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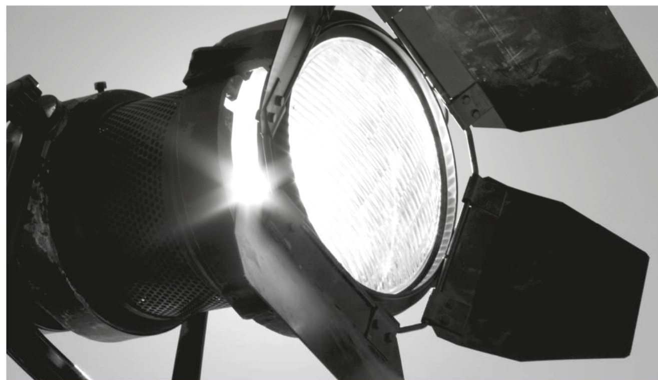


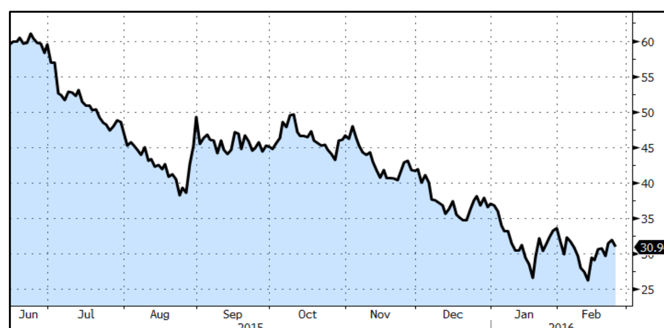
Aquila & Co. AG | 25. February 2016

The influence of oil price movements on financial markets is set to fall

The collapse of the price of oil has led to a massive income transfer from oil producers to oil consumers.
At current rates of oil production – around 90 million barrels a day (mbd) on a global basis – a $30 cut in the price of a barrel of oil implies an income transfer of around $1000bn. a year in favor of the oil consumers and at the expense of the oil producers. Europe and Japan are the big beneficiaries, gaining $70bn and $50bn respectively on an annual basis. Russia and Saudi Arabia are the big losers, with losses each around the $130bn mark on an annual basis. As the oil consuming countries tend to spend more of their disposable incomes than the oil producing countries, one might assume that a lower oil price would tend to boost the global economy.

But lower oil prices have not yet led to a pick up in world economic growth.
The fall in the oil price from around $60 a barrel in the middle of 2015 to around $30 a barrel today has not so far had the positive impact on the world economy that might have been expected. In fact, the opposite seems to have occurred. The collapse of investment in the US oil and gas sector has cut America's GDP by around ½%. Moreover, while the income transfer to the US consumer implied by these lower oil prices is also around ½% of US GDP, America's consumers have so far spent only a portion of this windfall. A similar, although less strong, tendency to increased saving is also apparent in Europe and Japan. The result is that the sharp fall in oil and gas investment on a worldwide basis has been only partially offset by more consumer spending. An additional depressant so far as world economic growth is concerned has been the reduction in spending among oil producing countries.

Crude oil price (WTI) since mid-2015, USD per barrel



Source: Bloomberg

This hitherto unfavorable combination of trends in consumption and investment should improve.
We assume that this unfavorable combination - whereby higher consumption does not fully offset collapsing investment - will improve over the balance of 2016. First, the longer oil prices stay very low, the more consumers are likely to view low prices as being in some way permanent. As a result, they will over time become more likely to spend the increase in their disposable incomes which has resulted. Second, we note the International Energy Agency (IEA) now predicts that the 25% drop in investment in the world's oil and gas industry last year will be followed by a smaller decline (17%) in 2016. In the US, investment in the oil and gas sector would have to fall nearly to zero in order to have the

same negative impact on US GDP that it did last year. We therefore expect that the dampening impact of investment in oil and gas on overall growth will be reduced in 2016. Also, the consumer should be more inclined to spend the increased savings that have come from cheaper oil.

Oil markets have found some sort of balance, at least in the short term, at around $30 a barrel.

The fact that the oil price has been able to average around $31 a barrel since the start of the year suggests to us oil markets have managed to find some sort of balance, at least temporarily. Iran's reentry into oil markets, potentially as a major supplier, and the fact that oil production still exceeds consumption by around 1.5mbd worldwide, indicate that oil prices are unlikely to rise much from here. On the other hand, low oil prices are in a sense their own enemy as over time they lead to a curtailment of oil supply. Those producers who produce only so that oil revenues can make a contribution towards offsetting fixed costs will eventually suspend operations because on a full-cost basis their production is loss-making. Moreover, in the normal way of things, world oil consumption tends to rise by around 1mbd per year. Such arguments speak against a further significant fall in the price of oil and we rather believe that, with oil having hit a low point at around $26 a barrel on February 11, the period of most extreme price turbulence now lies behind us. Although we don't rule out sharp, short-term declines in the spot market, these would not cause us to adjust our basic scenario.

The oil price is likely to lose its dominance over the financial markets.

Given the considerations outlined above we believe that market anxiety as to the viability of companies in the oil and gas sector will abate. Current pressures on the sovereign wealth funds of oil producers to sell assets will also be lessened. As a result, movements in the oil price are set to lose their dominant influence on financial markets. Moreover, the positive impact of cheaper oil on overall demand should over time assert itself. For all these reasons we expect the equity markets to face fewer headwinds in future and maintain our neutral commitment to the equity asset class.

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