

Keeping the lights on – an update on the oil price

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The oil price has continued to rise strongly during the first half of 2008. In this article we explain what is driving the price of oil higher and we consider the role of market speculators and the implications of a higher oil price for the global economy.

You may have noticed recently that, if an investment fund buys an equity or a debt security, it buys an investment; but if it buys a commodity, apparently it enters the realm of speculation! If one believes much of the press, or recent pronouncements from politicians, the move in the oil price to \$135 per barrel can be explained entirely by the actions of 'speculators'.

The oil price has risen from \$10 per barrel in 1998 to \$135 per barrel today. Over the course of the last decade, a rising oil price has failed to stimulate a material increase in supply; we have written previously about the factors behind tightening supply, including depletion of the world's major oil fields, the geographic concentration of remaining oil and the limited access of oil companies to oil reserves.

Meanwhile, demand for oil has been surprisingly strong, with price 'elasticity' proving to be limited. The main drivers of sustained demand have been globalisation, the outsourcing of manufacturing to developing nations, increasing transportation, and the transference of wealth to populous nations with growing aspirations for higher (fuel-intensive) standards of living. We believe that these factors are fundamental reasons for the escalation in oil prices.

The actions of 'non-commercial buyers' have also had an impact on the pace and scale of oil price changes. Participation by investment funds has been growing over the last two years, with some managers and consultants recommending that portfolios hold a significant proportion (often as much as 5%) of their assets in commodities, generally as a tool to hedge indirectly against inflation. It is difficult to dispute that increased competition for commodities-based futures contracts has exaggerated price rises, but whether long-term investment in commodities is any more speculative than investment in real estate, for example, is doubtful.

The growth of hedge funds has led to an escalation in a secondary form of commodity investment, by which funds take long and short positions in certain 'term contracts' in commodities, essentially betting on the relative mispricing of oil. These investments are more

speculative in nature and can have a significant short-term impact on the price of oil.

The rise in the oil price to \$135 per barrel in May was not driven by 'speculators' as prevailing political rhetoric would have us believe. Instead, it owed much to a capitulation by commercial buyers, such as airlines and other large-scale users of oil, who had been waiting for the oil price to fall (as had been forecast by most commodity specialists in light of an impending slowdown in global economic activity). Even the 'bullish' (and widely-followed) Goldman Sachs commodity team had suggested a near-term 'correction' in the oil price.

When the Goldman Sachs team issued a short-term outlook note in early May, in which it increased its forecast for the end-of-2008 oil price by 30% (from \$115 to \$149 per barrel), commercial buyers scrambled to 'buy the curve'. The rise in the oil price was exaggerated by the actions of hedge funds which, as the true speculative buyers, reversed the 'time spreads' which had entailed their betting on the 'short' end of the curve against the 'long' end.

The short-term price of oil remains very difficult to anticipate. The negative impact of higher prices on demand in the OECD economies continues to be offset by disappointing additions to supply. With the oil market seemingly being highly sensitive to short-term news, volatility is likely to remain heightened.

In the absence of decisive moves to limit demand, we find assessing the longer-term outlook for the oil price a little easier. Although exploration performance is improving, current production is still not being replaced, and data shows that new, more complex projects are taking longer to approve and implement than previously. Material new projects are occurring in ever-deeper waters, with higher-pressure reservoirs, and they require the building of extensive infrastructure. The giant Kashagan project in Kazakhstan, for example, now looks likely to be productive only in 2012, six years after originally planned.

In essence, the price of oil is likely to continue to increase in real terms. This will cause inflation to increase and will present a considerable challenge to global economic wellbeing.

Unlike during previous oil price 'spikes', there appear now to be few options to 'get out of jail free'. We are witnessing not simply an 'oil problem', but rather the first stages of what could become a global energy crisis. The challenge now is the dearth of inexpensive, available energy sources to permit the reduction of oil demand through fuel switching.

Natural gas has taken up the slack in previous crises. Recently, however, liquefied natural gas prices have risen faster than crude prices. Our global oil and gas analyst's recent trip to the Middle East confirmed just how tight the global gas market is becoming. In the Middle East, a shortage of natural gas is having a direct impact on oil supply: first, because oil products are being burned instead of natural gas and, secondly, because reduced gas injection into oil reservoirs is curbing the production of crude oil.

Elsewhere, environmental concerns and tight supply are limiting coal substitution, while nuclear energy capacity is ageing and the use of renewable energy for transportation fuels risks stoking inflation by reducing the availability of crops for food.

Oil prices should rise to the point at which demand is reduced. Unfortunately, the majority of world oil demand comes from high-growth economies (approximately 85% being from China, India and the Middle East), in which there is significant subsidization of oil product prices by governments. These subsidies

serve, ironically, to boost prices, by suppressing market-based price signals and fuelling demand.

Regrettably, politicians around the world are too worried about short-term inflation to take the steps required to overcome the challenges. Calls by former US presidential candidate Hillary Clinton and by Nicholas Sarkozy, the incoming President of the European Union, for the reduced taxation of transportation fuels, fail seemingly to recognise the long-term issues.

Furthermore, the recent political focus on limiting investors' exposure to commodities futures markets overlooks the core problem. Like subsidies, such intervention to seek to control markets for the benefit of consumers is counter-productive. Failing to take tough decisions will lead to an extended period of energy inflation. This will prevent OECD economies from stimulating growth through monetary policy, while developing economies, burdened with subsidies, will be forced into trade controls and commodity hoarding.

There are no easy answers, but price signals are required to limit demand and to stimulate investment. Positive intervention (rather than the taxing of oil companies' 'super' profits) is needed to remove barriers for new energy technologies and to incentivise fuel efficiency. There are a number of other measures that governments should consider adopting: for example, mandatory investment in hydrogen networks, carbon sequestration and the development of second-generation biofuels (that do not compete with the food chain). The real cost and impact of energy prices must be tackled, or the lights really will start to go out.

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