



Energy Boost

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At Appian we don't make forecasts for the future price of oil. However we do consider the impact of moves in energy prices for major players in economies such as producers and consumers, and key economic variables such as inflation and interest rates as well as the prospects for the different sectors of the markets that we invest in.

Energy prices have been making headlines in recent weeks and months. From their peak in June this year oil prices, using Brent Crude as an indicator, are down currently 30% from their peak in US dollar terms. This has been a relatively swift and substantial move. Going back to 2010 Brent Crude had rarely broken out of a 90 – 110 \$ range. Even when considered in Euro terms, this recent fall is noteworthy – in excess of 24%.

Energy prices are a highly responsive indicator – widely and heavily traded – and can be influenced by political tensions, regional conflicts or the actions of producers.

But the underlying drivers of this recent move are straightforward – less demand and more supply.

We're using less fuel than we expected to. Demand for energy is forecast to grow this year at half the rate that was expected as recently as June. In June, demand was expected to grow by about 1.4M barrels per day. That figure is now expected to be close to 0.7M barrels. And into the bargain, supply of oil has been stronger than anticipated.

This slowdown in demand is reflective of a more sluggish global economy as the Eurozone remains shackled and China moderates. Supply on the

other hand is being boosted by new sources such as shale in the US, where production is reaching 30 year highs.

What is the impact of a 25% drop in the oil price? Simply put it means a shift of wealth from producers to consumers. Global oil exports are about 40M barrels a day, so a 30\$ drop, which is about what we have seen in Brent since June, if it stayed there for 12 months, would mean a transfer of 400Bn\$ from exporters to importers. Does this impact on economic growth? Energy analysts note that oil consuming countries are more likely to spend their income more quickly than oil exporters, so the net effect on global growth is a positive one. A 30\$ drop could add up to 0.5% to global growth. Here in the Eurozone we spend about 3% of our GDP on net oil imports so will see a benefit. Even the US which only imports a relatively small share of oil – about 1% - will still see a net gain. Consumers will get an extra 70B\$ to spend which will offset perhaps a 40B\$ reduction in investment spending by US oil companies. The drop in petrol prices alone will boost consumers' wallets by 500\$ a year if prices stay at current levels.

Exporters obviously lose and their response is complicated by their degree of dependency on oil and the role it plays in their own economies. Kuwait for example which has been disciplined in its public finances, can balance its budget on a price of 44\$ per barrel. Venezuela on the other hand really needs a price of 160\$ to balance its budget. Other susceptible economies (and currencies!) are Russia and Nigeria who need oil over 100\$ on a sustainable basis.

This highlights some of the geopolitical ramifications of these seismic shifts in energy prices. Trying to navigate through these political currents is difficult at the best of times but given the current landscape with factors such as Russia and the Ukraine and Saudi Arabia and ISIS, the fog is particularly dense. Hence we get headlines of Saudi Arabia rejecting "price war" claims. This can be a rapidly changing context.

So the OPEC response will be important. But it is no longer just about OPEC. Low oil prices will also make for on the ground shifts in areas such as the US, where many of the newly minted shale facilities are unprofitable below 100\$ a barrel. Even if sales have been hedged there will be a cash flow impact. The International Energy Agency estimates that at today's prices we will see a 10% fall off in investment in US shale facilities.

How does a lower oil price impact on policy decisions such as interest rates?

Lower oil prices should foster better economic growth but as we've seen the biggest impact from this is likely to be in regions such as Eurozone, Japan or China where growth is desperately needed and there is sufficient slack for economies to grow before we would face the welcome problem of needing to raise interest rates. The US consumer would see some benefit but to date the US consumer hasn't really turned up for this recovery yet and the profile of consumption in this cycle is well below par. While in the US we have seen

solid growth in job numbers, wages and consumption are lagging. Lower energy prices might make for a more balanced recovery.

As regards interest rate policy, there's clearly a trade-off between this stronger growth potential – Capital Economics forecast that Brent sticking at today's levels boosts global demand by 0.5% - and less inflationary pressure from the cost side. Less inflationary pressure allows policy makers more flexibility in managing the interest rate cycle. And yes policy makers do tend to look to “core” measures of price pressure that exclude energy costs, but even core inflation rates will see an indirect impact from lower energy prices.

In terms of financial markets, lower energy prices are in aggregate a positive, boosting growth and dampening inflation. This means a better demand environment for many producers coupled with lower production costs. Goldman Sachs, for example, have estimated that oil at 80\$ per barrel, compared to its level for the first half of the year, is the equivalent of an additional 4% growth in profits for US companies in the S&P 500 for 2014 and even greater in 2015. Of course the energy sector itself faces headwinds but interestingly major companies such as Shell, with strong cash flows and efficient production profiles, are well positioned to cope with the turbulence and their shares have done significantly better than the oil price itself in this recent sharp fall off.

Lower energy prices are a supporting tail-wind for financial markets. Those dynamics could of course change but incremental moves are not an issue. Today investors find themselves at one with Saudi Arabia's oil minister Ali-al-Naimi who is working hard to ensure “price stability”!



Brent Crude Price Move Year to Date (as at Nov. 14th 2014)



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