86 million barrels a day). At the same time the sources of cheap easily extractable oil are drying up. As a result the long term trend in the oil price is being driven by demand and supply factors and will remain up.

#### But has it become a bubble in the short term?

Over the last six to 12 months the rise in the oil price has become exponential, even though the supply and demand situation hasn't really changed that much. This suggests it

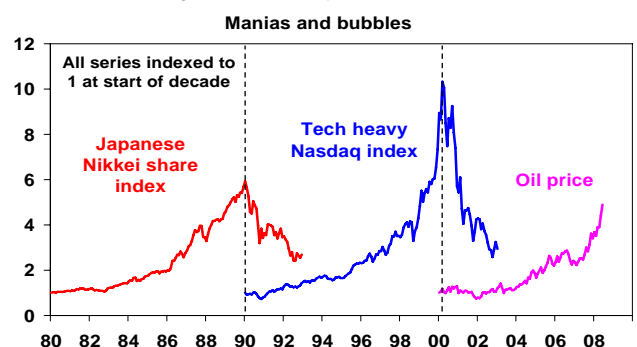
may be starting to run ahead of fundamentals. Speculative manias tend to have several key elements:

- Easy money and low interest rates;
- A fundamental dislocation which underpins initial price gains and provides enthusiasm for the eventual mania;
- A means to allow mass speculation; and
- The extrapolation of past price gains into the future.

Many of these are now arguably present in the case of oil.

- The cut in US interest rates has provided the easy money backdrop and the associated fall in the \$US has increased demand for commodities as a hedge against dollar weakness. Falling share markets have also encouraged investment flows into commodities.
- The China story and all the talk about "Peak Oil" has helped provide a fundamental justification.
- The advent of commodity funds investing into futures has provided a means to easily invest in commodities. These have up to 74% benchmark weights in energy.
- Analysts have been falling over themselves trying to come up with ever higher predictions for the oil price. Expectations of \$US150 to \$US200 are now common.

Certainly, the surge in the oil price is starting to look like past bubbles such as the bubble in Japanese shares in the late 1980s and the tech bubble in the late 1990s, ie prices rise steadily for many years justified by fundamentals only to then start rising exponentially. See the next chart.

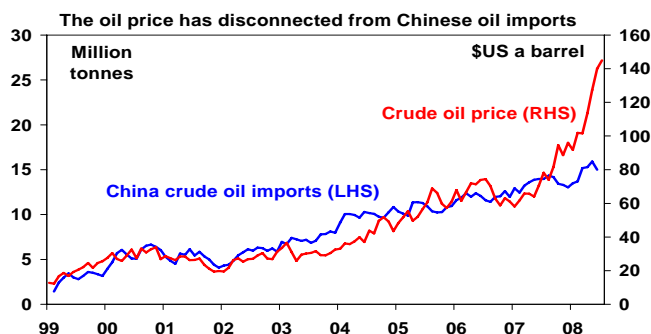


Source: Thomson Financial, AMP Capital Investors

Of course, the argument that the surge in the oil price has become speculative has been subject to much debate. Some have argued that it's hard to find definitive proof of speculative involvement. Measures of speculative positioning in oil and sentiment are mixed. But then again it's always hard to prove that price surges are due to speculative bubbles. Secondly, it's been argued that there can't really be a speculative mania in oil because if there were then demand would dry up, production would surge

and stockpiles would go through the roof burning the speculators and this hasn't happened. However, against this it may be the case that demand is just responding with a long lag. **Supply growth may be struggling to keep up with demand but the situation has not changed so much over the last year to justify a doubling in the oil price.** There is also an argument that futures pricing plays a much bigger role in the setting of spot oil prices than in the case of other commodities because Saudi Arabia actually uses oil futures prices to set sale contract prices.

The chart below also suggests that **the exponential rise in oil prices this year has disconnected from Chinese oil demand.** Over the last decade China's oil imports have steadily increased and this has remained the case and yet the crude oil price has gone exponential over the last year.

