Shane Oliver, Head of Investment Strategy & Chief Economist

Will the world slip up on oil yet again?

EDITION 7 – 29 FEBRUARY 2012

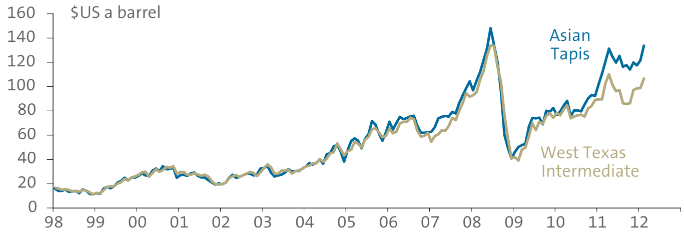
Key points

- World oil prices have been pushed higher by worries about Iran on the back of strong long-term demand growth from the emerging world and increased confidence regarding the global outlook.
- Current oil price levels are probably not a big threat to growth, but a continuing rise would be.
- Current oil prices imply further pressure on Australian petrol prices.

Introduction

World oil prices are rising again. Since its low last October, US West Texas Intermediate is up 40% and Asian Tapis oil prices (which drive Australian petrol prices) are up 18%.

World oil prices on the rise again



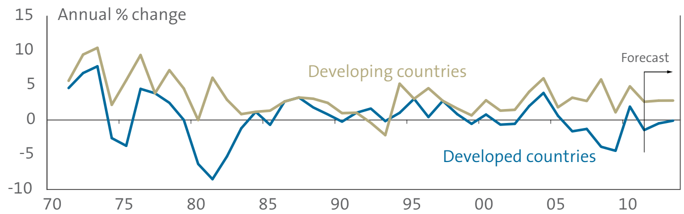
Source: Thomson Financial, AMP Capital

Last year a similar surge in the oil price left global growth weak and vulnerable to European and US debt scares in the September quarter. So what is the risk this time around?

What's behind the latest surge in oil prices?

The latest surge in oil prices reflects three key developments. Firstly, we are seeing a long-term structural rise in oil demand in the emerging world on the back of rapid industrialisation in key countries, including China.

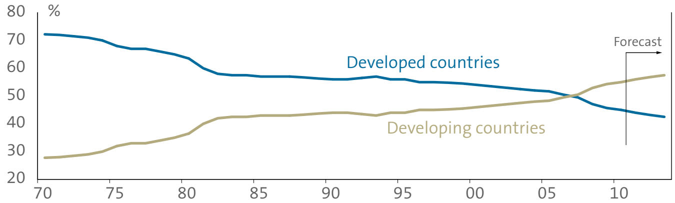
Developing countries are driving oil consumption



Source: AMP Capital

This likely has much further to go as annual oil consumption is just 2.5 barrels per person in China and just one barrel per person in India compared to around 15 barrels per person in Australia and 24 in the US. So while oil demand growth is weak in developed countries reflecting poor growth, energy efficiencies and the growth of alternatives, it remains strong in the emerging world. See the previous chart. As a result the developing world now accounts for a greater share of world oil consumption than do developed countries

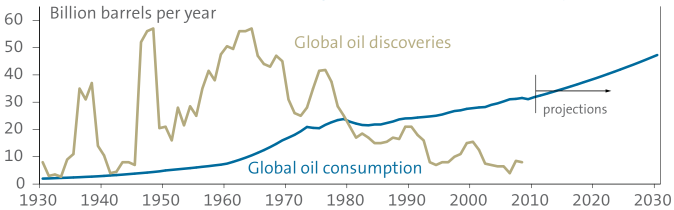
Share of world oil consumption



Source: AMP Capital

As the 'Peak Oil' crowd have been pointing out for years growth in demand for oil is exceeding that of new supply.

Global oil consumption is rising faster than new supply



Source: www.aspo-ireland.org, IMF, AMP Capital

The end result has been a rise in the equilibrium price of oil. OPEC countries appear to be reinforcing this as falls in the oil price below $US100 a barrel have been met with supply cutbacks as OPEC countries seek to maintain their revenue flow in order to fund stepped-up public spending.

Secondly, oil prices have benefitted from an improvement in the global growth outlook. This has been seen in most growth assets – shares, commodities, the A$ – which have all rebounded over the last few months and oil has been caught up in this. This has been accentuated more recently by a renewed fall in the US$, since oil is priced in US dollars.

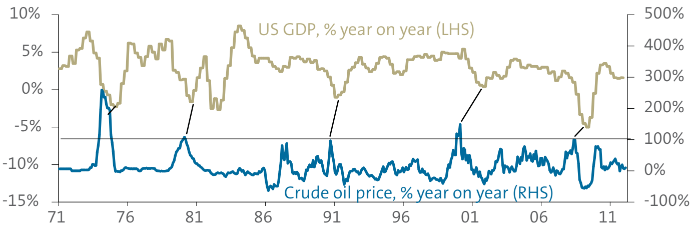
Finally, we have seen a renewed rise in the geopolitical risk premium associated with tension in the Middle East. Iran is at the centre of this with western countries moving to impose an embargo on Iranian oil and Iran, in turn, threatening to close the Strait of Hormuz. At the same time the civil war in Syria is worsening, bringing with it the risk of western intervention which runs the risk of further inflaming tensions in the Middle East as Syria is an Iranian ally. Syria is not a big oil exporter, but Iran exports roughly 2.5 million barrels a day compared to global oil production of 90 million barrels a day, posing a bigger threat than Libya last year which exported 1.5 million barrels a day. This can be made up for by Saudi Arabia which has roughly 2 million barrels a day of spare capacity. A bigger problem would arise if Iran did close the Strait of Hormuz as some 16 million barrels (or 18%) of world oil production flows though it each day.

