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-0.62%	-0.12%	+36.45%	-50.00%
5335.3000	$0.84	$4.53	$0.20

Negotiating the new politics of oil

STIRLING LARKIN THE AUSTRALIAN DECEMBER 06, 2014 12:00AM

Venezuela's state-owned oil company PDVSA will be adversely affected by OPEC's decision not to cut production. Source: AFP

CARL von Clausewitz, the father of modern military theory, thought that war was the continuation of politics by other means.

What we are seeing in energy markets over the past fortnight can only be described as war, as Saudi Arabia and its Gulf alumni wield their market power in the pursuit of political ends.

These ends would see higher-cost competitors such as Russia, Venezuela, Iran and most importantly, the ISIS caliphate, whom the Saudis vehemently despise, suffer.

OPEC's strategy in this war has been to increase its production relative to its quota, as the graph illustrates, such that oversupply has reached new highs not seen since 1998, when oil prices fell by 30 per cent, year-on-year.

Moreover, the cartel clearly has a lot more ammunition left to fire in this war, which means the events of recent weeks are likely just to be the opening salvo in a much larger and ongoing geopolitical OPEC campaign.

What makes this current episode interesting, is that unlike the 1973-74 OPEC crisis, which saw the

Saudi coalition wage war against its client base — namely the US and OECD economies which includes Australia — this episode has seen “core” OPEC turn on marginalised OPEC members plus non-OPEC producers.

Saudi-aligned OPEC members are willing to accept lower prices for some time in order to preserve market share. They are happy to do so even if it means further disenfranchising the already marginalised OPEC member states of Iran, Venezuela and Nigeria.

However, of more direct interest to the global investor, is the understanding that these events have sizeable knock-on effects that directly affect other asset classes and investment markets; many of which the Australian economy still heavily relies upon.

Australian ultra high net worth (UHNW) investors, in particular, are acutely aware these include global equity markets, international real estate, spot metal markets such as copper and iron ore, precious metal markets, including gold and silver and oil substitutes seen in thermal coal and LNG.

This grouping collectively accounts for a considerable proportion of Australia’s current terms of trade, GDP and macroeconomic “DNA” and movements on the ASX this week have reflected this close association.

It also corroborates the view that China is not the only dragon in this den.

Deutsche Bank believes that OPEC’s manoeuvring has not principally been an effort to force supply discipline in non-OPEC producers, but more an attempt to reduce the attractiveness of substitutes; many of which are listed coal, LNG and tight oils entities on our ASX as well as America’s S&P 500.

According to former economic adviser to president Ronald Regan, Harvard professor Martin Feldstein, this correlation exists because today’s oil price is also directly linked to the anticipation of future interest rates.

Professor Feldstein argues that this is because oil producers have an investment choice: they can increase production now, selling the additional oil at today’s price and investing the proceeds at the existing long-term interest rate or they can leave the oil in the ground as an investment.

A low rate of interest encourages producers to leave oil in the ground.

When the current abnormally low interest rates on long-term bonds rise over the next few years, it will become more attractive for producers to increase the supply of oil and invest the resulting income at the higher rate.

Unless expectations about the fundamentals of future supply and demand change, the rise in the interest rate will cause oil prices to fall further.

Accepting the political factors, Australian UHNW investors have also taken the time to understand the natural market forces at work, which still play out in the short-term. Current market conditions suggest that the supply situation for oil could remain at current levels for most of next year, dampening the risk of a quick recovery in oil prices.

After the recent correction, however, further downside risks are also somewhat limited.

This is because while prices between $US70 and $US80 seem acceptable for OPEC countries such as Saudi Arabia, Kuwait, the UAE and Qatar — at least for a certain period — a further drop to $US60 or even $US50 is probably unacceptable and below their break-even cost of production.

OPEC knows that Venezuela, Iran, Russia and the ISIS caliphate are heavily dependent on their oil revenue to support their governments’ spending — especially massive transfer programs in the case

of Venezuela, Iran and Russia and total war in the case of the ISIS caliphate.

Even at $US75 or $US80 a barrel, these governments will have a difficult time financing the populist programs that they need to maintain public support.

A further decline in the price of oil could have major geopolitical repercussions — a price of $US60 a barrel could hurt Russia in particular and events of the past fortnight saw the rouble face its largest fall since the Russian financial crisis of 1998.

Apparently, there has even been a dark joke circulating in Moscow this week which goes that the price of oil, the rouble's value against the dollar and Vladimir Putin himself will all hit "63" next year.

While OPEC continues to wage this war well into next year, sophisticated investors, many of whom vividly remember the 1973-74 OPEC crisis, are keeping an even closer eye on anticipated future interest rates, which we now know will affect global equity markets, bond and credit markets as well as energy sectors, such as crude oil.

Clausewitz also taught us that we must pursue one great decisive aim with force and determination: if our aim is to succeed as investors then we must accept that nothing is accomplished without daring.

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