FLASH

Falling oil prices: more boon than curse

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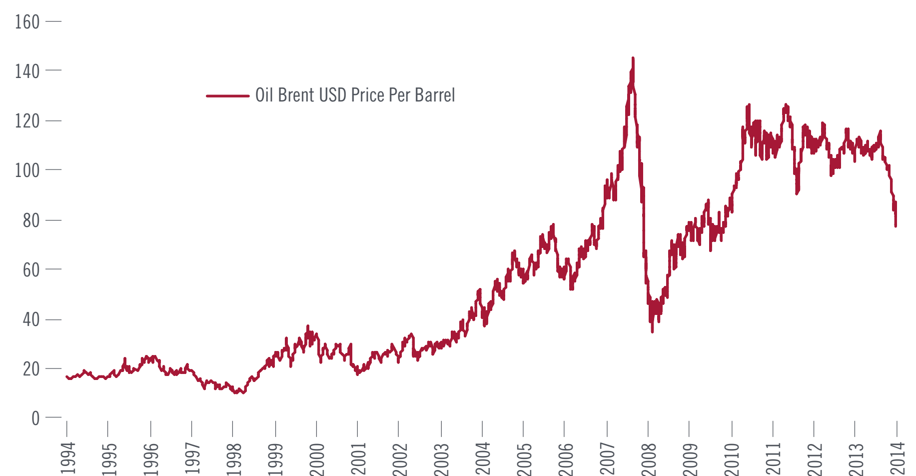
- Failling oil prices provide a lift for the global economy
- Consumer and transport stocks, emerging market oil importers to benefit
- Russia, Venezuela's economic woes are likely to deepen

Oil prices have fallen below USD80 a barrel, the lowest level since August 2005 on an inflation-adjusted basis. The steep decline since June is likely to provide a lift for the global economy by boosting consumer spending. Consumer and transport stocks should benefit, as will the economies of oil importers in the developing world, such as India and Turkey. But there will also be losers. The economic problems of Russia and Venezuela could deepen should oil prices fall further.

A decline in oil prices is a rare event during an expansionary phase in the global economy. The last time oil fell as much as it has done recently was in the aftermath of the Asian crisis in 1998 when global oil demand[1] fell at an annualised rate of around 5 per cent, which compares with a rise of 0.75 per cent currently. Indeed, excluding 1998, this is the largest fall in the oil price outside of a recession in the past 20 years (See Fig. 1).

FIGURE 1: BRENT OIL PRICE MOVES IN THE PAST 20 YEARS



Source: Thomson Reuters Datastream

Although sharp falls in the oil price are usually precipitated by a sharp fall in demand, the causes of this recent slide are more complex.

Falling demand is clearly a factor. The global economy is growing at a subdued pace, while China's shift from an export-based to a domestic demand-based economic model has also resulted in lower-than-expected demand for energy resources in Asia. Rapidly slowing imports from the US are also responsible – the country has imported 7 million barrels of oil per day on average this year, more than a third below its peak and down 17 per cent from 2012.[2]

However, we believe that supply factors have been more important than weakening demand. In the US, the Shale gas revolution has redrawn the energy landscape. Indeed, thanks to the Shale gas, the US is set to become the biggest oil producer in the world by 2019, having already increased its output by 70 per cent in the past seven years. Yet, in the face of rising supply elsewhere, OPEC countries have yet to take any action to cut their own production.

Some industry observers also suggested Saudi Arabia, currently the world's Number 1 oil producer, has allowed the oil price to fall to put pressure on its US shale rivals, who need higher prices to pay for the cost of development. Although the oil price is currently below Saudi Arabia's breakeven price, a level which pushes its budget into deficit, the

[1] Global net demand, International Energy Agency
[2] US Department of Energy
[3] Total foreign assets of Saudi Arabian Monetary Authority

country's foreign assets[3] of close to 100 per cent of GDP give it flexibility to withstand lower oil prices for a longer period of time. What is more, growing geopolitical tensions between the US and Russia and Saudi Arabia and Iran may also be adding to oil price volatility.

More rewards than punishment for global economy

We believe the economic impact of lower oil prices is positive. We estimate that the 30 per cent decline since June is likely to add around 0.5 percentage points to global economic growth. According to our calculations, this would take economic growth to 3.2 per cent next year from this year's expected 2.7 per cent.[4]

The main beneficiary would be consumers, especially in the US. Since as much as 9 per cent of their spending is related to energy goods (although these include a variety of energy products outside of oil), they have more disposable income to spend at stores especially as the holiday season begins. Consumer spending accounts for around 70 per cent of annual US GDP.

Europe and Japan -- also large net oil importers -- are expected to benefit substantially next year.

Globally, inflation is expected to fall by up to 0.2 percentage points, according to our calculations. However, in the euro zone, where inflation remains stubbornly low, falling oil prices may give more leeway for the European Central Bank to pursue aggressive stimulus measures to boost the economy and reduce deflationary risks. This is likely to benefit the broader global economy, in our view, especially as the US Federal Reserve is set to raise interest rates some time next year.

Boost for consumers

Consumer-related and transport sectors, should be already getting a boost even if the oil price stabilises in the near future. And if oil prices indeed bottom out, energy stocks may evolve into interesting opportunity, as they are oversold and under-owned, representing the cheapest sector in our composite valuation scorecard.

Emerging winners and losers

In the emerging markets, falling oil prices are likely to accelerate the growing divergence in the financial fortunes between manufacturers and energy producers. Our analysis suggests the Philippines, Malaysia and India stand to benefit the most from the fall in oil prices. Taiwan and Korea, which are also net importers of oil, should also feel positive economic effects.

Interestingly, many emerging markets such as Indonesia and India are using the opportunity provided by the move in oil to accelerate structural changes by phasing out energy subsidies.

According to our scorecard that ranks emerging markets based on measures such as valuation, growth and currencies, Colombia stands to benefit the most should oil prices bottom out.

The biggest loser is Russia, which is the world's second largest energy exporter with net oil exports contributing to 13 per cent to its GDP. The rouble, which has lost nearly a third of its value against the USD this year, could come under further pressure as a result.

Latin America's biggest exporter Venezuela, which receives 96 per cent of its foreign currency revenues from oil, is also vulnerable. The country is already wrestling with annual inflation of over 60 per cent and a chronic shortage of basic goods.

The oil price is likely to remain volatile, but we expect it should bottom out in the near future before gradually rising in line with a recovering global economy next year. Indeed, prices further along the futures curve have held steady relative to near-term prices[5], indicating that the sharp decline may prove to be a short-term phenomenon.

Another potential trigger for an oil price recovery is OPEC, OPEC countries could cut production, but we do not believe the group would agree to a reduction large enough to tip the supply and demand balance in a meaningful way.

Additional analysis by Supriya Menon and Philippe Pol.

[4] Pictet Asset Management
[5] Long-term forward prices of oil, a proxy for marginal cost of production, Thomson Reuters Datastream

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