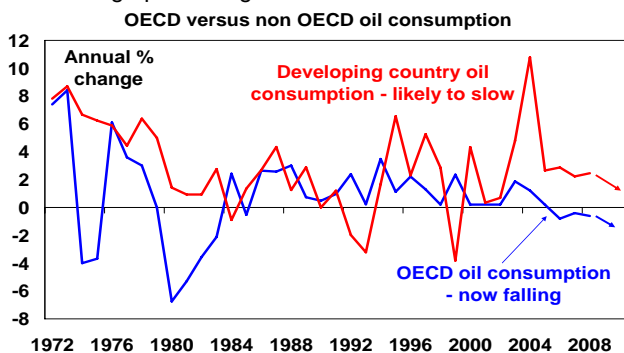


Source: Bloomberg, AMP Capital Investors

**Signs of an oil price correction on the way**

Bubble or not, it's looking increasingly likely that the oil price has gotten ahead of itself in the short term and the fundamental backdrop is starting to move against oil prices:

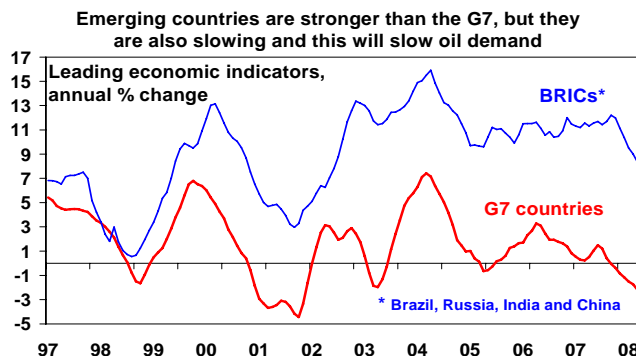
- First, for the rich world it has become increasingly obvious that the "choke point" has been reached. This particularly relates to the speed with which the oil price rises. Oil prices rose dramatically over the 1998-2007 period but the 3 steps forward 1 back process gave businesses and consumers time to get used to it. The doubling over the last year is a lot different and has come at a time when key economies are already struggling on the back of the credit crunch. This is showing up in falling oil demand in these countries.



Source: AMP Capital Investors

- Second, there are now numerous indications that the same will occur in the emerging world. Slower growth in rich countries is leading to a slowdown in emerging world exports. This is clearly evident in China where export growth has slowed dramatically. Monetary tightening in response to rising inflation will lead to

slower demand growth ahead in these countries, particularly in Asia where inflation has become more of a problem. As a result, the OECD's leading indicator for developing countries has slowed significantly. Share market collapses in these countries are also warning of much slower growth ahead. For example, Chinese and Indian shares have fallen 56% and 38% respectively.



Source: Bloomberg, AMP Capital Investors

Taken together with now rising fuel prices in such countries this is likely to start slowing emerging world fuel demand over the year ahead.

Of course, a risk premium of \$US10-15 a barrel for the threat of conflict between Israel & Iran has been priced into oil. If Israel has a military fight with Iran the sky is the limit for the oil price in the short term. Iran produces 4.3 million barrels a day of which it exports 2.5. If this is taken out it will use up all of OPEC's spare capacity. How this unfolds is anyone's guess, but assuming commonsense prevails then the risk premium should fade over the next few months. The other wild card is the US hurricane season, which could also adversely impact short term oil supply.

With speculators now playing a big role in the oil price, the very short term outlook is hard to predict. The oil price could easily spike higher. But **the bottom line is that barring a major 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.** To the extent this is driven by weaker growth, industrial commodity prices generally will also be vulnerable as will resources shares.

**Oil is the factor 'X' for shares**

It looks increasingly likely that the surge in oil prices is this year's factor 'X' for the global economy and shares. Where oil prices go from here is critical. We remain of the view that while shares are due for a short term bounce (and US Government support for Fannie Mae and Freddie Mac may help provide this) the next few months are likely to be rough. But our view remains that shares will rally hard in the fourth quarter on the back of very attractive valuations once the news flow starts to improve. Things to look for to confirm this is on track would be:

- A sharp and sustained fall in the oil price;
- A fall in inflation worries as represented in bond yields;
- A relaxation in central bank hawkishness;
- A slowing in US house price falls; and
- A sustained improvement in credit markets.

**Dr Shane Oliver  
Chief Economist and Head of Investment Strategy  
AMP Capital Investors**

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