The question then becomes how far Iran is prepared to go before it backs down. Economic pressure on Iran is mounting and the current Iranian regime would probably not like to go the way of Sadam Hussein's Iraq or Colonel Gaddafi's Libya. Then again I am not a Middle East political expert.

Oil prices and the global economy

What happens if the situation regarding Iran continues to escalate? Past oil price surges have clearly played a role in triggering US and global downturns. See the next chart.

Oil prices are not at a choke point yet



Source: Thomson Financial, AMP Capital

It's not so much the oil price level that counts as its rate of change, as businesses and consumers get used to higher prices over time. Trouble normally ensues if the oil price doubles over 12 months and we are nowhere near that – West Texas Intermediate (which is constrained by a US oil production surge and transport constraints) is up 10% year on year, Brent is up 9% and Tapis is up 15%. US household spending on energy as a share of income is not historically high and the oil price surge has occurred when the labour market is improving. Our view is that the world can probably live with West Texas Intermediate at around US$110 a barrel (or Brent around US$120). The following table estimates the impact on GDP of a US$10 rise in the price of oil for the year ahead in the second column and then applying that to the impact of oil at US$120 a barrel and US$150 a barrel.

Impact on GDP of rising oil prices, % points

Country	Impact of $10 rise in oil price	Impact of oil at $1.20*	Impact of oil at $1.50*
US	-0.3	-0.3	-1.2
Europe	-0.5	-0.5	-2.0
Japan	-0.3	-0.3	-1.2
Asia	-0.8	-0.8	-3.2
World	-0.4	-0.4	-1.6
Australia	-0.25	-0.25	-1.0

* Relative to a base case of $US110 for WTI. Source: IEA, IMF, OECD, AMP Capital

Global growth this year is currently forecast to be around 3%, so if the world oil price (WTI) settles at around US$120 a barrel then global growth would be reduced to around 2.6%, soft but not disastrous. However, a sustained spike to US$150 a barrel would be much more worrying. Asia is the most vulnerable, reflecting its heavy reliance on imported oil and its more intensive oil use. Australia is less vulnerable as it is a net energy exporter.

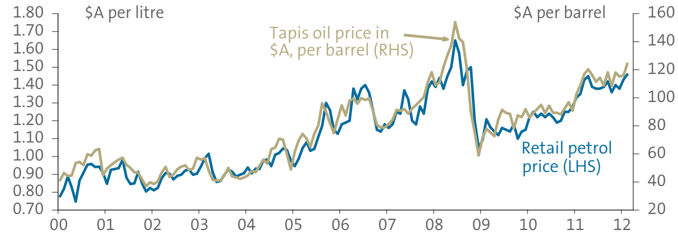
The rise in the oil price will also boost inflation with roughly a US$10 a barrel rise adding 0.5% to inflation in the US and Australia and 0.7% to inflation in Asia. Given the negative growth impact though, it's hard to see central banks reacting.

The bottom line is that current oil price levels are probably not enough to derail the global recovery. However, if oil prices rise to US$150 a barrel the threat would be significant.

Impact on Australia

While the strong A$ acts as a buffer, the protection is partial as so far this year the Asian Tapis oil price is up 13.8% in US dollars whereas the Australian dollar is up only 5.8%. Australian petrol prices have already risen to around $1.46 a litre (with a range of around $1.40 to $1.50) and at current oil price levels a further rise in the weekly average petrol price to around $1.53 a litre is likely.

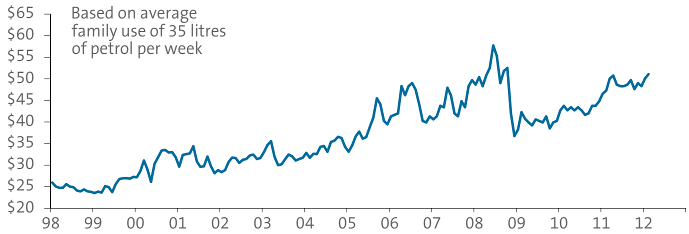
Aust petrol prices could have more upside given current oil prices



Source: Thomson Financial, AMP Capital Investors

While this will add to headline inflation, the flow on to core inflation is likely to be modest, reflecting constrained corporate pricing power. The more significant impact will be the blow to household spending power implied by higher petrol prices. The rise in petrol prices this year has already pushed the typical Australian family's weekly petrol bill up to around $51, which is its highest level since July 2008.

Weekly petrol bill for a typical Australian household



Source: AMP Capital Investors

Coming at a time of rising prices for necessities such as rent, utilities, health, insurance and education, this will further limit the ability of households to buy discretionary items. So tough times may continue for discretionary retailers for a while yet.

Implications for shares

The surge in oil prices is great for energy shares, but not good for the rest of the market given the impact on profit margins and consumer demand. It has also come at a time when the global economic recovery is fragile. And similar to a year ago, global shares are somewhat vulnerable to a correction after a strong rally and higher oil prices risk being a trigger. Our base case is that the oil price will settle around US$115 for West Texas Intermediate, or US$125-130 for Brent, and if so it wouldn't be a major problem for the global economy and share markets. Obviously the risk would rise if the situation regarding Iran escalates. So keep an eye on oil prices.

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

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers	**Your Business Development Manager or call 1300 139 267**
Personal Investors	**Your Financial Adviser or call us on 1800 188 013**
Wholesale Investors	**AMP Capital's Client Services Team on 1800 658 404**