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Oil certain to remain a vital signal for global investors

STIRLING LARKIN THE AUSTRALIAN DECEMBER 5, 2015 12:00AM

Last year's oil price shock continues have an affect across geographies and markets.

With global leaders convening in Paris to discuss the future of energy and climate, it should not come as a surprise to learn how integral oil and its related products remain to our global economy.

The impact of last year's oil price shock continues to be seen across geographies and markets, and contrary to most predictions, a return to balanced supply-and-demand dynamics does not appear to be anywhere in sight.

What separates ultra high net worth (UHNW) wealth advisory from other private client investment communities is a noticeably heightened emphasis on capital protection and awareness of exogenous factors — such as unforeseen oil shocks — solely and simply because UHNW investors are far more preoccupied with protection than growth of their accumulated wealth.

Also, too many of these investors remember the pervasive and eroding consequences of the 1973-74 OPEC crisis, which led to hyperinflation, first in the US and then later in Australia.

Because of this, energy, and specifically oil, remains a recurrent topic in almost every UHNW investment conversation heading into next year.

But before then, the influence of the cheaper oil must be well understood given its impact on US inflation metrics, which matter greatly for a "data dependant" US Federal Reserve, which is about to take its most significant decision since the global financial crisis.

As mentioned recently in this column, if we dismiss official US headline inflation numbers, which includes the effects of the oil shock and suggests a rate running near 0.2 per cent, but instead refer to what Federal Open Market Committee member James Bullard suggests — which is the Dallas Fed's trimmed mean inflation rate, measured year-over-year, and excludes the effects of the shock — we come to a far more realistic and representative 1.7 per cent current inflation reading for the US economy.

Given FOMC's declared inflation target is 2 per cent, Bullard argues this measure meets the committee's mandated goal and satisfies the requirements for a rate rise at their next meeting.

Looking deeper than this, the impact of cheaper oil, both for US industry and consumers, must also be properly understood given industrial and consumer prices have dropped dramatically and remained lower since the shock began just over a year ago this week.

On this, declines in consumer petrol prices alone have saved the average US household $US700 ($955) this year, according to US government assessments, as the price of a gallon (3.8 litres) of petrol has fallen by nearly $US1.50 from its peak of $US3.70 in April 2014.

It is important to note this number did not take into account secondary benefits, such as lower food prices, thanks to cheaper freight and other ancillary benefits to consumers.

At a time of slow US wage growth, this boost in discretionary income has been significant and matters to the global investor, who continues to look at the health of the underlying US real economy.

What comes next for the global investor is an assessment of the energy sector and an honest appraisal of the likely effects that higher real US interest rates will have on the already challenged US shale, LNG and thermal coal sectors.

There are many factors, but the graph sums it up best — there remains a global supply glut, and this is unlikely to change, despite the 2014 predictions to the contrary.

Assessing this as an equity, bond or credit market investor and not necessarily as an industry participant, what becomes important is to determine the future trend, as, after all, global investing is about positioning today for tomorrow's outcomes.

During a year when global oil "barrel count over limit" (meaning barrels produced exceeding storage capacity) has been the highest on record — which exceeds even the excessive oversupplied Rockefeller and "Standard Oil" era — data from Baker Hughes, a petroleum industry specialist since 1944, suggests that rig counts globally are at their lowest level since June 2010.

Even despite these contractionary signs, a global oil surplus is likely to persist next year on further OPEC production growth, resilient non-OPEC supply and slowing demand growth, with risks skewed to even weaker demand given China's slowdown and its negative emerging market feedback loop. The news this week that China's yuan met the standards of being "freely usable" and will join the US dollar, euro, pound and yen within the IMF's Special Drawing Rights basket, may also impact energy markets next year given China's rapidly rising role within this sector.

This is because international sovereign wealth funds — which will need to rebalance their currency reserve holdings to reflect the 10.92 per cent weighting in the basket the yuan will have when included on October 1, 2016 — need also to recalibrate their riskier allocations.

These include high-yield credit and debt investments, alongside direct private equity investments made within energy. It should not be forgotten that while the pace of Chinese economic growth may be slowing, it still continues to grow, and when it comes to Sinopec and the energy sector, the Chinese are ramping up rapidly.

Taking a step back and acknowledging that the drivers of this year's oversupply will persist through 2016, what becomes timely for UHNW investors and others to appraise is what are the operational stresses seen within this dynamic that could push oil to $US20 a barrel — its natural long-term average price.

Regardless of what is determined in Paris this week or New York on December 16, oil will remain one of the most influential forces affecting economies and markets.

Remaining attuned to how it continues to fuel the global economic engine, affords the global investor a rare level of clarity.

That is valuable during these particularly uncertain times.

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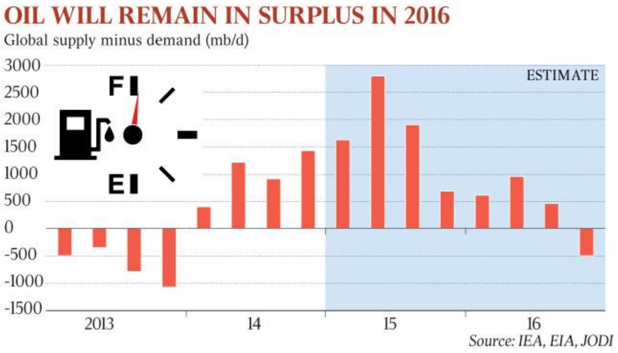

Oil surplus.