BT Investment Solutions

The question of oil

29 January 2016

The volatility in equity markets continues with oil seemingly the most important factor. Equity markets have been moving in line with daily movements in the oil price this year.

Tim Rocks, Head of Market Strategy and Research, considers whether this influence is justified by looking at the different ways in which oil prices can affect economies.

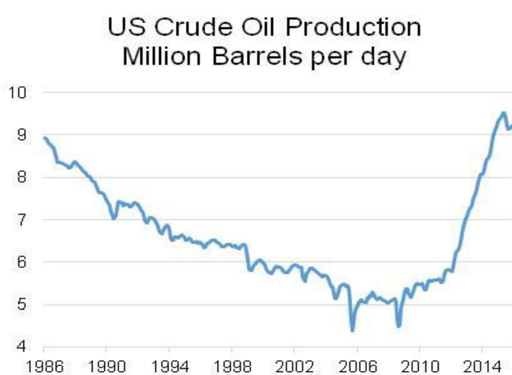
On the whole, lower oil should be a positive as it provides consumers with more money to spend elsewhere but we need to monitor the potential for financial distress and defaults amongst energy producers and the broader implications for the financial system.

We anticipate the broader implications to be minimal based on the following:

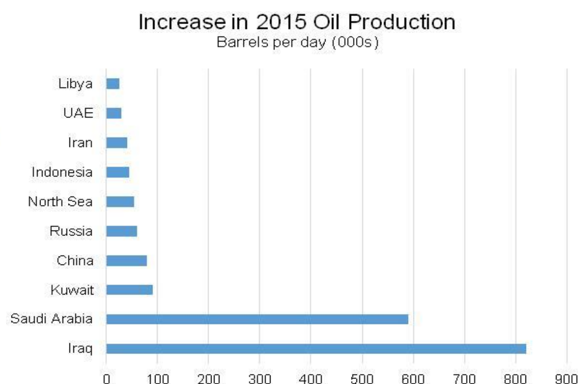
+ oversupply is the key to the fall in oil prices
+ most consumers benefit from lower oil prices
+ the US economy is not dependent on oil
+ there is financial support for energy producers.

The fall in oil is about supply and not demand

The collapse in oil prices is not being caused by a deterioration in demand so is not signalling a material change in the economic outlook. The problem is all on the supply side. As shown in the following charts, oil supply has surged since 2010 led by a doubling in US production as a persistently high oil price encouraged innovation in extraction methods.



Source: Datastream

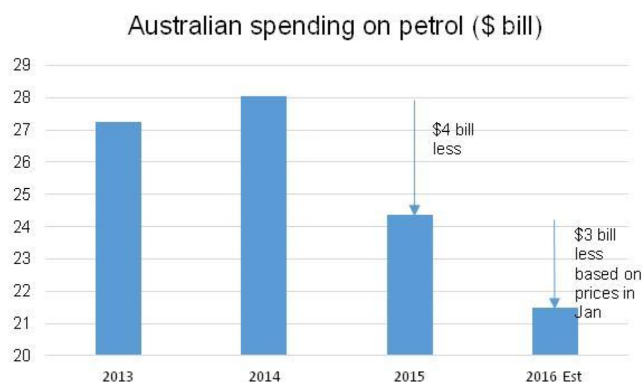


Source: Datastream

Supply is also increasing in other regions. In 2015 the big increases came from Iraq and Saudi Arabia. The rise of Saudi Arabia is particularly significant because it signals the end of the influence of the Organisation of Petroleum Exporting Countries (OPEC) cartel. In previous cycles, Saudi Arabia would cut production to sustain high prices but is no longer willing to do so. OPEC's importance has been declining for some years as production has picked up in a range of countries including Russia, China and the US. The return of Iranian exports will add further to supply in 2016 as its export embargo is lifted.

Lower oil prices are good for motorists

Lower oil prices are good for most economies. Cuts to petrol prices mean motorists have more money to spend elsewhere. Australian consumers spent $4 billion less on petrol in 2015 than 2014, and will spend another $3 billion less in 2016 than 2015, if current prices are sustained as shown in the chart on the right. Since there is a transportation component in the cost of all goods, there will also eventually be a broader range of price falls that will benefit consumers.

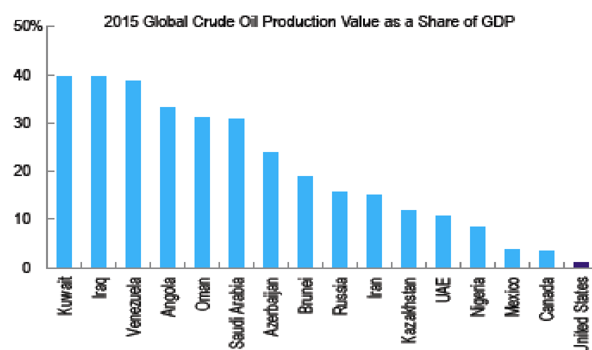


Source: Datastream

Another positive is that lower inflation means that central banks across the world are able to run easier monetary policy. The Federal Reserve in the US will raise rates more slowly while there could be more stimulus in Japan and Europe. Lower Australian inflation will also allow the Reserve Bank to cut interest rates if needed.

Lower oil prices are not a major risk to the US economy

Falling oil prices is unlikely to trigger a US recession. Even though the US energy sector has expanded, it is less than 1% of the economy. Some economies will be much more affected but, given their small size, they are unlikely to have a major impact on global growth. Crude oil production is around 40% of GDP for Kuwait, Iraq and Venezuela as shown in the chart on the right.

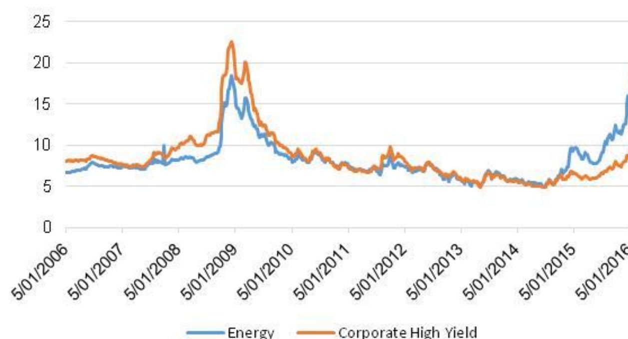


Source: Datastream

Watching producer defaults

While the effect of lower oil prices is mostly positive, one risk is the financial distress created among energy producers. Bank balance sheets could take a hit and there might be broader implications for the financial system. These concerns have seen a large jump in the interest chart on the right, and fears of contagion have caused a rise in corporate bond yields for a broader range of companies.

We will be monitoring this effect closely but think these concerns are likely to be exaggerated based on the reasons listed below.



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+ Interest rates are very low making it easier for companies to service debt for longer.
+ Many companies have been able to extend the maturity of debt to 2017 and beyond.
+ Producers will be at least partially hedged against falls in the oil price. This will delay the effect of the lower price.
+ US banks' energy exposure is only 2-3% of their total loan books.

Conclusion

At this stage, we are making no major changes to our view on returns across the major asset classes. Lower oil prices are not a signal of deterioration in economic conditions and should ultimately be a positive. However, we need to monitor closely the potential for financial distress and defaults amongst energy producers and the broader implications for the financial system.

For more information about oil prices and your investments, please contact BT Financial Group.

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