absolute return partners newsletter

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The Case for Higher Oil Prices, Part Two:

Last month, we wrote extensively on the long-term outlook for oil prices. We suggested that, over the next several years, oil prices are likely to rise significantly from current levels. In fact, we predicted that oil prices could reach $100 per barrel within 10 years.

Following the March newsletter, we received many reactions (mostly complimentary, thank you). Some readers wanted to know how we arrived at $100. The truth is we didn't. Frankly, we have no idea whether oil prices will reach $60, $80 or $100 per barrel, but that is not the point.

We wanted to point out, and emphatically so, that the world is at risk of facing excruciatingly high oil prices, which will be detrimental to economic activity, corporate profits and hence also share prices.

This month, we will look at the implications of such a rise in oil prices. In October of last year, Gerben Driesprong, Ben Jacobsen and Benjamin Maat of Erasmus University in Rotterdam published a paper named *"Striking Oil: Another Puzzle"*. They found that changes in oil prices strongly predict future stock market returns in many countries around the world. In Europe and the United States, the link is very powerful. In Asia, the relationship is not quite so strong.

Countries most negatively affected:
Italy
Sweden
Germany
Switzerland
Spain

Countries least negatively affected:
Hong Kong
Australia
Canada
Singapore
Japan

Note: Emerging markets not included.

Their findings are further validated by Stephen Leeb in his recent book *"The Oil Factor"*, in which he puts forward a case for staying clear of the equity market (in this case U.S. stocks) when oil prices are up 20% or more year-on-year, as this often leads to a significant fall in share prices over the following 18 months.

These conclusions are hardly surprising. Higher oil prices lead to higher production costs for manufacturers, which again result in lower profit margins. Meanwhile, consumers share in the suffering because higher oil prices leave less money for discretionary spending, which explains why consumer cyclicals tend to be amongst the worst performing stocks during times of rising oil prices.

Let's return to the Erasmus University study for a moment. We suggested above that European stocks are more sensitive to changes in oil prices than, say, Asian stocks. This time, however, the order of pain could be very different. Oil prices are currently up about 23% year-on-year when measured in $ but only up 9% in €. The weak dollar has offered Europeans great protection from the rapidly rising oil price, a privilege not shared by Americans and Asians, many of whom have currencies that are pegged to the dollar.

However, before we get carried away and suggest moving all your equity investments into Europe, we need to remind ourselves that the weak $ in itself is a poison pill for European profit margins.

Another observation, which we believe is poorly understood by many investors by the way, is that there appears to be a strong link between oil prices and credit spreads. Professor Andrew Oswald at the University of Warwick has found that a large part of the variation in credit spreads can be explained by oil prices. In other words, when oil prices are on the rise, credit spreads widen and visa versa. It is our duty to point out that credit spreads are near their all-time lows and definitely in 'nose bleed territory'. Be careful!

It is probably prudent, at this stage, to point out that, in the short term at least, we do not expect energy prices to continue their journey northwards. Our long-term prognosis is largely a supply driven argument, although rising demand will not exactly ease the pain. Oil prices have always been highly sensitive to short-term speculative forces driven by inventory imbalances, OPEC policy changes, etc., and this time is no different. We would not be at all surprised to see the oil price drift back towards $30 per barrel over the next few months, all other things being equal.

Some people - mostly those who disagree with our long-term view - argue that the world continues to improve its fuel efficiency (i.e. we produce more and more goods for each barrel of oil consumed). While this observation is absolutely correct, it misses the point by a mile. Each and every day, the world gobbles up about 80 million barrels of oil. This is up from 60 million barrels in 1980 and 20 million in 1960. With China growing rapidly, we would not bet against the current growth rate continuing for a little while yet.

Case in point: China has about five times the population of the United States. However, the U.S. has about 140 million vehicles; China has less than 5 million. On average 'Joe Public' consumes 25 times as much oil as his Chinese cousin. Just do the maths, as Andrew Oswald suggests.

So how do you position yourself to benefit from a world of rising oil prices? Well, the good news is that you have numerous options.

The simplest approach would be to invest in a portfolio of oil stocks. If this is your preferred approach, remember that smaller exploration companies are much more leveraged to the oil price than large integrated oil companies such as BP or Shell. Drilling companies may also do quite well as a result of the need for new investments in exploration.

If you have the appetite for something slightly more exotic, take a closer look at the Canadian oil sector. Canada is blessed with huge reserves of so-called tar sand, which is rich in oil. So rich, in fact, that Canada by some estimates have oil reserves many times that of Saudi Arabia! It is technologically challenging, and very expensive though, to turn tar sand into oil. Furthermore, it requires huge amounts of water and the whole process is quite polluting so there is no free lunch. Nevertheless, if the oil price is destined to go ever higher, these reserves could become very valuable indeed. One of the largest players in this field is a company called Suncor.

Alternatively, think of investing in an energy/natural resources fund. Some very smart people manage these funds and it may save you a headache or two to let others do the stock picking. Feel free to call us for names.

Also, do not lose sight of the fact that if oil prices go up as suggested, alternative sources of energy will become more attractively priced relatively speaking. Wind energy has proven to be one of the most viable sources of alternative energy and could be facing a very prosperous future if our oil price scenario unfolds as expected.

Another approach would be to invest directly in energy futures. Both on Liffe (London) and Nymex (New York) it is possible to trade futures on a variety of commodities. This is not a game for novices, though, and we would strongly discourage participation unless you are a seasoned futures investor.

If you like the idea of direct exposure, think of the Goldman Sachs Commodities Index (GSCI) instead. It offers considerable exposure to energy (about 65% of the index is energy related), and there are many products readily available in the market place which are based on this index.

Rising energy prices will, most likely, have a significant impact on inflation. Therefore, consider including gold and/or inflation index linked bonds in your portfolio. Both these asset classes will likely do well, assuming our expectations are met.

On the flipside, the studies referred to above suggest that consumer cyclical stocks first, and financial stocks second, are likely to be the worst performing sectors within the stock market. Bonds generally, but long-dated bonds in particular, are also likely to fare quite poorly. Bonds with substantial credit risk will probably do considerably worse than less risky government bonds.

Finally (and this is our 10 second commercial), you are more than welcome to contact us for a more detailed discussion. We would be delighted to suggest a solution that not only matches our investment outlook but also sits well with your existing portfolio.

An afterthought: In the past, rising commodity prices have proven an excellent indicator of inflation accumulating in the pipeline. So have interest rates. The problem facing investors at the moment is that the two indicators are telling us vastly different stories.

So why do bonds continue to ignore this fact, which, even to the casual observer, appears pretty straightforward. Two reasons stand out. First and foremost, productivity in the U.S. has grown sharply in recent years and is showing no signs of losing momentum. When productivity grows sharply, the growth in unit labour costs (i.e. the cost of labour per unit produced) turns negative.

Unit labour costs now run at -2.3% year-on-year. No other statistic has a higher correlation with consumer price inflation than unit labour cost. Such a significant drop can offset very significant amounts of inflationary pressure originating from rising commodity prices.

Put differently, it is possible for producer price inflation not to find its way to consumers. Price increases then get absorbed by companies. The net result? Deteriorating profits.

It also explains why Alan Greenspan appears relatively relaxed about rising raw materials prices, and why corporate profits are growing a lot faster in the U.S. at the moment than elsewhere.

Secondly, due to increasingly open borders (also known as globalisation), more and more good are produced in Bangkok or Shanghai rather than in Boston or Sunderland. These are very powerful deflationary forces that may continue for a while yet (but, ultimately, even the Chinese will have to face producer price inflation as well). One may even argue that, without some inflationary pressure from raw materials, the world could quite possible be flirting with deflation at this point in time. And, as we all know, deflation is actually a lot worse than inflation.

The Bull versus the Bear

So much has been said and written about the many problems facing the U.S economy at the moment that we decided to bring some balance into the debate. The dialogue below aims to bring to you both sides of the story.

The large, and rapidly growing, twin deficits[1] will ultimately undermine the U.S. economy and force it back into recession. This could reverberate throughout the world and cause a global recession.

Most bears assume implicitly that interest rates will have to rise in order to continue to attract foreign investors to buy U.S. debt to finance the deficit(s). They completely miss the point that this adjustment process primarily works through the currency markets – not the credit markets. But whereas higher interest rates usually have a negative impact on economic growth, a lower dollar may actually help the U.S. economy. Thus, while the bears are right that there are serious imbalances, they are wrong in assuming that these will bring down the economy.

Perhaps, but the U.S. fiscal deficit is out of control.

Total U.S. public sector debt is now about 48% of GDP, well below its 1995 peak of 58%. The European Union on aggregate carries public sector debt of about 60% and in Japan it is over 90%.

But what about total net debt of the U.S. nation which now stands at $3 trillion?

While an enormous amount of money in absolute terms, total net debt is still below 30% of GDP. This is very much in line with many other western countries such as Sweden (25%), Spain (27%) and the Netherlands (31%), and well below the levels seen in some highly developed countries such as Australia (60%) and New Zealand (92%).

U.S. household debt has continued to rise as a percentage of GDP and is now close to the record levels reached during the great depression in the 1930s. If the public sector problem won't kill the economy, then household debt will.

The bears have been concerned about household debt for over 40 years. And while it is true that debt levels are at a historically high level, it must be viewed in the context of increased stability in the overall economy. Over the last century, the volatility of personal income, consumption and GDP has dropped by 75%. It is this reduction in risk that has caused households to assume more debt. It is only rational for households to take on more debt, and for bankers to be willing to lend more, when the risk of doing so drops. Of course, the rise in household debt cannot go on forever, but whereas personal bankruptcies are on the rise, delinquency rates[2] on consumer loans and mortgages have been declining for a year now. Since delinquencies lead bankruptcies by several quarters, it is not unreasonable to expect bankruptcies to start falling relatively soon.

The economic recovery *cannot* continue unless more jobs are created, because without people going to work, there is little hope of consumers driving the economy forward.

This argument completely ignores the fact that productivity growth has exceeded, and continues to exceed, even the wildest expectations. Simply put, the surge in productivity means that the U.S. economy can grow about 3% without a single job being created. Productivity growth is the single biggest driver of this economic recovery and cannot be ignored.

The only area where the bulls and bears appear to agree is the outlook for the dollar, which is not pleasant unless the debt trend is reversed quickly. According to our sources the dollar could see ¥70, €1.60 and £2.35 within 3-4 years if net indebtedness reaches $5 trillion as current trends suggest.

However, as mentioned above, this is not necessarily negative for the U.S. economy. It would be far worse if the adjustment works through credit markets. Fortunately, that rarely happens.

Finally, it ought to be said that we remain concerned about the escalating U.S. deficits, as we do not believe that the issue is being taken seriously enough by policy makers. Neither do we think, though, that the U.S. economy, and with it the rest of the world, is coming to an end; hence the need for a balanced debate.

[1] *A rapidly growing public sector deficit combined with a large current account deficit.*

[2] *A measure of late payments*